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THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

SELECTED ISSUES

July 2025

This paper on The Federal Democratic Republic of Ethiopia was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on June 16, 2025.

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THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

SELECTED ISSUES

June 16, 2025

Approved By
African Department

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POTENTIAL DRIVERS OF POST-REFORM PARALLEL MARKET PREMIUM

A comparative analysis of Ethiopia with Angola, Egypt, and Nigeria highlights three structural factors that may be sustaining the parallel market premium despite exchange rate unification: (i) some remaining current account restrictions, including a 2.5 percent commission payable to National Bank of Ethiopia (NBE) on foreign exchange (FX) sales; (ii) a tightly closed capital and financial account coupled with low returns on Birr denominated assets; and (iii) an underdeveloped financial market, lacking hedging instruments and dominated by a single bank, which weakens competition and reduces market efficiency. While each case has its own distinctive features, Ethiopia's conditions most closely resemble those of Angola during its transition to a more flexible exchange rate regime, where a significant parallel market premium persisted.

A. Background

1. Before the FX reform, the parallel market premium increased steadily from early 2013 to mid-2022, rising sharply from late 2022. By November 2023, it had surpassed 100 percent and remained elevated through the end of June 2024 (Figure 1). This widening coincided with acute FX shortages and FX controls. Efforts to curb FX demand are reflected in the contraction of imports of durable consumer goods (Figure 2). At the same time, NBE's FX reserves declined steadily as NBE allocated FX for essential imports (fuel). Eventually only fuel, fertilizer and medicine were receiving FX at official rates from NBE and the banking system. FX reserves remained below one month of import coverage from November 2021 to June 2024, except for a brief recovery in October 2023.

2. Adoption of a market-determined exchange rate in July 2024 and the removal of most distortive exchange restrictions led to a rapid convergence between official and parallel market rates. The parallel market premium collapsed, reaching near-zero by early September 2024, as the official rate aligned with market conditions. Since then, the premium has increased to approximately 16 percent by late October 2024, then narrowed and stabilized in the single digits until the end of December. By early May, it gradually widened again to around 17 percent. FX reserves increased to approximately US$4 billion in April 2025, covering nearly two months of prospective imports.

3. Several structural factors may help explain the persistence of the parallel market premium following the exchange rate unification. Since the parallel market serves as a clearing mechanism for unmet demand or supply in the official market, several factors can sustain residual pressures:

- Remaining current account restrictions such as limits on the amount of FX that can be bought for particular transactions or high costs associated with accessing official FX channels.
- Capital account controls, particularly on outflows, whose demand is also affected by the financial returns on local currency denominated assets relative to foreign assets.

- An underdeveloped financial market, lacking the depth and instruments (e.g. hedging products) needed to meet diverse investor needs and enable effective competition.
- The following section examines how parallel market premiums behaved during the post-FX reforms period in Angola, Egypt, Ethiopia, and Nigeria—countries that undertook major FX liberalization efforts.

Figure 1. Ethiopia: Reserve Adequacy and Parallel Market Premium

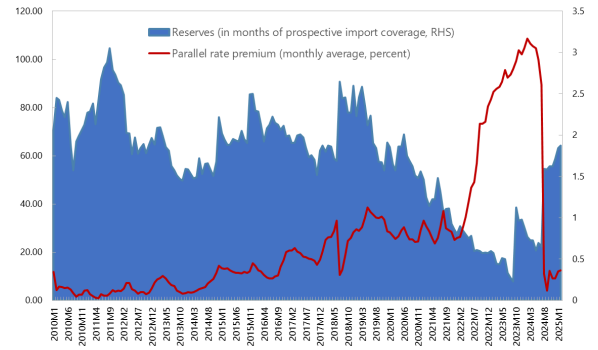
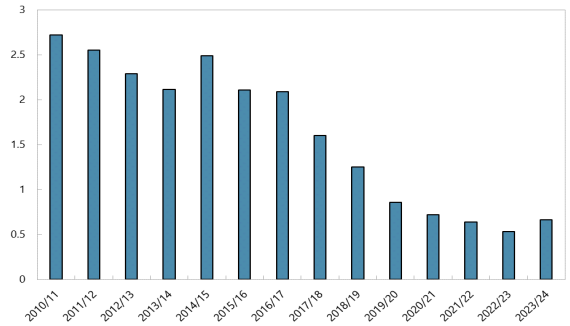


Figure 2. Ethiopia: Durable Consumer Goods Imports
(In percent of GDP)

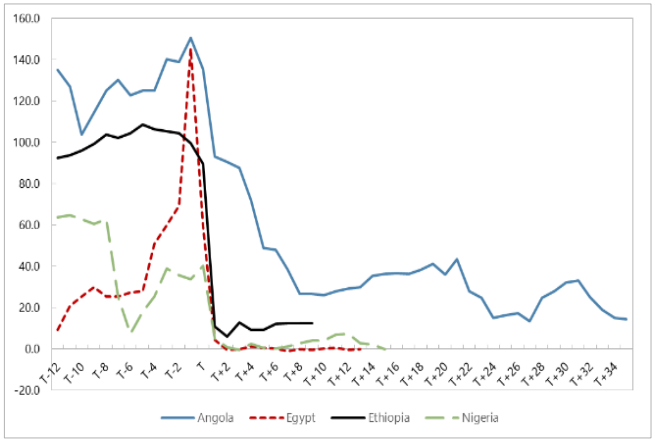


Sources: Ethiopian authorities and IMF staff estimates.

B. Comparative Analysis of Structural Features: Angola, Egypt, Ethiopia, and Nigeria

4. Parallel market premia typically decline following major exchange rate adjustments. Figure 3 shows that six months after the major exchange rate adjustment, the parallel market premium was 48 percent in Angola, 0.2 percent in Egypt, 12.4 percent in Ethiopia, and 0.3 percent in Nigeria. Angola's premium gradually declined to 15 percent by 34 months after the reform, though it rose during two separate episodes (to a post reform high of 44 percent 21 months after the exchange rate adjustment), indicating a more protracted adjustment process. In contrast, for Egypt, the parallel market premium has remained below 1 percent for the 11 months following the exchange rate adjustment, suggesting a smoother and more sustained post-reform stabilization.

Figure 3. Selected African Countries: Parallel Market Premium
(in percent of official rate)



Note: 'T' is month of major exchange rate adjustment.
Sources: Haver and IMF staff estimates

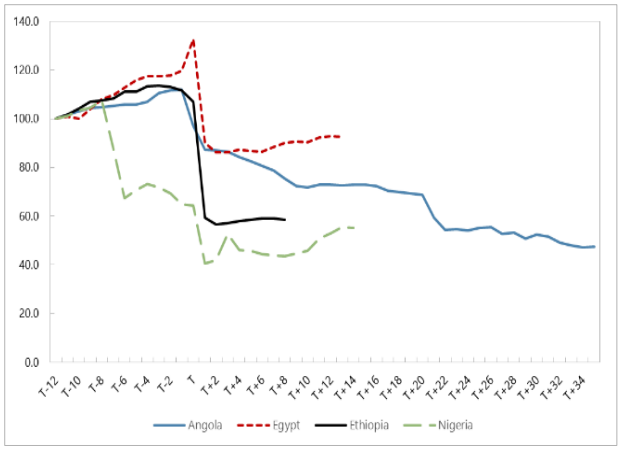
Remaining Exchange Restrictions for Current Account Transactions

5. Even after major FX reforms that eliminate broad-based FX rationing, some exchange rate restrictions on current account transactions are often retained. Angola, Ethiopia, and Nigeria maintained some exchange rate restrictions on current account transactions while Egypt retained one such restriction (Figure 4). These remaining restrictions typically limit access to FX for specific current account transactions or increase the cost of securing FX, but they differ from earlier, broad-based FX rationing. While they may contribute to some residual demand in the parallel market, their macroeconomic impact appears modest. This is supported by the observation that the REER has remained stable for Egypt, Ethiopia and Nigeria while, given less initial adjustment, it continued to depreciate slowly in Angola during the post-unification period, suggesting that the official rate broadly reflects changes in international prices (Figure 5). Additionally, the types of current account transactions affected represent only a small proportion of consumer spending, carrying low weights in CPI baskets, further moderating their potential impact on price distortions and FX pressures.

Figure 4. Selected African Countries: Remaining Exchange Restrictions Post-Exchange Rate Unification

Angola (2018 AIV consultations SR, 2019 First Review under the EFF SR)	i. Limits on the availability of foreign exchange for certain invisible transactions i.e. travel expenses ii. Limits on unrequited transfers to foreign□based individuals and institutions iii. Discriminatory application of the 0.1 percent stamp tax on foreign exchange operations iv. Special tax of 10 percent on transfers to non-residents under contracts for foreign technical assistance or management services.
Egypt (2023 EFF program approval SR)	100 percent cash margin requirement on import payments, since the payor is required to block resources for a period of time as a condition for making a payment for current international transactions, with no alternative ways to pay for such imports.
Ethiopia (2025 Second review under the ECF SR)	i. Hard ceilings on access to and use of FX for travel purposes ii. Prohibition of access to and use of FX for the purposes of cross-border payment of moderate family remittances iii. 2.5% NBE exchange commission iv. Tax clearance certificate requirement for repatriation of dividend and other investment income v. Requirement to provide a clearance certificate from the NBE to obtain import permit vi. Restriction imposed on the access and use of FX for the repatriation of backlog dividends.
Nigeria (2024 AIV consultations SR)	i. Absolute limits on the amounts of foreign exchange available when traveling abroad (BTA)/PTA), and the monthly absolute limit on the availability of FX for the making of payments in respect of foreign mortgages; all such limits cannot be exceeded even upon verification of the bona fide nature of the transaction; ii. Unavailability of FX as a PTA for persons aged under 18 years when travelling abroad iii. Requirement to use only own funds to pay for certain current international transactions; iv. Unavailability of FX for resident Nigerian nationals to purchase and transfer abroad moderate amounts for family living expenses v. CBN discretionary approval to access FX to make payments for certain current international transactions.

Figure 5. Selected African Countries: REER Index
(T-12=100)



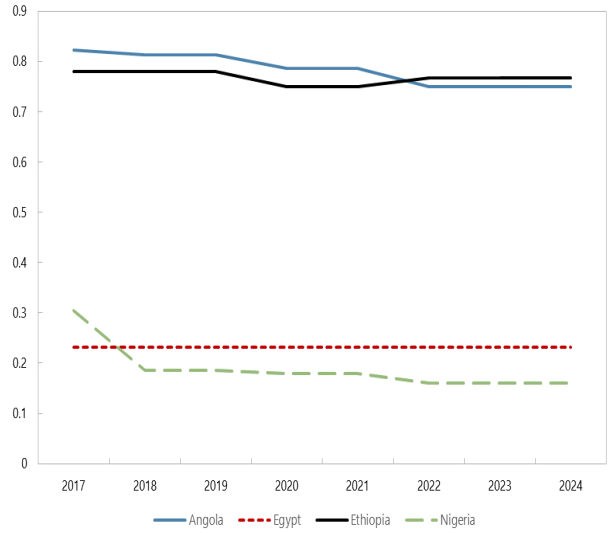
Note: 'T' is month of major exchange rate adjustment.
Sources: IMF AREAER and IMF staff estimates

Tightly Closed Financial Account and Relative Attractiveness of Local Currency Asset

6. The extent of capital and financial account restrictions varies significantly across countries following ER reforms. Angola and Ethiopia have imposed stricter controls on the capital and financial accounts of the BOP than Egypt and Nigeria. The Financial Account Restriction Index (FARI), based on information in the IMF Annual Report on Exchange Arrangements and Exchange Restrictions, indicates that Angola and Ethiopia have regulations on approximately 70 to 80 percent

of total capital account transactions, whereas Egypt and Nigeria have regulations on only 10–20 percent of total capital account transactions (Figure 6).

Figure 6. Selected African Countries: Financial Account Restriction Index



Sources: IMF staff estimates.

7. Demand for FX in the parallel market, intended to bypass capital controls, is also influenced by the relative attractiveness of foreign currency-denominated assets compared to local currency-denominated assets. One way to evaluate this is by comparing the expected yield of overseas investments, adjusted for anticipated inflation and exchange rate changes, with the expected real yield of local currency-denominated assets. This analysis resembles an assessment of the degree of deviation from uncovered interest rate parity, which posits that the expected rates of return on identical assets in two different countries, adjusted for exchange rate changes, should be equal. The difference in expected real yield between the two assets can be calculated as follows, using realized values to approximate expected inflation and exchange rate changes:

$$\Delta = \left\{\left(R_{T-bill} - R_{inflation\ in\ US}\right) + \left(\frac{R_{forward}}{R_{spot}} - 1\right)\right\} - \left(R_{local\ yield} - R_{inflation\ in\ local\ economy}\right)$$

Where:

R_{T-bill} = *US 3-month T- Bill rate*

$R_{inflation\ in\ US}$ = *Realized 3-month forward inflation rate in US*

R_{spot} = *Spot parallel market rate*

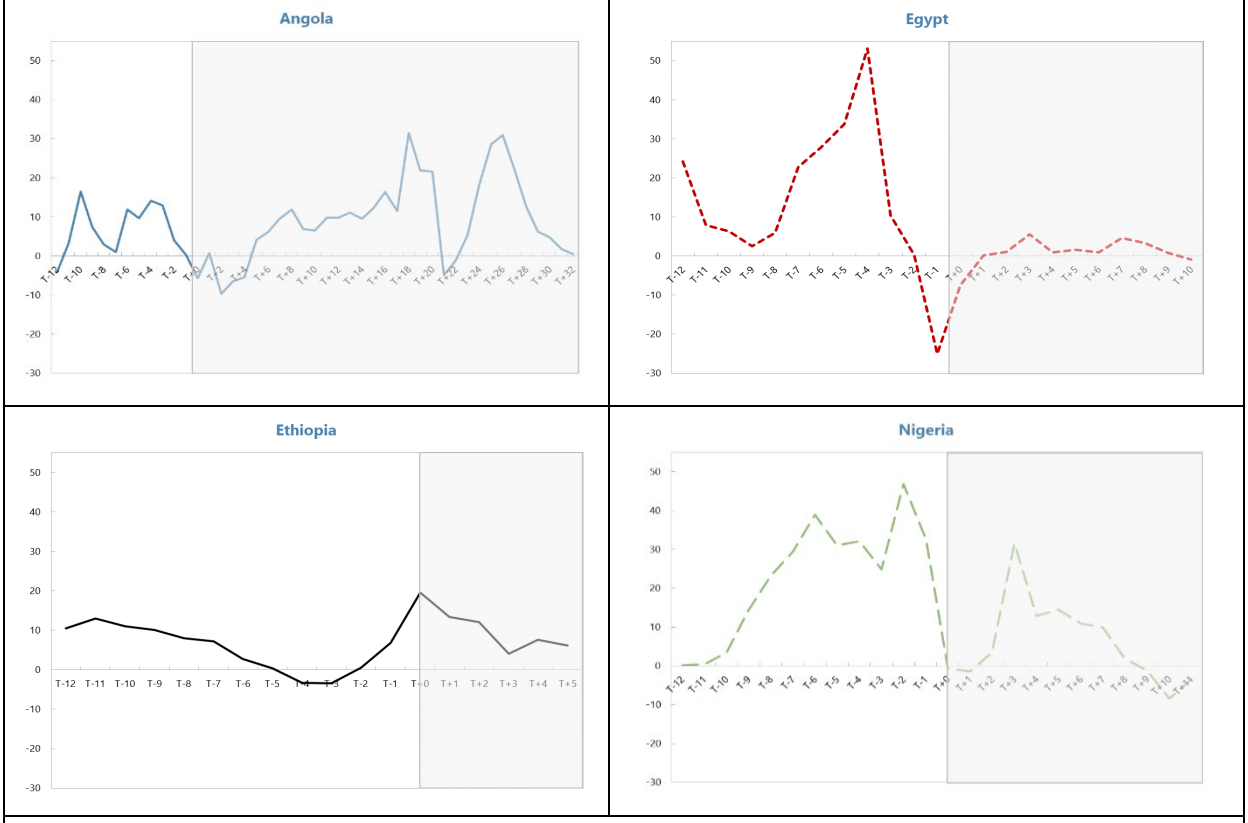
$R_{forward}$ = *Realized 3-month forward parallel rate*

$R_{local\ yield}$ = *Interest rate on saving deposits in local currency*

$R_{inflation\ in\ local\ economy}$ = *Realized 3-month forward inflation rate in the four countries*

A positive delta (*Δ)* suggests higher expected returns from overseas investments than those from domestic investments, increasing incentives for capital outflows via the parallel market. This dynamic can place additional pressure on the premium, even after current account liberalization. A positive delta continued in Ethiopia for five months for which data are available following the FX reforms (Figure 7). This primarily reflected low nominal yields, as some financially repressive measures remained in place even as inflation was higher, in the mid-to-high teens. To eliminate an expectation of depreciation, domestic interest rates need to compensate for the inflation differential plus some risk premium as well as nominal yield from foreign investment.

Figure 7. Selected African Countries: Difference in Expected Real Yield between Overseas Investment and Domestic Investment
(In percent)

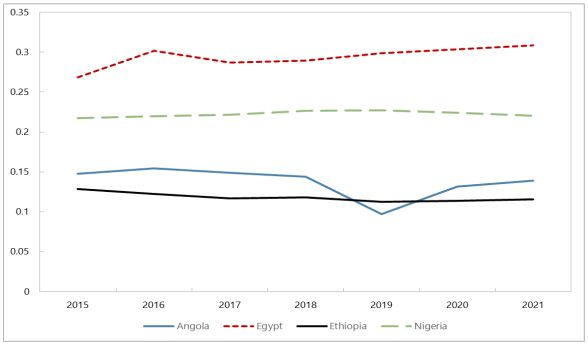


Note: 'T' is month of major exchange rate adjustment; Shaded area refers to post-reform period.
Sources: Haver and IMF staff estimates

Financial Market Underdevelopment

8. Ethiopia ranks lowest on the financial development index among the four countries, slightly below Angola. The index provides a relative ranking of countries based on the depth, access, and efficiency of their financial institutions and markets. In Ethiopia, the lack of hedging instruments against exchange rate risk is cited by importers as one of reasons why they resort to the parallel market. Importers fear sharp depreciation between the time letters of credit (LCs) are opened and when payments are settled, particularly since deferred LCs are commonly used instead of sight LCs or advance payments (Figure 8). This is further amplified by a lack of natural counterparties. Importers may wish to hedge their FX exposures, but exporters

Figure 8. Selected African Countries: Financial Development Index



Sources: IMF staff estimates.

expecting depreciation have little incentive to do so. Meanwhile, foreign investors, who could act as structural counterparties, are absent due to capital account restrictions that limit access to Birr-denominated assets.

9. A lack of competition among banks can result in insufficient FX mobilization from FX earners, such as exporters and recipients of inward remittances. This creates unmet FX demand, which could drive demand for FX in the parallel market. Ethiopia has the highest one bank concentration ratio among the sample, with the state-owned Commercial Bank of Ethiopia (CBE) accounting for approximately half of the total bank assets in the sector (Figure 9). While CBE's financial position has been strengthened and its mandate is being reformed to give a clearer commercial focus, it has a net short FX position as a result of its legacy as a policy bank, potentially reducing incentives to mobilize FX given the depreciation risks and the bank's dominant position. While direct evidence on banks' competitive strategies is not available, other banks may prefer not to diverge from the market leader, opting to maintain a business model that yields high fees on low volumes, rather than a more competitive model with lower fees and profitability deriving from a higher volume of transactions (Figure 10).

Figure 9. Selected African Countries: One Bank Concentration Ratio

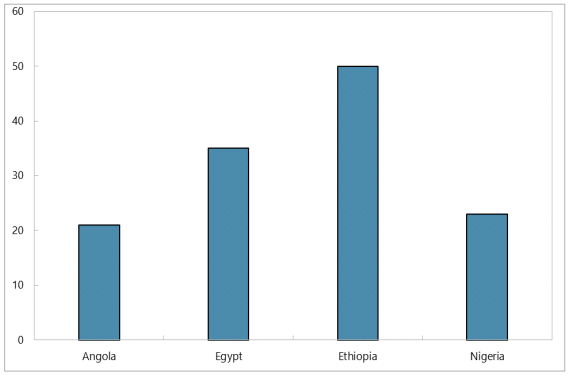
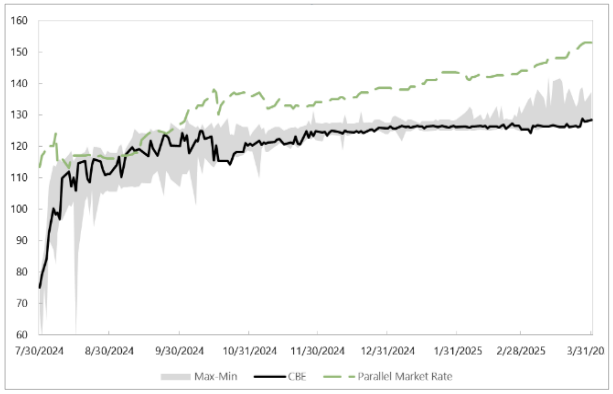


Figure 10. Ethiopia: Range of Bank's Daily Weighted Average Rate
(Birr per US$)



Sources: IMF staff estimates.

C. Conclusions

10. Comparative analysis of structural features suggests that a moderate parallel market spread is likely to persist in Ethiopia. Structural features such as exchange rate restrictions, tightly closed financial account, limited financial instruments, and high bank concentration continue to drive unmet FX demand into the parallel market. Ethiopia shares several characteristics with Angola during its transition to a floating exchange rate regime—a period when Angola's parallel market premium was higher than in Egypt and Nigeria. Other deeper structural factors in Ethiopia—notably concerns about property rights, security, and conflict also play a role is encouraging outflows of wealth through the parallel market.

11. Policy efforts should continue to focus on developing a well-functioning and unified FX market to enable efficient and transparent FX allocation. A key priority is the phased removal of remaining exchange rate restrictions on current account transactions which increase the costs of using the formal market, or leave some demand for FX unsatisfied, driving parallel market demand. Positive real interest rates that make holding Birr-denominated assets more attractive will reduce incentives to use the parallel market to hold wealth in FX. In the longer term, a well-sequenced opening of the financial account can be considered, focusing first on strong regulatory and supervisory capacity and ensuring the financial sector can manage cross-border flows soundly, and attracting long-term capital flows before considering facilitating shorter-term investors. Effective enforcement of net open position (NOP) limits and robust FX exposure monitoring are critical regulatory prerequisites for safely managing cross-border flows during financial account liberalization. Deepening the financial market, e.g., growing liquidity in interbank money and FX markets, and creating the necessary pre-conditions to develop hedging instruments would help reduce the demand for FX in the parallel market. Finally, enhancing competition in the banking sector, notably through more transparency on fees, commissions, and pricing, and including through possible participation by foreign banks, would allow customers to choose the most competitive bank, improving price discovery and the efficiency of FX intermediation.

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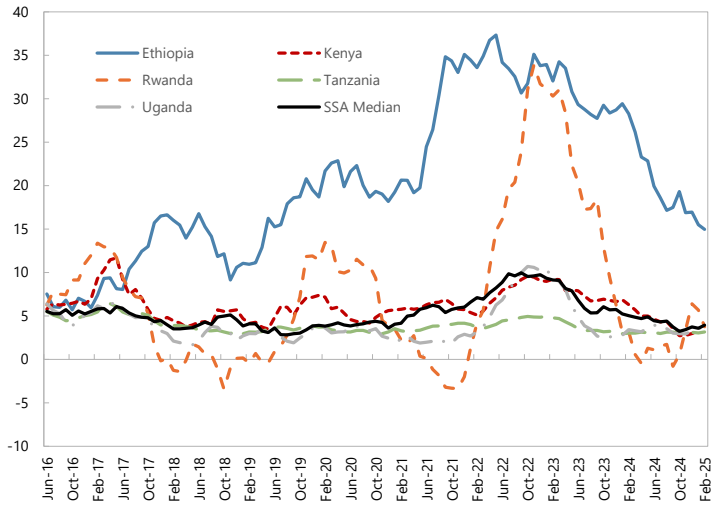
BUILDING MONETARY POLICY TRANSMISSION IN ETHIOPIA

This Selected Issues Paper reviews Ethiopia's transition to an interest-rate based monetary framework. For this framework to be effective, monetary transmission—the process through which policy rate changes affect inflation and economic activity—must function reliably. Achieving this, requires a clear, well-communicated policy framework, strong analytical capacity, and continued efforts to address structural features that may hamper transmission.

1. Although price stability has been an important NBE objective, Ethiopia has struggled to achieve it over the past decade. The NBE has had a legal mandate to deliver stable prices (among other objectives historically including financial sector and exchange rate stability and promoting economic growth). However, inflation has been persistently high, compared with other regional economies, and exceeded double digits since 2018 (Figure 1).

Figure 1. Ethiopia: Inflation versus Sub-Saharan Africa Peers, June 2016–February 2025

(Percent change, y/y)



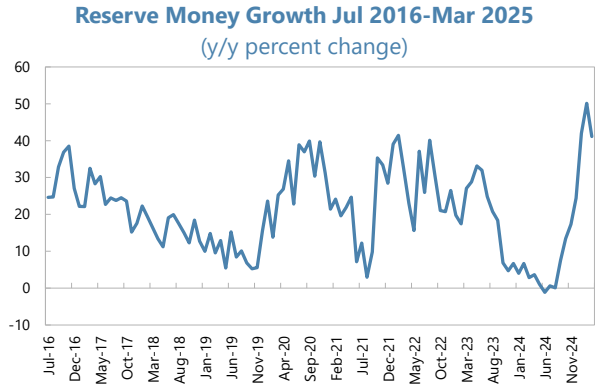
Source: IMF WEO; Haver.

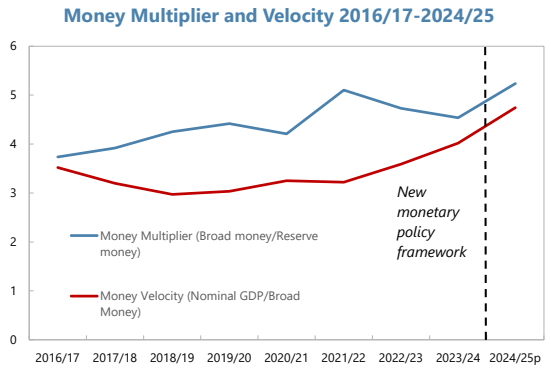
2. Modernizing the monetary policy framework is a key part of the Homegrown Economic Reform Agenda (HGER), launched in 2020, with the objective of correcting macroeconomic imbalances and supporting private sector led growth. Efforts to strengthen monetary policy aim to reduce inflation, including managing potential inflationary impacts from the transition to a flexible exchange rate (another key element of the HGER). In this connection, both monetary and fiscal policy have been tightened to gradually reduce, and in FY2024/25 eliminate, the use of direct NBE advances to finance the budget.

3. Prior to July 2024, the NBE operated under a monetary targeting (MT) policy framework. MT frameworks are grounded in the quantity theory of money, which holds that inflation can be controlled by managing the growth of the money supply, assuming that demand for money has a stable relationship with aggregate output and prices (i.e. a stable velocity of money). Under this framework, the NBE used reserve money as an operational target. While monetary targeting frameworks may be appropriate in some circumstances, stable money demand relationships are rarely observed in practice, making MT frameworks less effective and with often

unpredictable results. In Ethiopia, money demand has shifted over time, reflected in changes in both the money multiplier and velocity of money, which may be due to behavioral changes induced by the long period of high inflation (Figure 2).

Figure 2. Ethiopia: Monetary Aggregates





Source: Ethiopian authorities; IMF Staff Calculations.

4. To support Ethiopia's transition to a modern monetary policy framework, the NBE began using market-based interest rates to guide monetary conditions in July 2024. This marks a shift away from administrative and quantity-based controls toward an interest rate-based framework where the policy rate is used to influence short-term market rates. Broader policy reforms to lay the foundations for this shift are ongoing, including enhancing central bank independence, strengthening the commitment to price stability, deepening financial sector and building technical capacity (Table 1). The framework is supported by open market operations (OMOs), a policy rate corridor, and improvements in liquidity forecasting.

5. To operationalize this new approach, the central bank sets a reference price for money, allowing market forces to determine the quantity of liquidity. This supports more efficient credit allocation by reducing distortions caused by quantity-based controls. To operationalize the new framework, the NBE introduced full allotment liquidity absorbing OMOs, established standing lending and deposit facilities to form a policy corridor at ±300 basis points, and set the overnight interbank lending rate as the operational target. These choices are appropriate for Ethiopia, where financial markets and institutional capacity are still developing. A fixed-rate full-allotment operational framework does not require short-term forecasts of changes in autonomous factors and is robust to changes in banks' demands for excess reserves (IMF, 2022). It was also important that the initial OMO was liquidity absorbing given the structural liquidity surplus and absence of widely available collateral. While a narrower policy corridor can help anchor short term rates, the decision to begin with a wide policy corridor, gradually narrowing over time as operational experience builds, provides flexibility and avoids frequent rate adjustments (which could complicate communication of the policy stance). In October, a new interbank market was launched to support banks' liquidity management. Complementary reforms include improvements to the T-bill market and the introduction of an Emergency Liquidity Assistance framework.

6. While the foundations of the new framework have been established, further reforms are needed to ensure it operates effectively. In the transitional phase, NBE still maintains some quantitative restrictions on lending, including a cap of private credit growth, which it has committed to phase out. The NBE is also taking several measures to further market development and improve liquidity management, including launching a Central Securities Depository (CSD) and fully dematerializing government securities. Given current market structure and the early stage of interbank market development, transitioning to a secured money market provides a practical foundation for a reliable short-term rate. Collateralized transactions can encourage broader participation, enhance confidence among market participants, and support the growth of the government securities market. Ongoing efforts to strengthen inflation forecasting and analytical tools, supported by IMF technical assistance are also critical to help enhance the framework's credibility and effectiveness.

Table 1. Ethiopia: Foundations for Interest-Rate Based Monetary Policy Framework[1]

Component	Policies in Ethiopia
Central bank independence: Need to ensure that central bank policy decisions do not succumb to government's fiscal demands. Requires both strong institutions and fiscal discipline	End to NBE direct advances NBE Proclamation NBE internal organization changes Establishment of the Monetary Policy Committee (MPC)
Clear commitment to price stability: Central bank should avoid targeting other objectives (e.g. exchange rate stability).	NBE mandate enhanced to prioritize price stability over other goals Exchange rate reform Strengthened communication policy
Strong financial sector: Effective and competitive financial sector will help ensure effective monetary transmission.	Gradual reduction in financial repression (phasing out mandatory purchases of T-bonds, ensuring better functioning Treasury bill markets)
Technical capacity: Need to develop capacity to forecast inflation and liquidity developments and the policy response.	Ongoing technical assistance (e.g. FPAS, liquidity forecasting).

[1/] Components adapted from lessons outlined in IMF (2015).

Transmission Channels

7. An effective monetary transmission mechanism will be a key factor in the success of the new monetary policy framework. The transmission mechanism refers to how the instruments used by NBE to implement monetary policy influence financial and economic conditions, and ultimately policy objectives, notably controlling inflation. Transmission typically occurs through the following key channels:

- *Interest rate channel.* Monetary policy rate changes transmit to market interest rates (i.e. interbank rates, Treasury bill rates, deposit and lending rates), influencing the opportunity costs

of lending and saving, and private sector investment decisions. These decisions in turn affect aggregate demand and prices. This is generally considered the strongest and most effective channel of monetary policy transmission in mature interest rate-based regimes. For Ethiopia, however, the low private credit base and the history of financial repression suggests this channel is likely weak and strengthening it will be critical to enhancing the effectiveness of monetary policy.

- *Expectations*. Changes in monetary stance can influence expectations about the economy and inflation dynamics, which in turn may change economic agents' price setting behavior. In Ethiopia, while this channel is still developing, anchoring expectations will become increasingly important as the central bank builds credibility under the new interest rate–based framework.
- *Credit channel*. Monetary policy can transmit into changes in aggregate credit in the economy, influencing aggregate demand and inflation either through bank lending (changes in the policy rate can impact banks' cost of funding and hence their willingness to lend) or firms' capacity to borrow (the balance sheet impact of a policy rate change can affect the value of the collateral they can post to obtain loans). This channel may be less relevant in the context of Ethiopia; the impact on banks' cost of funding is limited given that they do not borrow from capital markets. Firms may also have limited borrowing options, and bank credit has historically been rationed at low interest rates.
- *Exchange rate*. In open economies, an increase in the domestic interest rate relative to the foreign interest rate typically leads to currency appreciation, which can influence inflation directly (by lowering the cost of imported goods) and indirectly (though reduced net exports and aggregate demand). Although Ethiopia currently maintains a closed capital account, the exchange rate channel remains relevant. Transmission may occur through exchange rate expectations and price-setting, with agents using exchange rate changes as "shorthand" for future inflation and the costs of imports, or the parallel market, where interest rate differentials can affect unofficial capital flows and movements in the parallel market exchange rate (IMF, 2020).

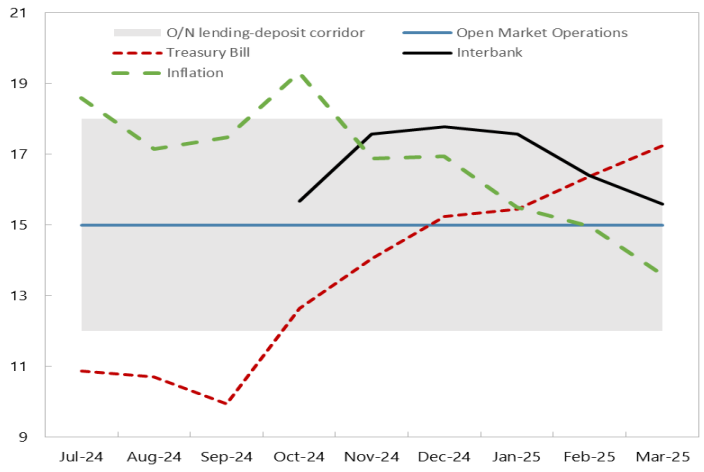
8. Transmission channels tend to be weaker, more volatile, and less predictable in low-income countries (LICs) where financial markets are shallow and monetary frameworks are still evolving. Effective transmission in developing countries is often hampered by the absence of market-based debt issuance, overreliance on central bank financing, and weak institutional capacity to forecast and manage inflation (Debelle et al.,1998). Addressing these constraints is essential for interest rate changes to influence credit conditions, inflation expectations, and ultimately, price stability. Empirical findings are mixed: standard empirical methods often find limited evidence of transmission (Mishra and Montiel, 2013) while more granular analyses show clearer effects (e.g. Berg et al., 2013).

8. In Ethiopia, the first links in the transmission chain are developing. Since the new framework was put in place, both interbank and Treasury bill rates have risen above inflation (Figure 3), while Treasury bill yields also exceeded the policy rate and inflation. While slower to respond, some, some banks increased lending rates in March 2025, the first sign of transmission

through the bank lending channel. With inflation declining quickly and still considerable uncertainty following the exchange rate reform, the strength of the exchange rate channel remains uncertain.

Figure 3. Ethiopia: Interest Rates

(Monthly average percent)



Source: Ethiopian authorities; IMF Staff Calculations.

1/ Treasury bill and interbank rate weighted average across maturities.

Peer Country Experience

10. The experience of other countries that have recently undergone transitions to interest-rate based monetary frameworks may be instructive for Ethiopia as it builds monetary transmission (Table 2). This includes examples from regional peers (Kenya, Tanzania, Rwanda, Uganda) as well as an economy in transition to a more private sector led development model (Uzbekistan). In all cases, building monetary transmission is a process that takes time (Table 3). Many of these peer countries also started their transitions to interest-rate based frameworks at relatively more advanced stages (e.g. with further experience with market determined interest rates).

11. Clarity, consistency, and predictability in the monetary policy framework are essential for strengthening transmission, and the NBE has already taken steps in this direction.

- *Communication.* To influence expectations and behavior, NBEs' policy signal and operating target needs to be clearly communicated. Drawing on experience of cases like Tanzania, Rwanda, and Uganda, which have emphasized communication in their policy frameworks, the NBE has begun publishing Monetary Policy Committee (MPC) statements after meetings to improve transparency and clarity.
- *Consistency and predictability:* Effective transmission relies on consistency between the policy signal (policy rate) and policy actions (OMOs) and predictability in how policy rate changes influence short-term rates. Banks are more likely to adjust lending rates that guide real sector investment and spending decisions when they trust the interest rate structure will be sustained (IMF, 2015). Given the relative importance of the interest rate channel, the central banks' ability to guide economic activity often depends on its control over short-term inter-bank interest rates and how these affects lending rates (Maehle, 2020). This control is strengthened when there is a clearly defined operating target, as (e.g. as in Uganda). In Ethiopia, the NBE has set the operating target as the interbank rate and will phase out the use of quantitative restrictions on bank lending.

12. Credible and consistent implementation is essential for effective monetary policy transmission. To achieve this, central banks must have the capacity to influence short-term interest rates and keep them aligned to the policy rate. This requires progress in three core areas:

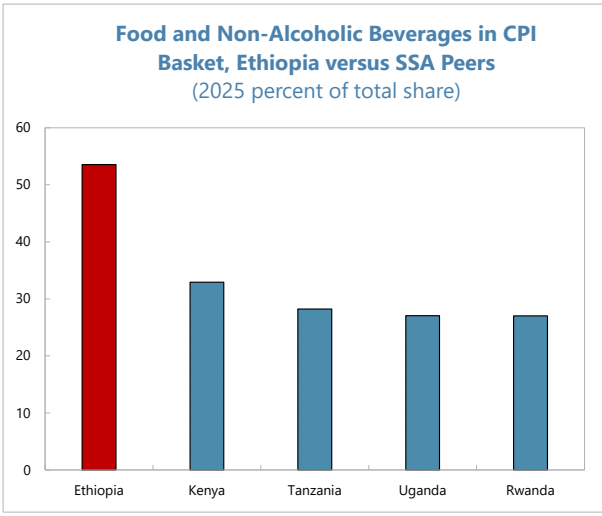
- *Effective monetary policy instruments:* The NBE is making progress in building operational tools (OMOs), standing facilities, and liquidity forecasting. For the policy rate to guide market behavior, it must be complemented by a transparent, market-based reference rate that reflects actual interbank activity such that it serves as a benchmark (as have been implemented in Kenya, Rwanda, and Uganda, for example).
- *Operational autonomy and a sound financial position:* A central bank's ability to guide market rates also depends on its institutional and financial autonomy. Without enough capital, the central bank may need government support to cover losses, such as those from sterilization or exchange rate changes, which can weaken its credibility and expose monetary policy to fiscal and political influence. (IMF, 2015). Some peer countries have taken steps to improve their central bank capital (Uzbekistan, Rwanda), as has Ethiopia under the revised NBE Proclamation to strengthen governance, limit fiscal dominance, and enhance financial resilience.
- *Analytical capacity for forward-looking policy:* monitoring and analyzing the links between the policy rate and inflation outcomes requires technical capacity, tools, and data This may be especially important in Ethiopia, where inflation is often driven by supply side shocks (e.g. drought and floods) and food prices which make up a large share of the CPI index (IMF, 2015) (Figure 4). Responding to negative supply shocks can be complicated since the policy response must balance the inflation shock that challenges the price stability objective with the negative impact on output. Sufficient data and analytical capacity are needed to distinguish between temporary shocks and more persistent inflationary pressures. NBE is updating their quantitative framework for monetary policy analysis through the Forecasting and Policy Analysis System (FPAS). This should be complemented by investment in data compilation and quality, especially to better capture high-frequency and disaggregated inflation drivers. Kenya provides a useful peer example of institutionalizing FPAS to support policy formulation and communication.

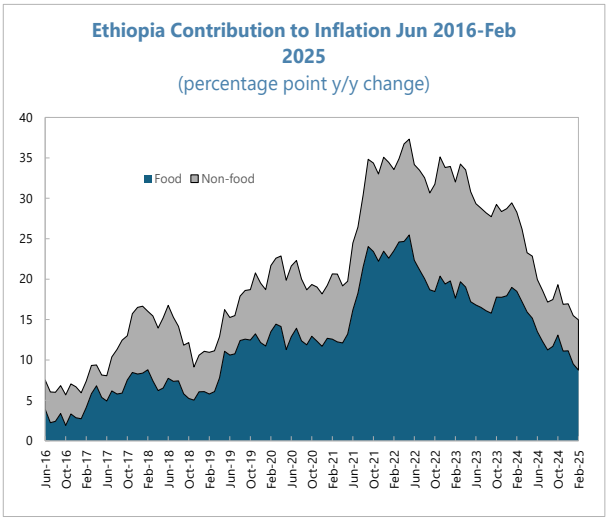
13. Addressing structural features that may weaken monetary policy transmission will also be important.

Structural features include:

- *Shallow money and bond markets.* Deepening of debt and money markets can help develop transmission and is in turn affected by the effectiveness of the monetary policy framework in controlling inflation. A more liquid market enhances NBE's ability to manage liquidity through OMOs and helps to transmit monetary policy rates to broader market interest rates and create trade-offs for banks and investors more quickly and efficiently. Ethiopia should seek to develop a collateralized repo market and encourage interbank trading beyond overnight and 1-week maturities. This will support the development of demand for longer maturities and help the formation of a yield curve from which longer-term private sector lending can be priced. Kenya, Uganda, and Rwanda have stepped up efforts in recent years to develop their local currency bond markets.

Figure 4. Ethiopia: Supply Shocks





Source: Haver; Ethiopian authorities; IMF Staff calculations.

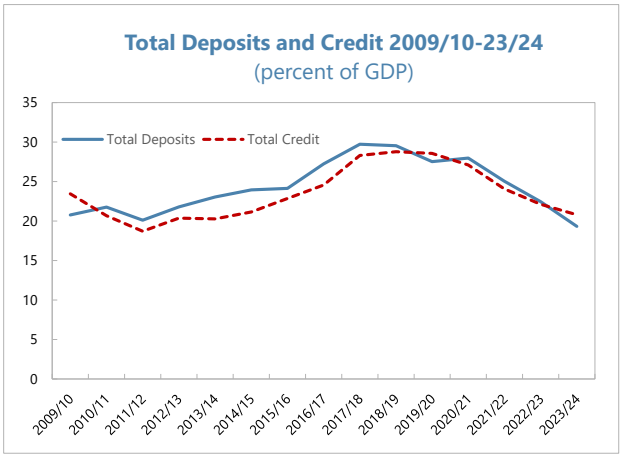
- *Limited financial sector development.* Financial sector development is important for effective monetary policy transmission, as it increases the share of households and firms whose investment and consumption decisions are influenced by interest rates. The Ethiopian financial sector is small with relatively low (and declining in recent years) levels of private sector lending compared with peers (Figure 5). Studies suggest that the interest elasticity of private consumption and investment increases with financial development, indicating that the transmission mechanism strengthens as countries' financial systems develop (IMF, 2015) To support financial sector development, the central bank can play an active role in developing market infrastructure, policy instruments, financial literacy, and access to formal financial services (e.g. as in Rwanda).
- *Risk management and loan pricing.* Transmission requires that banks make risk-based lending decisions that respond to changes in interest rates. However, poor loan quality (e.g. through practices like evergreening) can weaken this link by distorting lending decisions and creating capital constraints that limit banks' ability to lend. To address this, NBE is implementing reforms to strengthen credit discipline, including updated rules on asset classification and provisioning practices, closer monitoring of loan pricing practices, and alignment of capital and regulatory standards with international best practices (e.g. Basel II/III and IFRS).
- *Banking sector competition*. Limited competition can weaken transmission if dominant banks are less responsive to policy rate changes, with profitability not strongly linked to nimble and competitive changes in deposit and lending rates, or lending practices. Lending decisions may be influenced by non-price factors (customer relationships, other business lines, non-economic factors) rather than interest rates. Strengthening competition and ensuring state-owned banks operate on a commercial basis, with explicitly recognized public service obligations where these are needed, will help develop a more market-oriented banking system and improve monetary policy effectiveness. Ethiopia is already taking measures in this regard with ongoing reforms of

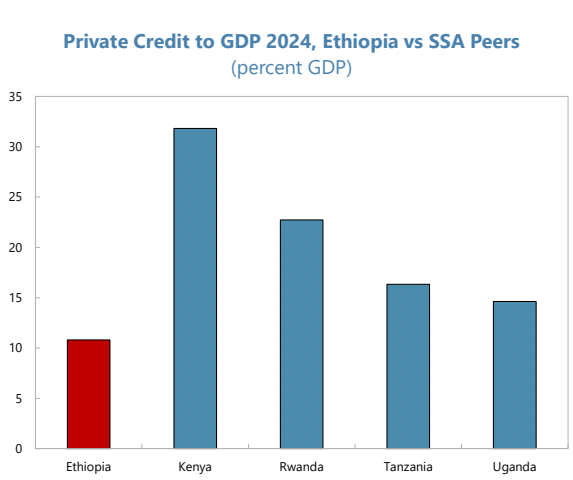
CBE to ensure it can operate as a commercially oriented entity, supported by the World Bank's FSSP project.

- *Capital mobility and exchange rate adjustment.* Limited capital mobility and exchange rate flexibility can weaken the exchange rate channel of monetary policy (IMF, 2015). When capital flows are unresponsive to interest rate differentials, and FX interventions limit exchange rate movement, the interest rate parity condition breaks down, dampening the impact of policy rate changes. Limited exchange rate adjustment through FX intervention could also force difficult trade-offs between achieving price stability and letting the exchange rate adjust and confuse market participants on the nominal anchor. While capital account liberalization is not a near-term priority in Ethiopia, greater exchange rate flexibility and smoother FX market functioning will still help strengthen transmission by allowing interest rate changes to influence inflation and exchange rate expectations more effectively as has been found in other cases. In Rwanda, for example, the authorities have conducted a diagnostic assessment of the FX market to strengthen the FX intervention framework. The objective is to limit FX interventions to preventing disorderly exchange rate adjustments and curbing excess volatility, thereby enhancing monetary policy transmission and supporting financial stability.
- *Central bank fiscal financing/policy-based lending.* In environments where central bank financing of government or directed lending to public bodies is significant, monetary policy signals can be diluted or become ineffective (e.g. policy lending in Uzbekistan). NBE has eliminated monetary financing of fiscal deficits and is developing market-based debt issuance. Developing and publishing predictable government financing plans is essential to reinforce these efforts. Over time, coordinating fiscal policy with the new monetary policy framework will help ensure that government financing needs do not undermine efforts to control inflation and stabilize interest rates.

14. Going forward, advancing modernization of the monetary policy framework will help strengthen the monetary transmission mechanism in Ethiopia, though it will take time. Key near-term priorities include continuing to develop a clear, well-communicated policy framework; moving to a single operating target (the policy rate), including with the phase-out of the cap on private credit; and strengthening analytical capacity for policy making. Strengthening NBEs operational autonomy, including by strengthening NBEs financial position and further efforts to support NBE independence (e.g. appointing Board members in accordance with the reformed law) will also enhance the effectiveness of monetary policy. Complementary efforts to develop money and bond markets, expand financial inclusion, financial regulations aimed at reducing financial repression and ensuring a market-oriented financial sector will help address structural features that currently weaken transmission. Over time, these reforms will lay the foundation for more effective and independent monetary policy.

Figure 5. Ethiopia: Financial Sector





Sources: Ethiopian authorities; World Bank WDI.

Table 2. Ethiopia: Lessons from Peer-Country Experience in Strengthening Monetary Transmission	
Lesson	**Examples**
Important components for strengthening monetary transmission:	
Communication	**Uganda:** Clear policy statements played a key role in strengthening transmission (Berg and Portillo., 2018). **Tanzania:** Emphasized the importance of communication in its transition to an interest-rate based policy framework by formally publishing its communication strategy in 2023, which includes publishing an annual calendar of MPC meetings as well as monetary policy and MPC meeting statements, and conducting workshops, seminars and other awareness sessions for communicating monetary policy (Bank of Tanzania, 2023).
Consistency between policy signal and policy actions and predictability of the link between policy rate and short-term rate	**Uganda:** Illustrates how a clearly defined operating target can help ensure the central bank has control over short-term rates. The central bank committed to a single operating target (the policy rate), even while experimenting with different implementation tools (e.g. using different repo operations) (Berg and Portillo, 2018).
Effective monetary instruments, including a transparent, market-based reference rate that reflects actual interbank activity	**Uganda:** Introduced a Central Bank Rate (CBR) in 2011, using it to guide the overnight interbank rate via a policy corridor and liquidity operations, while in Rwanda and Kenya, central bank policy rates are similarly supported by observable interbank rates to enhance transmission. Kenya introduced an interest rate corridor around the policy rate in 2023, lowering the discount window rate in tandem.
Central bank autonomy and a sound financial position	**Uzbekistan:** Central bank underwent a major capital injection in 2019[1] to support sterilization and reinforce independence. **Rwanda:** 2017 central bank law stipulates a clear legal framework for now that the National Bank of Rwanda capital can be raised.
Central bank analytical capacity	**Kenya:** The central bank adopted an FPAS in 2013 and the output from the framework serves as a key component of the information base for its MPC meeting and is supplemented with market expectation surveys, providing higher frequency and more granular indicators of the economy.

Table 2. Ethiopia: Lessons from Peer-Country Experience in Strengthening Monetary Transmission (Concluded)[1]	
Structural factors that may complicate monetary transmission:	
Shallow money and bond markets	**Kenya, Uganda**, and **Rwanda:** Have stepped up efforts to address shallow markets in recent years by developing their local currency bond markets. Ongoing reforms have focus on improving primary market practices, issuing benchmark bonds to support pricing and liquidity, diversifying the investor base, and strengthening the legal framework to support repo transactions with greater certainty.
Financial sector development	**Rwanda:** The central bank plays an active role in supporting financing development through engaging in initiatives and awareness campaigns to support financial literacy and inclusion, developing guidelines for women's financial inclusion, and introducing a mobile app that allows consumers to compare cost of financial services across sectors (IMF, 2023). .
Banking sector competition	**Uzbekistan:** State-owned banks had a large footprint (over 80 percent of total assets), and the authorities have taken direct measures to address their size through a banking sector reform program aimed at reducing their role to 40 percent of total assets, including through privatization (Al Rasasi and Cabezon, 2022).
Capital mobility and exchange rate adjustment	**Rwanda:** IMF (2023) found that while transmission through the exchange rate channel was weak, exchange rate passthrough was high. At the time, Rwanda was classified as having a de facto crawl-like exchange rate arrangement, and the country faced FX shortages. Allowing for more exchange rate flexibility was cited as an important way to manage the impact of passthrough on inflation.
Policy-based lending	**Uzbekistan:** the ongoing practice of policy lending, whereby state banks are required to carry out lending at preferential rates to promote social objectives, is cited as a key factor still constraining transmission (IMF, 2024c).

[1/] Authorized capital of the Central Bank to increase by 500 times.

Table 3. Ethiopia: Transition to Interest-Rate Based Monetary Policy Framework Country Examples

Country	Transition time period	Framework	Status of transmission
Kenya	Moved away from a monetary aggregate targeting framework in 2008. Transition has taken time, with interest rate controls imposed during 2016–19.	Forward-looking inflation targeting framework using the policy rate (central bank rate) to signal the monetary policy stance.	Weak but improving with the removal of interest rate controls and the relatively recent introduction and subsequent narrowing of interest rate corridor around the policy rate (IMF, 2024a).
Rwanda	Announced transition to an interest-rate based framework as of 2019. Policy rate and interest rate corridor were introduced in 2008 and 2012, respectively.	Medium-term inflation target (5 percent) with an inflation target band of +/- 3 percent. Operational target to keep interbank rate close to policy rate.	Transmission through the interest rate corridor has improved since the introduction of the new framework but remains limited in the exchange rate channel (IMF, 2023a).
Tanzania	Formally adopted interest-rate based policy framework in January 2024, but transition had been gradual.	Medium-term inflation target of 5 percent. Operational target is to keep the 7-day cash rate within a ±200 bps corridor with the policy rate.	Study before transition to framework found some evidence of active monetary transmission channels, particularly in the interest rate-based channels (overnight interbank and T-bill rates) (IMF, 2023b).
Uganda	Shifted to an inflation targeting regime in 2011.	Policy rate set in response to deviations of the medium-term forecast from the target.	Study on transmission over 2011–23 found transmission to lending rates only in the long run, with stronger transmission through T-bill and exchange rate channels (IMF, 2024b). Earlier studies prior to transition found weak transmission attributed to the lack of monetary policy credibility in the early stages of the regime (Berg and Portillo, 2018).
Uzbekistan	Transition to inflation targeting framework began in January 2020.	Inflation target of 5 percent with the policy rate as the key instrument. Operational objective is to ensure short-term overnight rates remain close to policy rate (within interest rate corridor).	Transmission has been constrained with limited changes to bank lending and deposit rates but improving as reforms have progressed (Al Rasasi and Cabezon, 2022).

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ETHIOPIA—FISCAL FEDERALISM: FISCAL POLICY CONSIDERATIONS FOR THE MEDIUM TERM

Interregional fiscal arrangements entail a sizable redistribution of resources. They help the objective of income redistribution and equity, as well as providing partial insurance against regional macroeconomic shocks. However, overall transfers from the federal government to regions have been constrained by limited fiscal space. By law, regions cannot borrow without Ministry of Finance approval. There is room to improve redistribution and stabilization features of Ethiopia's government finances, strengthen regional budgetary frameworks, and mobilize domestic resources to support socio-economic development. Implementation of revenue mobilization reforms will require support from the federal government to strengthen tax administration in the regions. Lastly, the curtailment of overseas development assistance would disproportionately affect regions with large humanitarian and disaster risk expenditure requirements.

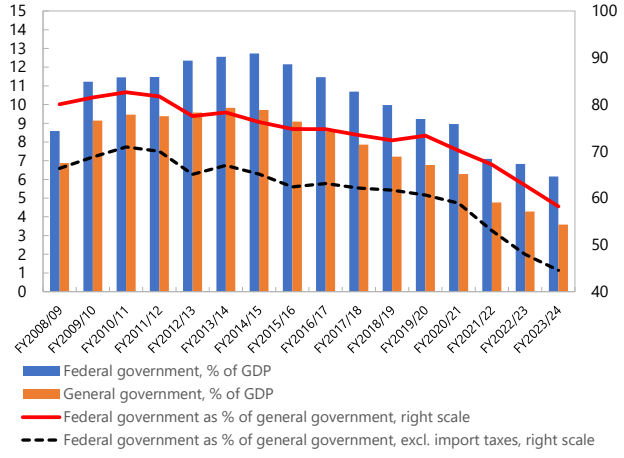
A. Main Characteristics of Intergovernmental Relations in Historic and Regional Context

1. The process of fiscal decentralization in Ethiopia started three decades ago. The foundational elements of revenue-sharing, regional self-governance, spending mandates, and fiscal responsibility are enshrined in the National Constitution approved in December 1994. Ethiopia's federal structures reflect ethnic or linguistics groups, with considerable variation in terms of land area, population, economic development, and urbanization. From the initial setup of nine states, the number of federal constituencies expanded over time to twelve, with the most recent change in 2023 with the three new regions formed from the previously Southern Nations, Nationalities, and Peoples' Region (SNNPR). Ethiopia's two largest cities, Addis Ababa and Dire Dawa, are under federal government jurisdiction.

2. A distinctive feature of Ethiopia's fiscal federalism is the split of revenue raising powers between federal and regional governments according to tax sources. Revenues are categorized as federal, state, or joint. The federal government has an exclusive right to tax international trade, domestic indirect taxes (VAT and excise) are split according to joint revenue sharing formulas, while regional governments collect direct taxes (including PIT) and certain royalties and fees (Table 1). For taxes not mentioned explicitly, the

Ethiopia: Federal vs General Government Tax Revenue

(left scale: percent of GDP, right scale: percent)



Sources: Ethiopian authorities and IMF staff calculations.

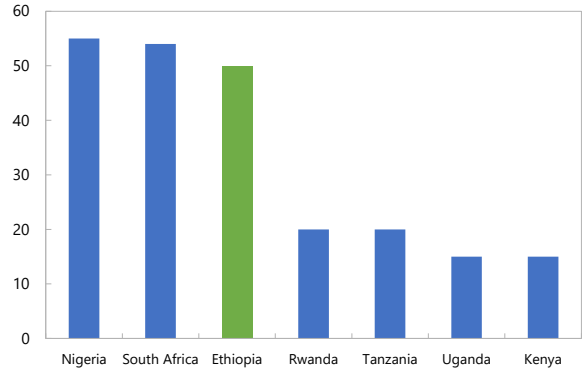
Constitution includes a mechanism to establish revenue assignment (a two-thirds majority vote of the joint session of the House of the Federation and the House of Peoples' Representatives). This mechanism applies to several new taxes envisaged under the National Medium-Term Revenue Strategy, namely property and motor vehicle circulation taxes.

3. Expenditure responsibilities in Ethiopia are close to those of highly decentralized systems. The federal government has responsibility for national defense, national infrastructure (air, rail, major roads, post, telecom), formulating country's overall economic and social development (IMF, 1997). In turn, regional governments are responsible for policy areas such as basic education and health, tailored to the specific needs of local populations.

4. All in all, Ethiopia is relatively decentralized compared to Sub-Saharan African countries. Most countries in Sub-Saharan Africa retain a highly centralized model of territorial government and fiscal arrangements, and only a handful have embarked on significant fiscal decentralization. Besides Ethiopia, only in Nigeria and South Africa does spending at the subnational government level account for half or more of general government spending. Of the rest, only in a few East African countries is spending at the subnational level significant (Kenya, Rwanda, Tanzania, and Uganda, where it amounts to about 15–20 percent of general government spending).

Selected Sub-Saharan African Countries: Subnational Government Spending

(percent of general government spending)



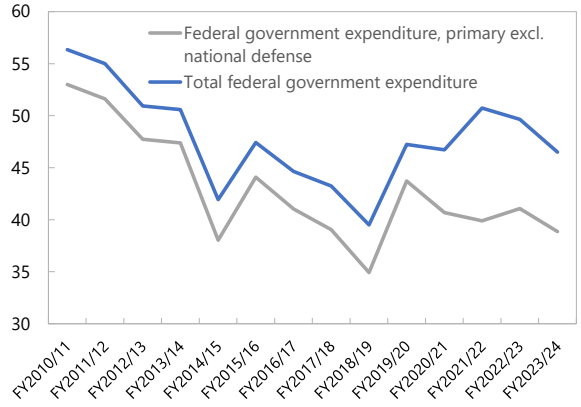
Source: Hobdari and others (2018).

5. Ethiopia's intergovernmental relations have evolved over the years. Vertical fiscal imbalances – the gap between revenue-raising capacity and expenditure responsibilities of different levels of government - have narrowed over the years, primarily due to the increase in regions' share of joint revenues. Key developments include:

- The revenue assignment of regional government was initially concentrated in direct taxes, including personal income tax. In the two decades following the introduction of the federal system, regions could cover only about 1/3 of expenditure mandates with own revenue, in part due to a lack of sustained growth of the income tax base. Most required a sizable grant transfer from the federal government to cover resource shortfalls. In the recent decade, regions' share of concurrent revenues has been increased with intent to reduce the vertical imbalances.
- The share of regions in total public expenditure has increased steadily, from about 35 percent of consolidated expenditure in mid-1990's to around 55 percent in the last decade.
- The regional block (general purpose) grant has shrunk relative to the federal government's resource envelope.

Ethiopia: Federal vs General Government Expenditure

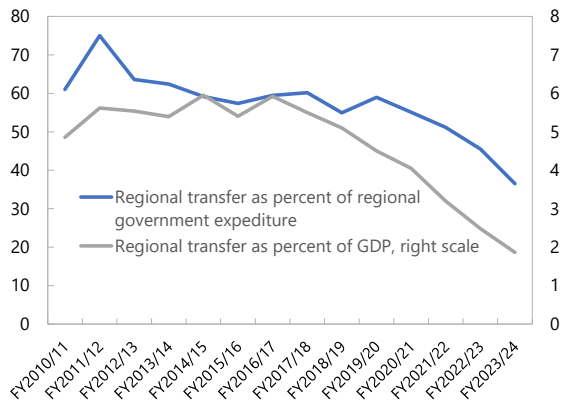
(As percent of general government expenditure)



Sources: Ethiopian authorities and IMF staff calculations.

Ethiopia: General Purpose Grant

(Percent)



Sources: Ethiopian authorities and IMF staff calculations.

6. Recent legislative reforms (Proclamation 1250/2021) have strengthened the legislative framework with regards to high-level policy principles and institutional arrangements. Key elements of the revised legal framework include: (i) a limit on revisions of the grant formula to once in five years, with the possibility of incorporating data updates, and (ii) creation of the House of Federation Secretariat, an independent technical body with parliamentary oversight, tasked with designing grant and joint revenue sharing formula recommendations and implementation of monitoring and evaluation activities. However, the status of implementation of institutional arrangements and the extent of technical capabilities of the autonomous body are unclear.

B. Revenue: Recent Developments and Reform Considerations

7. A sequence of revenue sharing methodology reforms has resulted in a significant improvement in regions' revenues and narrowing vertical imbalances. The joint revenue sharing formula has been revised eight times, resulting in a decline in the federal government's share of joint revenues from 70 percent in 2010/10 to 45 percent by 2023/24. The latest FY2020/21 formula revision (Table 2) had a significant impact on regions' share, which was increased from 30 to 50 percent for VAT, and from 40 to 75 for royalites. The joint revenue sharing methodology implemented in the FY2020/21 committed 50 percent of income taxes to regional states where businesses operate, though leaving the tax assignment of the two federal cities without change.

8. The division of tax administration and collection responsibilities between the federal and regional governments should balance minimizing administration and compliance costs with the fiscal sovereignty of the states. Inter-regional equalization argues for central taxation of tax bases that are unequally distributed across regions (e.g., if large corporate entities, or mineral wealth, are concentrated in particular locations). While this policy objective is present to some extent in all countries, it is often balanced, particularly in fiscal federations, by the desire to protect the economic policy autonomy of regions and allow the more dynamic regions to reap the benefits of

their economic success. Key revenue reform considerations for Ethiopia's medium-term revenue strategy can be identified as follows:

Direct Taxes

9. Ethiopia's decentralized model of progressive income taxation constrains scope for promoting interregional equity through tax policy. The equity considerations that underpin progressivity principle of personal income taxation warrant aggregation of personal incomes by sources and across regional tax jurisdictions. Though Ethiopia's salary income tax is progressive, other sources of individual incomes are taxed according to separate schedules (salary, rental income, self-employment). Furthermore, the income tax assignments are not aligned with the schedules. Income under a particular schedule can be allocated to the federal government, a regional government, or both, depending on the source. For example, a federal government employee's salary is taxed by the federal government while the rental income is taxed by the region. As total income is not aggregated across jurisdictions, the individual may not be subject to higher income tax rate bands. Division of taxing rights, with regions entitled to personal business income tax, in combination with the schedular income tax system limits the progressivity of taxation of personal incomes. Introducing progressive unified income at regional level could be feasible, although implementing and administering aggregation of income sources across tax jurisdictions is likely to be far more challenging.

10. Policy options, such as those identified in Fund TA, to improve progressivity of personal income taxation and to protect regions from presumptive tax revenue loss, will require collaboration of regional and federal tax authorities. One approach to improve progressivity of personal income taxes could involve applying a progressive scale to income that is taxable by the regional governments, and taxing federal income at a higher rate based on total earnings. Besides policy complexity, this design would require robust tax filing systems and inter-jurisdictional coordination. It requires centralized tax filing or enhanced information sharing between the federal and regional levels, that will take time to implement. Safeguards may be desired to protect regions from presumptive tax revenue losses, given that employment income tax and unincorporated business income tax account for almost 90 percent of regions' direct tax revenues. With the envisaged uniform design of the turnover tax rate across the country, regions could be given the flexibility to apply a surtax to the turnover tax revenues (e.g., 10 percent). Surcharges on excises could also be considered.

Indirect Taxes

11. The growing importance of indirect taxes as a revenue source will benefit regions in the medium term, although regions with lower tax bases and weaker administration capacity will benefit less. Ethiopia's nationwide and uniform VAT rate of 15 percent is applied across all regions and hence does not give rise to VAT cascading nor distortions to inter-regional trade and economic linkages. The 2024 VAT Proclamation benefits regional revenues by widening the tax base to include services, removing various VAT exemptions, and modernizing administration

arrangements. However, a few distinct features of the federal VAT arrangements[1] have implications for tax administration reforms and intergovernmental and interregional fiscal imbalances, specifically:

- **Division of responsibilities between the federal and regional governments to collect VAT.** Ethiopia's VAT is administered at federal level, with the regions carrying some delegated responsibilities for filing and collection. The 2024 VAT Proclamation clarified that VAT shall be assessed and collected by the Ministry of Revenue or the Customs Commission, as appropriate, but the Ministry of Revenue can delegate the Regional and City Administration Revenue Bureaus to assess and collect the VAT on its behalf. This division of administrative responsibility could introduce unevenness in the comprehensive and uniform application of the tax. Successful implementation of the new regime requires good coordination and information flow between regional and central tax authorities (e.g. on validation of VAT refunds and input tax credits).
- **The legal form of small businesses affects revenue assignment.** VAT revenues are withheld or collected from a business with assignment (federal vs concurrent) based on the legal form of the business. Regional governments are entitled to revenue from unincorporated businesses, while revenues from incorporated businesses are treated as joint and are subject to sharing. Small businesses (entrepreneurs and individual traders, defined as "category C" taxpayers by the Income Tax Proclamation) and "persons" defined under the Turnover Tax Proclamation, are subject to turnover tax which is a VAT counterpart for establishments with annual sales below VAT registration threshold. Turnover taxes collected from small businesses are assigned to regional government while VAT from larger entities are joint revenues, with VAT being jointly assigned to a region where the large entity trades within its territory. As a result, the division of the underlying tax base will remain dependent on the legal form of the establishment. Unless periodically adjusted for inflation, VAT registration thresholds could drift, forcing more businesses into the VAT's joint revenue pool.[2]
- **Ethiopia's VAT is based on the origin principle, with assignment to a region in which the seller (rather than purchaser or consumer) is registered for tax purposes.** Although a tax on consumption, VAT revenue is remitted in a region where a business entity is registered and where it pays taxes, rather than to a region where the tax base is located. A place of supply and consumption would usually coincide for small businesses, but it is not the case for large corporates, which tend to be based in Addis Ababa, selling goods and services across the country. When large corporations collect VAT from a poorer region that is remitted to the headquarters tax authorities, there is effectively a fiscal transfer from a poorer to a wealthier region or to federal government in case of companies headquarter in Addis Ababa. These imbalances are likely to grow with expansion of e-commerce and remote services, which have been subject to VAT following the recent reforms, implying that a periodic public debate on the balance between centralized and local taxation, and the effectiveness and suitability of the block grant, will remain an important feature of the system.

[1] For further discussion, see also Yesegat and Krever (2018).

[2] The 2024 VAT Proclamation has raised the mandatory VAT registration annual turnover threshold from 1 to 2 million birr but allowed voluntary registration otherwise (Article 13), in line with international best practice.

Property Tax Reforms

- Almost all tax revenues sourced in Addis Ababa and Dire Dawa are channeled to the federal government's coffers, with property tax and other municipal fees being the main own revenue source. The two cities are expected to be at the forefront of property tax reform, paving the road for other local administrations nationwide. The upcoming reform of the presumptive tax, which belongs to local authorities, provides additional revenue mobilization opportunity for the two cities.

Natural Resource Taxation

- Most countries also allow natural resource-rich regions to benefit from a portion of the tax potential associated with these resources that goes well beyond the local costs and negative externalities generated by the resource exploration. Although Ethiopia does not earn significant revenues from high value extractive mining operations, gold has become the most significant mined commodity, and other industrial materials and fertilizers are under consideration.

C. Regional Grant Framework

12. General purpose grants (GPGs) are intended to fill vertical fiscal gaps and manage the equalization objective of limiting horizontal imbalances across regions. Horizontal fiscal imbalances originate from differences in revenue generation, developmental levels, and administrative capacities across the regions (Yimenu, 2024). General purpose grants have been a key source for financing regional and local public services, aiming to support regions in delivering reasonably comparable levels of essential public services while facing comparable tax burdens. The grants serve to advance national objectives such as in education, health, social welfare policy, and access to basic infrastructure. The regional budget financing nature of the general-purpose grant is meant not to intrude on regions' decision-making autonomy, while ensuring a transparent allocation across regions.

13. Unconditional budget grants are complemented by a system of targeted regional grants for capital investment towards the achievement of Sustainable Development Goals (SDG). Relatively small in comparison to the general pool, these SDG grants were envisaged to support basic service-related capital projects guided by national policy priorities, while mitigating risks that SDG-related expenditure are rationed out due to current expenditure pressures. In recent years, these funds have been used by regional government for the construction of agro-industrial parks and small-scale irrigation infrastructure. Other sizable specific purpose transfers include urban and rural Productive Safety Net Programs (PSNP).

14. The regional grant framework is underpinned by institutional arrangements at the legislative and executive level. The formulation of the size of the GPG pool is undertaken by the Ministry of Finance, while the responsibility for allocation criteria rests with the House of Federation, the parliament's upper house with regional representation. The size of the grant pool is set as part of the annual federal budget cycle, and hence is subject to parliamentary approval. In practice this process lacks direct input and feedback from the regions as regards the size of the pool and amounts of regional grants.

15. The allocation of GPGs across regions is driven by a formula, which has seen eight modifications over three decades. Until 2007, the formula went through several modifications primarily to reflect regional populations, the level of economic development, and revenue raising capacity. Starting in 2007, however, the approach shifted to balancing differences in revenue-raising capacity and expenditure needs. The current formula, last modified in 2017, builds on three pillars: (i) difference in regional tax revenue, such as income, turnover, and VAT taxes, (ii) regional government expenditure, such as on primary and secondary education, agriculture and rural development, rural roads, and (iii) a dedicated though a rather small sub-pool, currently set at one percent of the total pool, to support the catch-up of the four least developed regions (Benishangul-Gumuz, Afar, Gambela, and Somali). The FY2024/25 work plan of the Standing Committee on Budget Subsidies and Shared Revenues foresees revision of the regional state budget allocation formula based on empirical data. Despite periodic revisions and recent legislative changes, there is no rule or procedural trigger guiding the periodicity of formula revisions. The main reasons include the lack of timely and adequate regional data and limited technical capacity. Lastly, the formula remains to be established for the three new regions, previously SNNPR.

16. The equalization function has been weakened by the decline in size of the of grant pool. The current grant sharing formula is intended to help fill the financing gap of the regions:

Region's Fiscal Gap = Region's Fiscal Capacity (tax revenue norm) + Region's Concurrent Revenue – Region's Expenditure Needs (expenditure norm)

Fiscal gaps are used to determine the shares of the regions in the pool. However, the overall size of the pool is set by the Ministry of Finance and in practice independently of the intended objective of gap filling. Constrained fiscal space and the decline in the tax-to-GDP ratio of the federal government have contributed to the shrinking of the pool, putting regions' essential public service delivery at risk. The decline of the pool can also lead to weaken interregional equity, as less resources flow from the federal budget to regions with weaker fiscal capacity. Furthermore, fiscal gap formula components aggregate multiple subcomponents, resulting in complex and data intensive calculations (World Bank, 2015), that make the allocations less transparent and can lead to questions about fairness. The following considerations are relevant in setting grants over the medium term:

- The equalization principles imply that taxes collected from states with higher revenue potential are shared with regions with less revenue potential. This is implemented through a norm approach to revenue potential of the region, but in practice the calculation of fiscal capacity is based primarily on the region's actual revenue collection as opposed to potential tax base and administration capacity. With states retaining a greater share of concurrent revenue, the resource pool for shared revenue declines, and the equalization function of the block grant can weaken.
- Vertical fiscal gaps can also arise due to imbalances in revenue gains and the expenditure implications of the program-supported reforms. The near-term macroeconomic and domestic revenue mobilization reforms will disproportionately benefit the tax base assigned to the federal government. This is due to revenue gains being concentrated in customs, primarily as a result of

exchange rate and excise reform, but also VAT and income taxes from SOEs established by federal government and businesses headquartered in Addis Ababa. In turn, the expenditure pressures for regions stem primarily from their developmental and poverty-reducing spending mandates. Federally financed programs, such as PSNP and rural development capital spending and SDG grant, can help narrow fiscal gaps, but it will be key to set the block grant size with consideration for the absolute fiscal gaps, and share the federal government's revenue windfall equitably with the regions. The sub-pool to support the catching up of the four less developed regions, already small, could decline further, and may need reconsideration.

- The increase in concurrent revenue shares has incentivized revenue mobilization for regions. Overcoming weaknesses in revenue administration capacity will require concerted effort and support from the federal tax administration to strengthen regional tax collection capacity. Regular and data driven grant formula updates can help attain fiscal equalization.
- Establishing a simple, fair, and transparent grant system is difficult in any federation. In Ethiopia's case, difficulties are compounded by the lack of timely statistics capturing interstate equity, tax effort, and policy implementation effectiveness. Outdated statistics tends to penalize regions with faster urbanization.
- Large fiscal gaps (horizontal and vertical) can be politically divisive. Fiscal equalization through the grant system can help foster a sense of political participation but can also foster resentment in net contributing regions and weaken incentives to raise revenue. Simplicity, objectivity, and transparency of grant allocations are critical for policy effectiveness, accountability, and public acceptance.

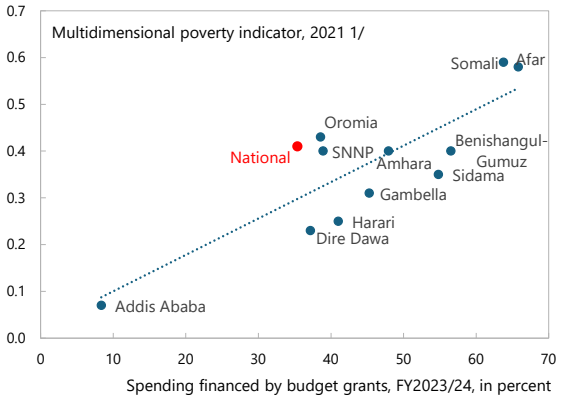
17. Analysis of recent regional fiscal accounts and socio-economic indicators confirms that budget grants have been effective at reducing regional fiscal gaps but have not fully offset the impact of regional disparities in fiscal capacity on multidimensional socio-economic poverty. Analysis of the FY2023/24 regional government's budget execution in combination with the multidimensional poverty indicator (MPI),[3] a composite metric that covers health, education, and living standards at the regional level, suggests the following:

- There is a positive correlation between region's dependence on general-purpose grants and that region's MPI (first panel below). Specifically, regions with higher MPIs tend to have greater shares of their budget expenditure covered by general-purpose grants. Furthermore, as indicated in the 2024 World Bank Poverty Assessment for Ethiopia, multidimensional poverty declined nationwide between 2016 and 2021 reflecting increased access to public services such as water and electricity, improved housing quality, and ownership of durable assets in rural areas, which are areas that fall primarily within the policy mandates of the regions. Taken together, this evidence suggests that federal budget grants have been effective at reducing interregional fiscal gaps that stem from socio-economic expenditure needs.

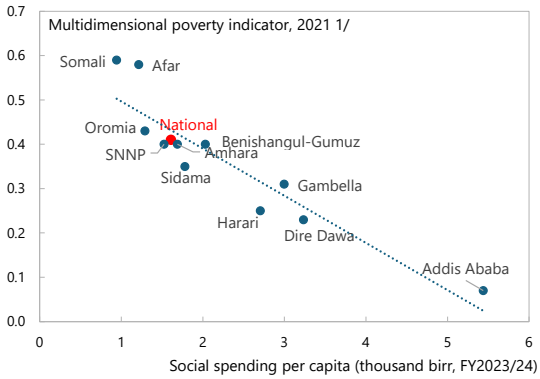
[3] Multidimensional poverty indicator (World Bank Ethiopia Poverty and Equity Assessment, 2024) ranges from 0 to 1, with higher value representing a higher level of deprivation. For methodology, see Alkire et al. (2021).

- At the same time, federal general-purpose grants do not fully offset the impact of regional disparities in fiscal capacity on multidimensional poverty, as indicated by the negative correlation between per capita spending on recurrent social services (education, health) and multidimensional poverty outcomes (second panel).
- Lastly, budget grants also appear to fall short in their ability to offset regional disparities in fiscal capacity. Although regions with higher MPIs collect less own revenue per capita (third panel), there is no clear statistical links between the per capita amount of the general-purpose grant and region's own revenue or the degree of severity of multidimensional poverty (last panel).

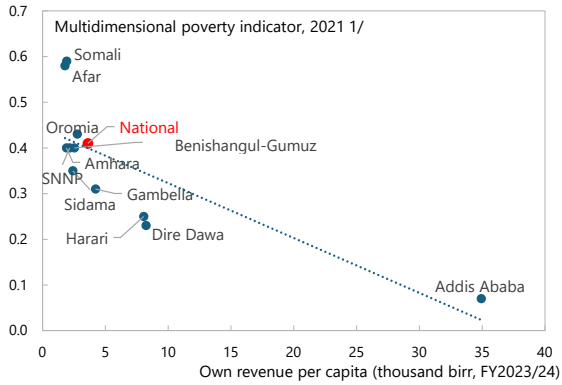
Ethiopia: Multidimensional Poverty Outcomes and Reliance on General Purpose Grant, by Region



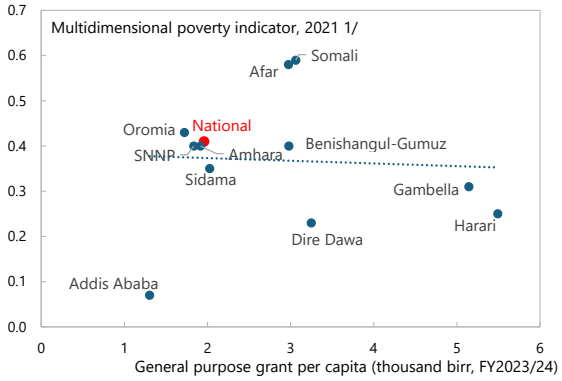
Ethiopia: Multidimensional Poverty Outcomes and Social Spending, by Region



Ethiopia: Multidimensional Poverty Outcomes and Own Revenue, by Region



Ethiopia: Multidimensional Poverty Outcomes and Block Grants Allocations, by Region



Sources: Ministry of Finance, Ethiopian Statistical Service, World Bank, and IMF staff calculations.

1/ Multidimensional poverty indicator (World Bank Ethiopia Poverty and Equity Assessment, 2024) covers health, education, and living standard dimensions, and ranges from 0 to 1, with higher value representing a higher level of deprivation. Computation is based on the Global MPI methodology by Alkire et al. (2021).

D. Macroeconomic Implications

18. The federal government's macroeconomic stabilization function should be strengthened. The fiscal stance, also determined at the federal government level, is set through the federal budget. In principle, the general-purpose grant pool, set in the context of the annual budget cycle, provides a mechanism to harmonize macroeconomic stabilization policy across federal and regional budgets, but in the past has been subject to strong budget constraints at the national level. Strengthening the federal government and regional budgetary frameworks, and rebuilding fiscal space, are needed to support the macro-stabilization function of public finances. Policy recommendations identified by the recent macro-fiscal TA focus on modernizing forecasting techniques, improving institutional coordination, and strengthening links between medium-term fiscal frameworks (MFF) and the annual budgets. Further information from the MFF could be produced to inform decisions during the budget preparation process, including impacts of budget decisions on debt and other sustainability indicators.

19. Policy coordination between the federal government and regional governments is necessary in many areas for ensuring effective economic governance and development. Tasked with formulating country's overall economic and social development, the federal government should encourage and support common best practices that can be replicated and implemented effectively at the regional level. Improving coordination of investment plans between government entities with different institutional functions would help ensure public infrastructure is delivered in the right areas and with appropriate funding. Policy recommendations of the 2024 Public Investment Management Assessment (PIMA) and Climate PIMA report call for better investment and budgetary resource planning, project implementation monitoring, systematic disclosure, as well as improving alignment of regional frameworks with federal climate priorities.

20. Insurance against regional macroeconomic shocks primarily works through federal safety nets programs while other channels are limited. The general-purpose grant formula is linked to revenue and expenditure norms, with 3-year averaging limiting responsiveness of the grant shares to temporary shocks. Although this design should allow automatic stabilizers to work on regional revenues, regional grant allocation shares are unaffected, and market borrowing is precluded. Helping regions cope with idiosyncratic shocks is effectively done through the shock response facilities of the federal government, namely PSNP and programs administered by the Disaster Risk Management Commission to address localized shocks, such as drought or livestock disease outbreaks. Curtailment of overseas development assistance would disproportionately affect regions with large humanitarian and disaster risk expenditure requirements and would increase the value of a stronger framework to manage regional macroeconomic shocks. Setting up an adequately funded national disaster risk management fund, as envisaged by the authorities, could help strengthen the response to natural disasters and humanitarian crises and channel available international resources transparently. Interregional stabilization and resilience to shocks can be strengthened through broadening the geographic reach of the safety nets, enhancing focus on livelihoods, and improving efficiency through e-payments, digitalization, and establishing National

Social Registry. Producing timely and adequate regional data to inform periodic updates of regional grant shares would also help.

21. Reinforcing the fiscal responsibility framework by maintaining tight control over regional borrowing should continue. Market discipline has not played a role in shaping decentralization. Regional governments are legally empowered to borrow domestically, subject to terms and conditions set by the federal government. But there has been no regional borrowing, with exception of Addis Ababa, constrained by scarce financial system capacity, potentially high risks, and federal government control over regional finances through the requirement for approval of any borrowing.[4] A range of legislative safeguards has precluded budget or project financing by regions. Tight control over regional borrowing should continue, as revenue mobilization capacity and fiscal space is rebuilt, and domestic debt market preconditions are established.

[4] The only possibility for regions to borrow provided by law is for projects, which requires a feasibility study showing capacity to repay the debt, and the borrowing request is subject to approval by the Ministry of Finance. External borrowing by regions is not permitted. NBE or commercial banks are not permitted to lend to regional governments

Table 1. Ethiopia: Taxation Powers of the Federal and Regional Governments

Federal Power of Taxation	State Power of Taxation	Concurrent Powers of Taxation
To levy and collect: • Custom duties, taxes and other charges on imports and exports • Income tax on employees of the federal government and international organizations • Income, profit, sales and excise taxes on enterprises owned by the federal government • Taxes on incomes and winnings from national lottery and games of chance • Taxes on income of air, rail and sea transport services • Taxes on income of houses and properties owned by the federal government • Fees and charges related to licenses issued and services rendered by organs of the federal government • Taxes on monopolies • Federal stamp duties	To levy and collect: • Income taxes on employees of the state and of private enterprises • Fees for land usufructuary rights • Incomes of private farmers and farmers incorporated in cooperative associations • Profit and sales taxes on individual traders carrying out a business within their territory • Income from transport services rendered on waters within their territory • Taxes on income derived from private houses and other properties within the state; and rent on houses and properties they own • Profit, sales, excise and personal income taxes on income of enterprises owned by the regional states • Taxes on income derived from mining operations, and royalties and land rentals on such operations • Fees and charges relating to licenses issued and services rendered by state organs • Royalty for use of forest resources	To jointly levy and collect: • Profit, sales, excise and personal income taxes on enterprises they jointly establish • Taxes on the profits and sales of companies and on dividends due to shareholders • Taxes on incomes derived from large-scale mining and all petroleum and gas operations, and royalties on such operation

Table 2. Ethiopia: FY2020/21 Joint Revenue Sharing Reform

Tax Type	Type of Revenue	Previous Formula (Share)		New Formula (Share)	
		Federal	Regions	Federal	Regions
SOEs Established by both federal and state government	Business Profit	Based on capital share	Based on capital share	50%	50%
	Income Tax	50%	50%	0%	100%
	Sale/Vat/Excise Taxes	70%	30%	50%	50%
Private Share companies	Business Profit	50%	50%	50%	50%
	Sale/Vat/Excise Taxes	70%	30%	50%	50%
	Dividend Tax from Share Holders	50%	50%	50%	50%
Large Mining, fuel and Petroleum works	Royalty	60%	40%	25%	75%
	Business Profit	50%	50%	50%	50%

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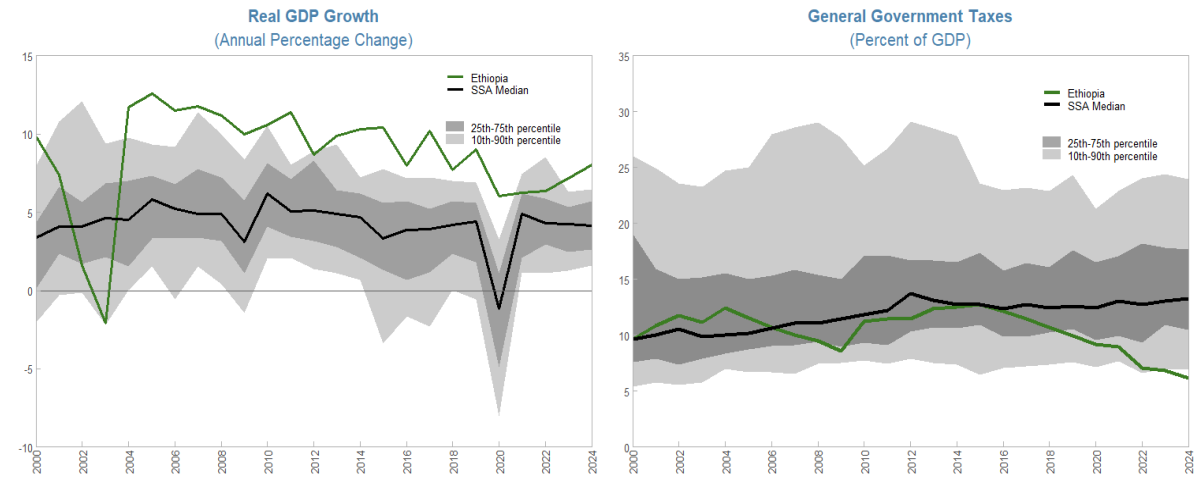
ETHIOPIA'S TAX SYSTEM: STRUCTURE, PERFORMANCE, AND BENCHMARKING

Ethiopia's tax system plays a critical role in shaping its fiscal sustainability and economic development trajectory. Despite being one of the fastest-growing economies in Sub-Saharan Africa (SSA), Ethiopia's tax-to-GDP ratio remains among the lowest in the region, highlighting persistent revenue mobilization challenges. While many peer countries have strengthened their tax capacity through policy and administrative reforms, Ethiopia's revenue performance has stagnated, limiting its ability to finance essential infrastructure, social programs, and development priorities. Given the increasing fiscal pressures and the need for sustainable domestic revenue mobilization, this SIP assesses Ethiopia's tax system by benchmarking its performance against regional and structural peers. It explores the key factors constraining tax revenue collection, estimates Ethiopia's tax potential, analyzes revenue elasticities to the business cycle, and assesses tax efficiency across major tax categories.

A. Motivation and Background

1. Ethiopia has sustained one of the highest growth rates in Sub-Saharan Africa (SSA), yet its tax revenue mobilization remains among the weakest in the region. Over the past two decades, Ethiopia's real GDP growth has consistently outperformed regional peers, driven by large-scale public investment, rapid urbanization, and structural economic shifts. However, despite this robust expansion, domestic revenue generation has lagged behind, severely constraining the government's ability to finance development priorities and maintain fiscal stability (Figure 1, left).

Figure 1. Ethiopia and Sub-Saharan Africa: Real GDP Growth and Tax Revenues



Source: WEO database. IMF Staff Calculations

2. Ethiopia's tax-to-GDP ratio is among the lowest in SSA, ranking below the 10th percentile of the regional distribution. While many countries in the region have made significant progress in enhancing tax collection, Ethiopia's performance has stagnated and, in recent years,

declined. The country's general government tax revenues remain below the SSA median and continue to diverge downward, reflecting deep-rooted structural inefficiencies in tax administration and compliance (Figure 1, right). This decline reflects lower contributions across all major tax categories.

3. The divergence between Ethiopia's economic growth and its weak tax performance highlights fundamental weaknesses in revenue mobilization. Despite a rapidly expanding economy, Ethiopia's tax system is characterized by a narrow tax base, high levels of informality, and inefficiencies in tax administration. In particular, personal income tax (PIT) and corporate income tax (CIT) contributions are low by regional standards, and weaknesses in consumption tax collection further constrain revenue potential.

4. Strengthening domestic revenue mobilization is essential for Ethiopia's macroeconomic stability and long-term development. Addressing structural weaknesses in tax policy and administration will be crucial in expanding fiscal space for critical investments in infrastructure and social programs. This paper benchmarks Ethiopia's tax performance against regional and structural peers, assesses the country's tax potential, and outlines policy measures to enhance revenue collection. The analysis is particularly relevant in the context of Ethiopia's engagement with the IMF and ongoing tax reforms aimed at improving fiscal resilience.

B. Tax Revenue Structure and Trends

5. Ethiopia's government revenue is heavily dependent on tax collection, with grants and non-tax revenues playing a minimal role. Like many other SSA economies, Ethiopia's fiscal framework is primarily supported by domestic tax revenues, while external grants and non-tax income contribute only a marginal share. The sustained decline in tax revenue has led to proportional expenditure reductions, particularly in capital spending and poverty-related programs, as the government seeks to contain fiscal deficits (Figure 2, top left).

6. Tax revenue sources are relatively balanced across different tax categories, though direct taxes currently play the dominant role. In the period 2021-2023, direct taxes on income, profits, and capital gains accounted for approximately 3.5 percent of GDP, making them the largest contributor to total revenues. Taxes on international trade and transactions were the second most significant source, generating around 2.2 percent of GDP, while taxes on goods and services—primarily VAT and excise duties—contributed approximately 2.0 percent of GDP (Figure 2, bottom).

7. Ethiopia's tax composition reflects the complexities of its federal structure, where tax rights are constitutionally divided between the federal government and regional states. While the federal government has exclusive authority over import and export duties, income taxes on civil servants, taxes on publicly owned enterprises, and national transport services, regional states levy taxes on private sector employees, agricultural income, property rents, and small traders within their jurisdictions. Additionally, some taxes, such as those on profits, sales, and excise duties of jointly established enterprises, as well as revenues from large-scale mining and petroleum operations, are concurrently administered by both levels of government. Despite this decentralized structure, the

federal government remains the primary tax-collecting entity, accounting for more than 70 percent of total tax revenues. Table 1 below outlines the taxation mandates of the federal and regional governments in Ethiopia.

Table 1. Ethiopia: Taxation Mandates of the Federal and Regional Governments

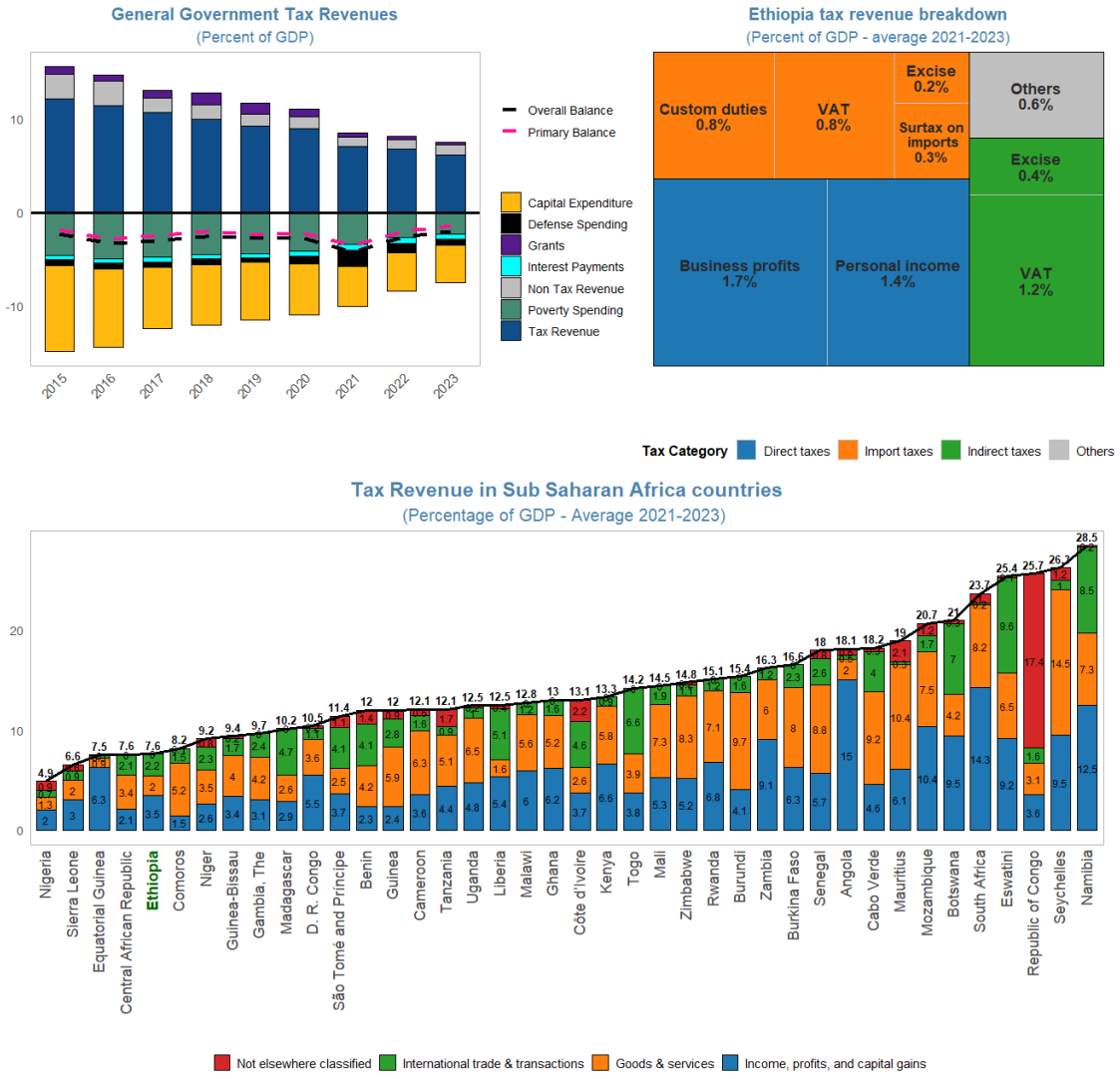
Federal government levies and collects:	• Custom duties, taxes, and other charges on imports and exports • Income tax on employees of the federal government and international organizations • Income, profit, sales, and excise taxes on enterprises owned by the federal government • Taxes on incomes and winnings from national lottery and games of chance • Taxes on income of air, rail, and sea transport services • Taxes on income of houses and properties owned by the federal government • Fees and charges related to licenses issued and services rendered by organs of the federal government • Taxes on monopolies • Federal stamp duties
State governments levy and collect:	• Income taxes on employees of the state and of private enterprises • Fees for land usufructuary rights • Incomes of private farmers and farmers incorporated in cooperative associations • Profit and sales taxes on individual traders carrying out a business within their territory • Income from transport services rendered on waters within their territory • Taxes on income derived from private houses and other properties within the state; and rent on houses and properties they own • Profit, sales, excise, and personal income taxes on income of enterprises owned by regional states • Taxes on income derived from mining operations, and royalties and land rentals on such operations • Fees and charges relating to licenses issued and services rendered by state organs • Royalty for use of forest resources
Both concurrently levy and collect:	• Profit, sales, excise, and personal income taxes on enterprises they jointly establish • Taxes on the profits and sales of companies and on dividends due to shareholders • Taxes on incomes derived from large-scale mining and all petroleum and gas operations, and royalties on such operations

Source: FDRE Constitution (1995), and Ethiopian Statistical Service (ESS) & World Bank (2024)

8. Specialized tax offices play a crucial role in Ethiopia's federal revenue collection, with large taxpayers contributing the majority of tax revenues. The Large Taxpayers Office (LTO) and Medium Taxpayers Office (MTO) have been instrumental in streamlining tax administration and compliance efforts. On average, LTOs have accounted for around 70 percent of federal tax revenues over the past five years, while MTOs and small taxpayer offices have contributed approximately 15 percent each. Collections are largely driven by state-owned enterprises (SOEs), which, on average, have accounted for approximately 45 percent of total LTO tax collections. This distribution underscores the continued importance of SOEs in Ethiopia's tax base, while the private sector's contribution has grown over time.

9. Tax revenues in Ethiopia are distributed across direct, indirect, and trade-related categories, reflecting the country's tax structure and jurisdictional divisions. As shown in Figure 2, top right—where the category colors align with those in the bar chart of Figure 2, bottom panel —on average, business profit taxes (1.7 percent of GDP) and personal income taxes (1.4 percent of GDP) account for the largest share of revenues. Import-related taxes, including customs duties (0.8 percent of GDP), VAT on imports (0.8 percent of GDP), and the surtax on imports (0.3 percent of GDP), represent a significant portion of trade-related revenues. Domestic consumption taxes include VAT (1.2 percent of GDP) and excise duties (0.4 percent of GDP).

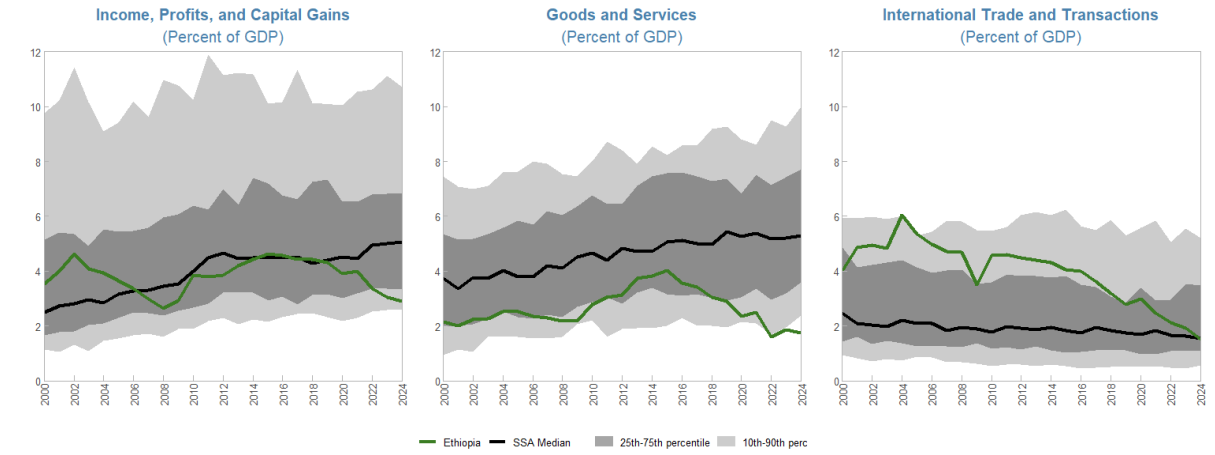
Figure 2. Ethiopia and Sub-Saharan African Countries: Tax Structure



Source: WEO database and Ministry of Finance. IMF Staff Calculations.

10. Unlike most SSA economies, Ethiopia has not seen a structural increase in income and consumption taxes, despite experiencing a relatively fast pace of urbanization. Across most economies, income and goods and services taxes have generally increased as economies urbanized and formalized. Ethiopia, while still having one of the lowest urbanization rates in the region, has been urbanizing at a faster pace than the SSA average, though it remains well below the regional median (Figure 4, left). However, this shift has not translated into higher tax collection. Until 2019, tax revenues from income, profits, and capital gains remained near the SSA median but have since declined, diverging from regional trends. While the SSA median increased to 5 percent of GDP, Ethiopia's income tax revenue fell to 2.9 percent of GDP in 2024 (Figure 3, left). Similarly, Ethiopia's revenue from goods and services taxes has been consistently weak, hovering around the 25th percentile between 2000–19 before falling below the 10th percentile in 2024 (Figure 3, middle).

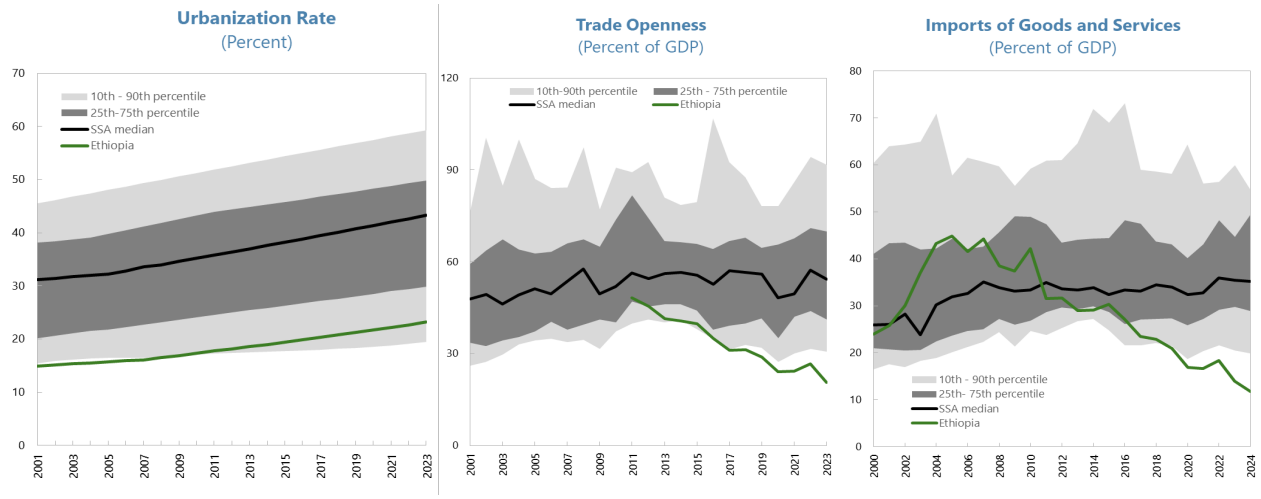
Figure 3. Ethiopia and Sub-Saharan African Countries: General Government Taxes



Source: WEO database. IMF Staff Calculations

11. Taxes on international trade and transactions have seen a sharp and sustained decline, mirroring Ethiopia's shrinking trade openness rather than changes in tax policy or enforcement efficiency. Trade-related tax revenues peaked at 6 percent of GDP in 2005, placing Ethiopia above the 90th percentile in SSA. However, this share has since declined to 1.5 percent of GDP in 2024—slightly below the SSA median reflecting the sharp contraction in trade openness (Figure 3, right and Figure 4, middle). This downward trend shows Ethiopia's structural shift in external trade dynamics, driven by a significant reduction in imports. Ethiopia's import-to-GDP ratio, which was above the 75th percentile in SSA between 2005–07, has fallen dramatically to below the 10th percentile by 2024 (Figure 4, right). Yet, trade tax revenues have declined less proportionally, suggesting a relatively strong collection performance in this category despite the shrinking trade base.

Figure 4. Ethiopia and Sub-Saharan African Countries: Selected Indicators



Source: WEO and WDI databases. IMF Staff Calculations.
Notes: Urbanization rate measures the share of population living in urban areas. Trade openness measures total trade (Exports plus imports) as a share of GDP

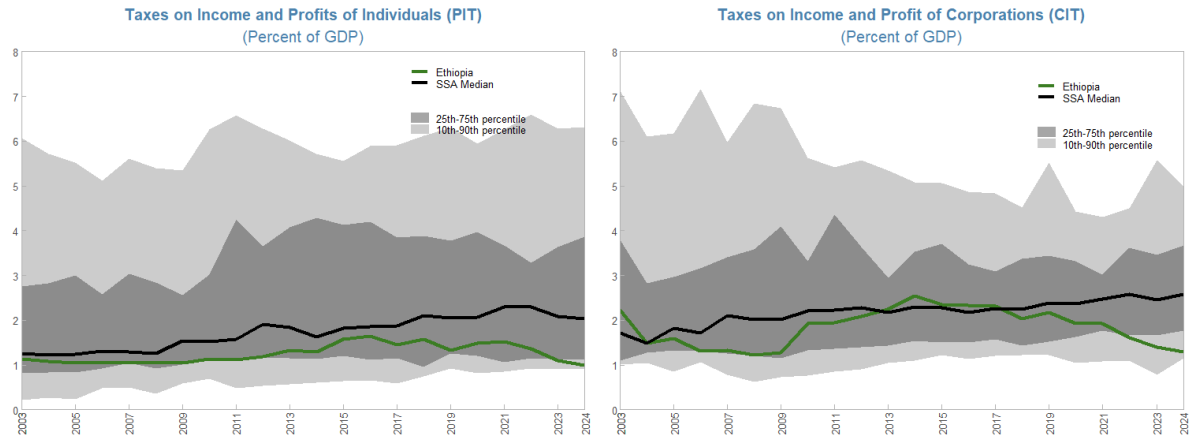
C. Tax Policy and Revenue Performance

12. Ethiopia's tax system comprises three major revenue sources—personal income tax (PIT), corporate income tax (CIT), and value-added tax (VAT)—with notable gaps in efficiency and collection. Despite having statutory tax rates comparable to regional peers, Ethiopia's revenue mobilization from these taxes remains among the lowest in SSA. The analysis of PIT, CIT, and VAT highlights structural inefficiencies, compliance challenges, and policy gaps that constrain tax revenue performance.

Personal Income Tax (PIT)

13. Average personal income tax (PIT) rates in Ethiopia are near the regional median, but revenue collection remains among the lowest percentiles. The PIT system features a progressive rate structure, with rates ranging from 10 to 35 percent (excluding exemptions), positioning it close to the median of low-income SSA economies (Figure 6, left). Despite this, PIT revenue as a share of GDP falls in the 25th percentile among low-income SSA countries, indicating a significant gap between tax policy design and actual revenue outcomes (Figure 5, left; Figure 6, top right).

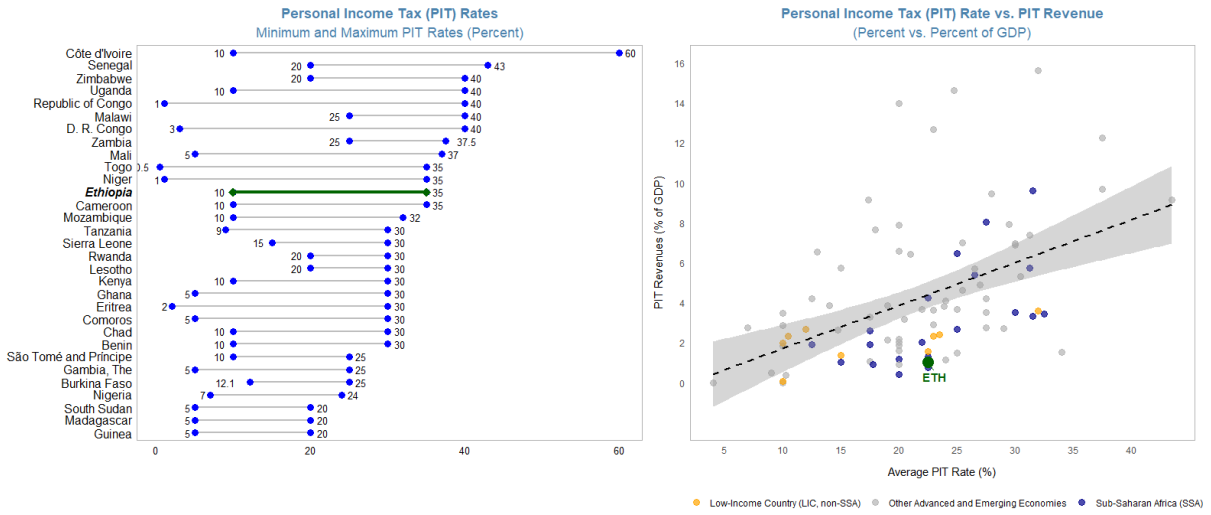
Figure 5. Ethiopia and Sub-Saharan African Countries: PIT and CIT Tax Revenues



Source: WEO database. IMF Staff Calculations

14. This revenue underperformance may in part reflect distributional issues within the PIT design. The threshold for the zero rate is low, and the top marginal rate applies at relatively modest income levels. As a result, a large share of formal wages is taxed at the highest rate, which may undermine perceptions of fairness and weaken incentives for compliance. In turn, this perceived inequity—combined with high effective tax rates at low-income levels—may discourage formalization, pushing firms and workers to remain in the informal sector and further eroding the tax base.

Figure 6. Ethiopia and Sub-Saharan African Countries: Personal Income Tax (PIT)

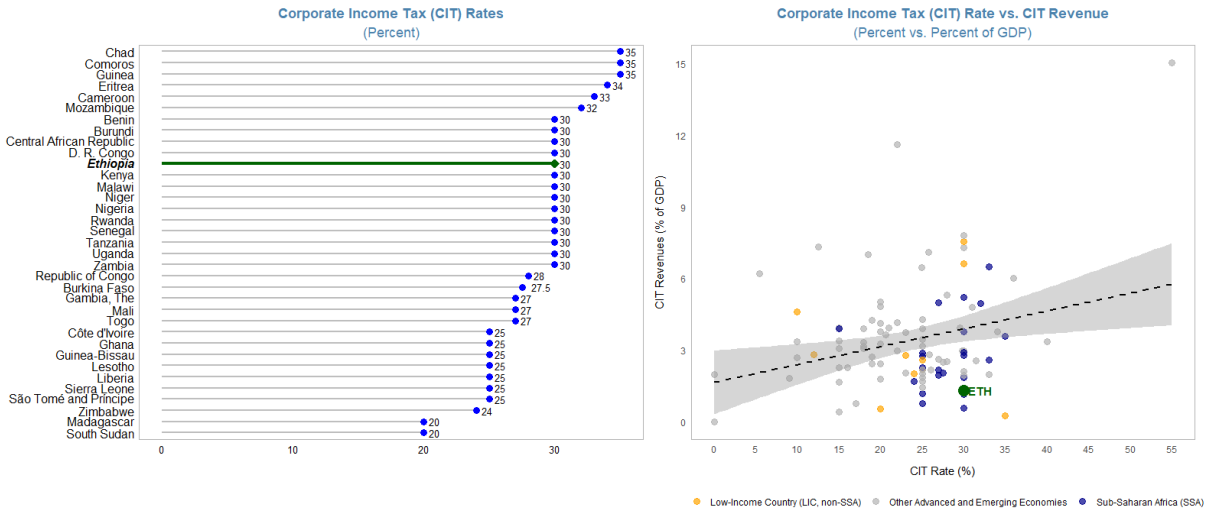


Sources: E&Y, KPMG, PwC, IBFD. WEO and WoRLD databases. IMF Staff Calculations
Notes: (1) The lower bound in the left chart represents the lowest non-zero statutory rate, excluding the exempted bracket. (2) The average PIT rate in the right chart is calculated as the mean of the top statutory rate and the lowest non-zero rate.

Corporate Income Tax (CIT)

15. The corporate income tax (CIT) rate is above the SSA low-income countries (LICs) median and on par with its closest geographic neighbors, but revenues remain weak. At 30 percent, Ethiopia's CIT rate is higher than the median for low-income SSA economies (Figure 7, left). However, actual CIT revenue collection is among the lowest in the region, placing Ethiopia between the 10th and 25th percentile (Figure 5, right). This indicates a substantial gap between statutory rates and realized revenues (Figure 7, right).

Figure 7. Ethiopia and Sub-Saharan African Countries: Corporate Income Tax (CIT)

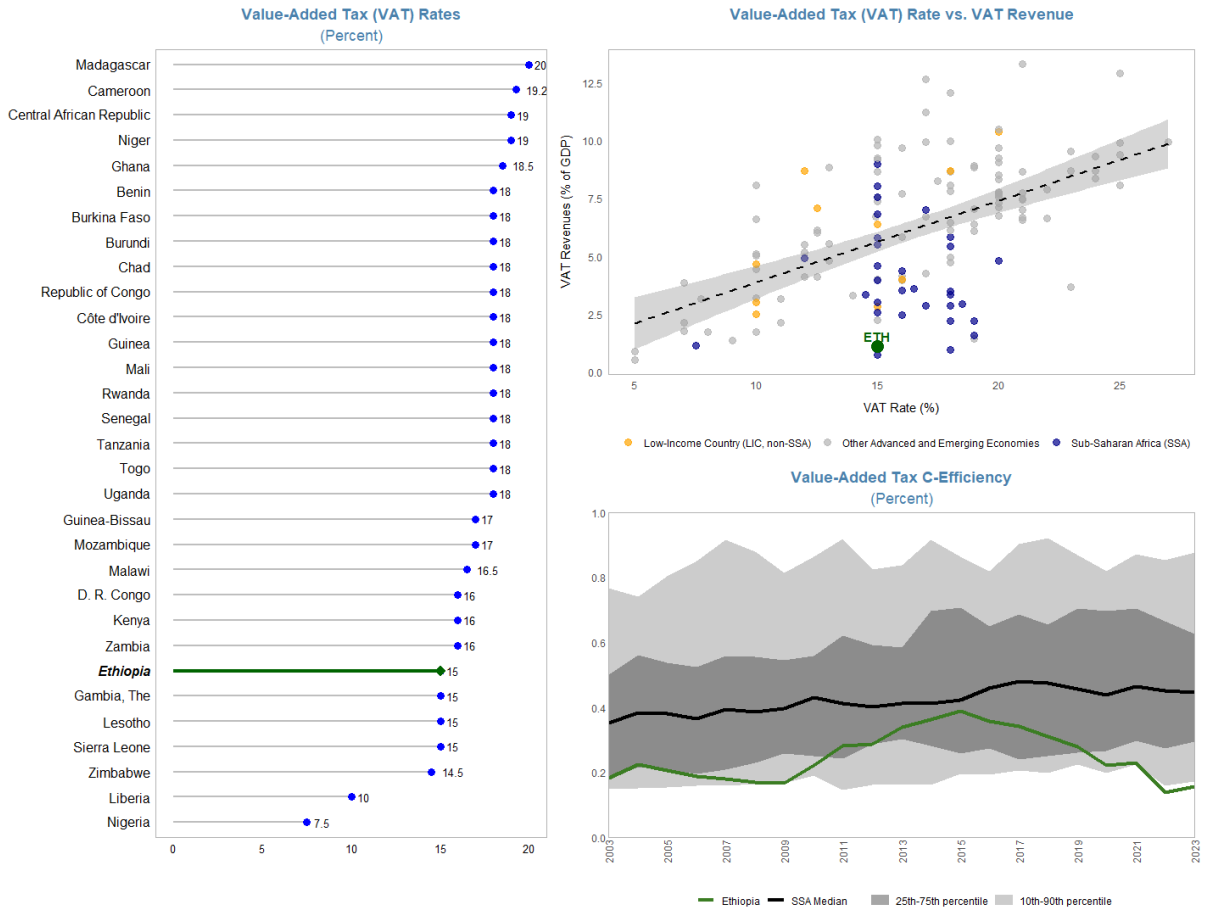


Sources: E&Y, KPMG, PwC, IBFD. WEO and WoRLD databases. IMF Staff Calculations
Note: The values in the left chart represent the top statutory CIT rate.

Value-Added Tax (VAT)

16. Value-added tax (VAT) rate is among the lowest in SSA low-income countries, with revenue collection significantly below peers. The standard VAT rate of 15 percent places Ethiopia near the lower end of SSA's low-income economies (Figure 8, left). Moreover, even among countries applying a similar VAT rate, Ethiopia collects substantially less VAT revenue as a share of GDP, suggesting underperformance in VAT administration and compliance (Figure 8, top right).

Figure 8. Ethiopia and Sub-Saharan African Countries: Value Added Tax (VAT)



Sources: E&Y, KPMG, PwC, IBFD. WEO and WoRLD databases. IMF Staff Calculations
Notes: (1) The values in the left chart represent the top statutory VAT rate. Other consumption taxes were excluded from the comparison. (2) The VAT revenue of top right chart is based on general sales taxes as a proxy for VAT collection. (3) VAT C-efficiency = VAT revenue / (VAT rate × private consumption).

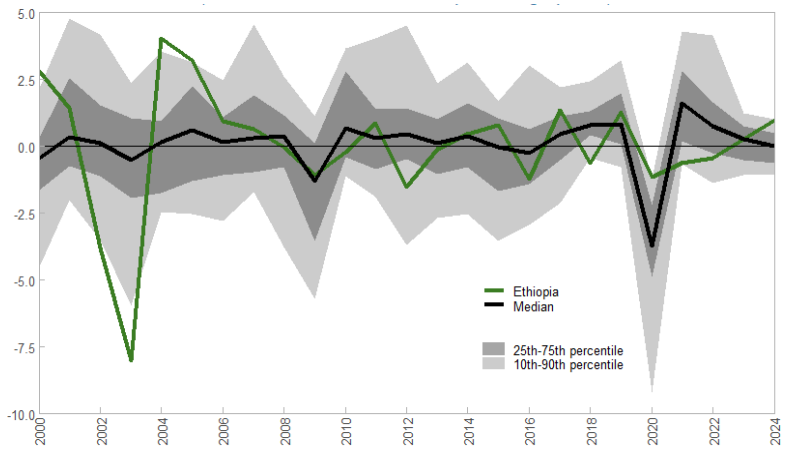
17. VAT efficiency has historically been low, with a declining trend in recent years. The VAT C-efficiency ratio — which measures how effectively VAT revenue is collected relative to the standard VAT rate and the potential tax base — has consistently ranked among the lowest in Sub-Saharan Africa (SSA), fluctuating around the 25th percentile. From 2010 to 2015, efficiency improved, nearing the SSA median, but it has since declined steadily and currently stands near the 10th percentile (Figure 8, bottom right). Changes in VAT revenue as a share of GDP can be

attributed to three factors: adjustments in the standard VAT rate, shifts in the share of private consumption in GDP, and variations in the C-efficiency ratio itself. The persistent weakness in Ethiopia's C-efficiency suggests significant revenue leakage, likely driven by policy gaps (such as exemptions), compliance challenges, widespread informality, and weak enforcement mechanisms.

D. Tax Revenue Elasticities and the Business Cycle

18. Ethiopia's output gap turned positive in 2023 after years of economic disruptions, with implications for tax revenue performance.[1] The economy faced significant shocks, including the COVID-19 pandemic and internal conflicts, which constrained growth and weighed on tax collections (Figure 9). As economic activity recovers, the responsiveness of different tax categories to the business cycle—measured by their elasticity to the output gap—offers insights into the country's tax revenue system.

Figure 9. Ethiopia and Sub-Saharan African Countries: Output Gap
(Deviation from trend GDP, in percentage points)



Source: WEO database. IMF Staff Calculations.
Note: Output gap computed using Hodrick-Prescott filter.

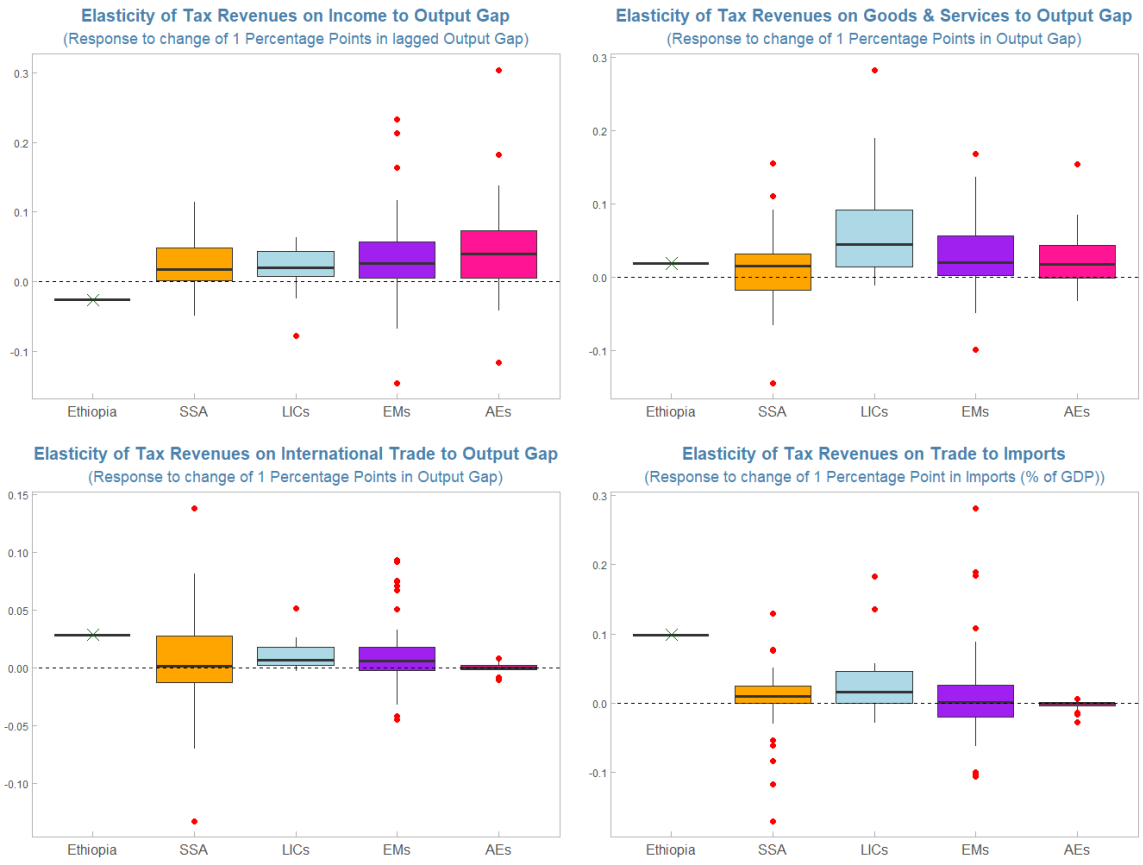
19. Personal and corporate income tax revenues exhibit weak responsiveness to economic fluctuations, diverging from other country groups. In most economies, income and profit taxes are procyclical, meaning they increase as economic activity expands. However, Ethiopia's elasticity of tax revenues from income, profits, and capital gains is negative, although not statistically significantly different from zero (Figure 10, top left). This contrasts with all benchmark country groups, where income tax elasticity is generally positive. This matters especially for Ethiopia, where strong economic growth in recent years has not translated into commensurate income tax revenues, highlighting missed fiscal dividends that a more responsive tax system could have captured without the need to raise rates.

20. Consumption taxes exhibit a positive correlation with the business cycle, yet Ethiopia's collections on goods and services remain below potential. The elasticity of tax revenues on goods and services to the output gap is broadly in line with other country averages (Figure 10, top

[1] The output gap is measured as the deviation from the short-term trend, using the univariate Hodrick-Prescott (HP) filter. While various methodologies exist for estimating the output gap—including univariate filters, multivariate approaches, and structural models—the HP filter was selected in this case due to its flexibility and consistent applicability across a wide range of countries, facilitating homogeneous comparisons between different economies.

right), indicating that these revenues tend to rise during economic expansions. However, despite this positive correlation, Ethiopia's VAT and excise tax collections remain structurally low, as highlighted in previous sections. The limited revenue mobilization potential of consumption taxes may be attributed to policy choices, including exemptions, compliance challenges, and high informality.

Figure 10. Ethiopia and Other Economies: Estimated Elasticities of Tax Revenues to Business Cycles



Source: WEO database. IMF Staff Calculations.
Note: Boxplots show estimated elasticities of tax revenues to economic indicators using OLS regression. The boxes represent the interquartile range, whiskers extend to 1.5 times the IQR, and red dots indicate outliers. Ethiopia's estimates are marked with a green cross.

21. International trade-related tax revenues are the most responsive to economic activity but have declined due to Ethiopia's shrinking trade openness. Tax revenues from international trade and transactions exhibit the highest elasticity to both the output gap and import fluctuations (Figure 10, bottom) exceeding that of other country groups. This strong correlation confirms that trade taxes have historically been an important and efficient revenue source. It also highlights the country's effectiveness in collecting these revenues, as Ethiopia continues to generate above-median trade tax revenues despite having one of the lowest levels of trade openness among SSA countries.

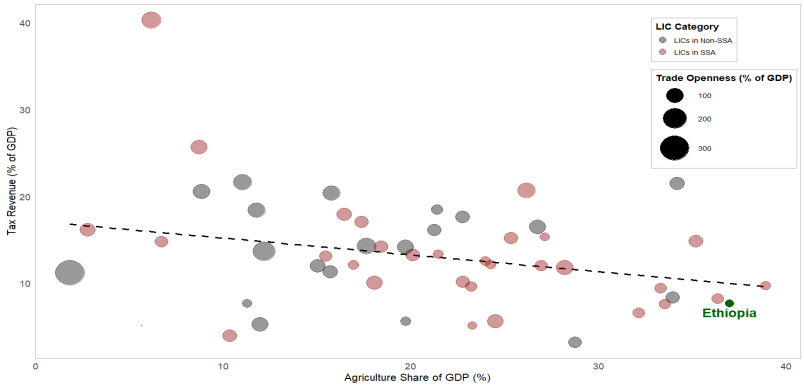
22. Improving tax responsiveness and efficiency is critical to strengthening Ethiopia's revenue mobilization capacity. Ethiopia's tax system exhibits uneven responsiveness to economic fluctuations, with trade and consumption taxes displaying high cyclicality, while income taxes remain structurally constrained. Enhancing revenue performance also requires strengthening the country's ability to mobilize revenues more effectively across different phases of the business cycle.

E. Revenue Potential and Tax Gaps

23. Ethiopia's tax revenue collections remain well below their estimated potential, highlighting scope for improving revenue mobilization. Differences in tax mobilization across countries reflect structural economic characteristics and institutional settings. One approach to assessing Ethiopia's revenue potential is to compare its tax-to-GDP ratio with that of countries with similar economic and institutional characteristics. This allows for the estimation of a tax frontier—representing the highest level of tax revenue a country can achieve given its macroeconomic and institutional conditions. The gap between Ethiopia's actual tax collection and this estimated tax frontier defines the tax gap, which represents additional revenues that could be mobilized through improvements in tax efficiency and policy measures.

24. Structural economic factors, including Ethiopia's large agricultural sector and low trade openness, constrain its tax revenue potential. Countries with a high share of agriculture in GDP typically experience lower tax collection due to the sector's informality, fragmented production, and difficulty in enforcement (Fenochietto and Pessino, 2013). Ethiopia has one of the highest agricultural shares of GDP among low-income SSA economies with presence of many small producers, which limits its taxable base. Similarly, trade openness is positively correlated with tax revenues, as economies with greater trade flows tend to generate higher customs duties, VAT on imports, and excise revenues (Cevik et al. 2019 and Bacchetta et al. 2021). However, Ethiopia's trade openness is among the lowest in SSA, further restricting tax capacity (Figure 11). While Ethiopia collects trade taxes relatively efficiently compared to the size of its trade sector, the limited volume of imports and exports constrains the overall contribution of trade taxes to total revenue.

Figure 11. Ethiopia and Low-Income Countries (LICs): Trade Openness, Agriculture, and Tax Revenue

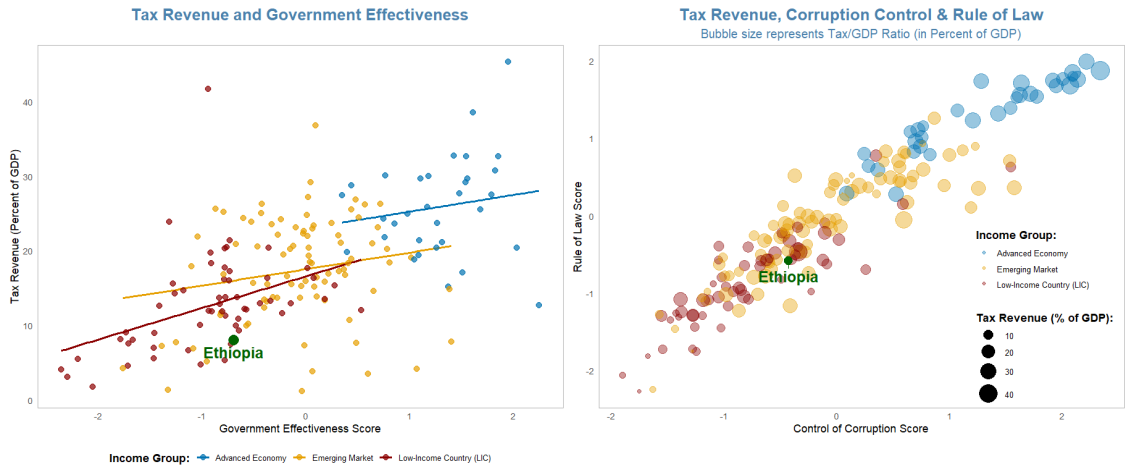


Source: WEO and WDI databases. IMF Staff calculations
Note: Bubble size represents Trade Openness (Percent of GDP), dashed line shows trend.

25. Institutional quality and governance effectiveness play a critical role in tax mobilization, with Ethiopia performing above LIC averages but below emerging and advanced economies. International evidence suggests that better governance, stronger rule of

law, and reduced corruption are associated with higher tax revenues. Ethiopia ranks above the LIC average in government effectiveness and corruption control indicators but remains significantly below emerging and advanced economies (Figure 12). Enhancing governance and public sector efficiency could strengthen tax compliance, enforcement, and overall revenue performance (Cevik et al. 2019 and Baum et al. 2017).

Figure 12. Ethiopia and Income Groups: Selected Indicators, 2020–23



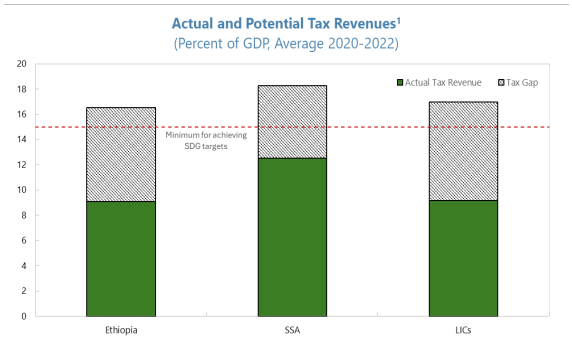
Source: WEO and WDI databases. IMF Staff calculations

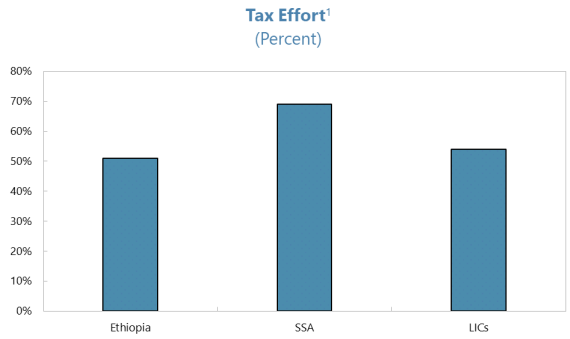
26. Econometric estimates suggest that Ethiopia's tax revenue potential exceeds current collections by a substantial margin. The results from the Stochastic Frontier Analysis model (Box 1) indicate that Ethiopia could achieve a tax-to-GDP ratio of about 17 percent, well above the average level of approximately 8 percent, implying a tax gap of around 9 percentage points of GDP (Figure 13, left). This gap suggests significant room for improving tax collection through better efficiency in administration and compliance.

27. Meeting the minimum tax-to-GDP threshold is essential for sustainable growth. Previous IMF research identifies a 15 percent tax-to-GDP benchmark as a critical threshold for accelerating growth and development (Gaspar et al., 2016). Ethiopia's average tax-to-GDP ratio of about 8 percent remains well below this level (Figure 13, left), constraining its capacity to finance essential services and achieve the Sustainable Development Goals (SDGs). Closing this gap is vital for enhancing fiscal sustainability and supporting long-term economic progress.

28. Tax effort remains low and broadly aligned with regional peers, highlighting substantial untapped revenue potential in both Sub-Saharan Africa and low-income countries. Tax effort, defined as the ratio of actual to potential tax revenue, provides a measure of the efficiency and intensity of revenue collection relative to a country's capacity. Ethiopia's tax effort is estimated at 51 percent, broadly in line with the LIC average but below the SSA average (Figure 13, right). This suggests that Ethiopia is collecting only about half of its potential tax revenues, underscoring the importance of both policy and administrative reforms to strengthen domestic revenue mobilization.

Figure 13. Ethiopia and Peers: Tax Revenue Potential and Tax Effort, 2022





1/Peer group values represent weighted averages using GDP in USD (WEO) as weights for each year (2020-22)

1/ Calculated as Actual Tax Revenue / (Actual Revenue + Tax Gap)

Source: WEO, WoRLD, WDI, and VDEM databases. IMF Staff Calculations.

Box 1. Stochastic Frontier Analysis: Estimating Ethiopia's Tax Potential

Stochastic Frontier Analysis (SFA) is used to estimate Ethiopia's tax potential by modeling the relationship between tax revenue and structural determinants while accounting for inefficiencies in collection. Unlike traditional regression models, which assume symmetrical deviations from predicted values, SFA assumes that deviations from the tax frontier are one-sided, meaning that countries only underperform due to tax policy and administrative inefficiencies (Benitez et al., 2023; IMF, 2022). The estimated equation follows:

$$ln(y_{it}) = \alpha_i + \sum \beta ln\,(x_{it}) + v_{it} - u_{it}$$

In this model, y_{it} represents the tax-to-GDP ratio for country i in year t. The explanatory variables, x_{it} include key structural determinants such as GDP per capita, GDP per capita squared, the share of agriculture in GDP, trade openness, and governance indicators, including corruption control and government effectiveness. The u_{it} represents tax inefficiencies, modeled as a one-sided truncated normal distribution, reflecting deviations from the estimated tax frontier due to weaknesses in tax policy and administration, while term v_{it} captures random shocks to tax collection, assumed to be normally distributed and independent of the inefficiency.

The efficiency score, which measures how effectively tax revenues are mobilized given structural determinants, is estimated as:

$$Efficiency_{it} = exp\,(-u_{it})$$

$Efficiency_{it}$ score approximates tax effort - the extent to which a country collects taxes relative to its estimated potential. The estimation method in this paper uses time-varying true fixed effects model (Greene, 2008) that accounts for country level unobserved heterogeneities, as captured by α_i in the first equation. Finally, the tax potential is computed as:

$$Tax\ Potential = y_{it} / \exp(-u_{it}), \text{ where,}$$

the tax gap is defined as the difference between estimated tax potential and actual tax revenue. The tax effort can also be defined as the ratio between the estimated tax potential and the actual tax revenue level.

The data used to estimate the stochastic frontier model are collected from the WEO, WoRLD, VDEM, and WDI databases. These data cover the period 1990–2022 and include 191 countries.

F. Policy Actions and Revenue Mobilization Under the ECF-Supported Program

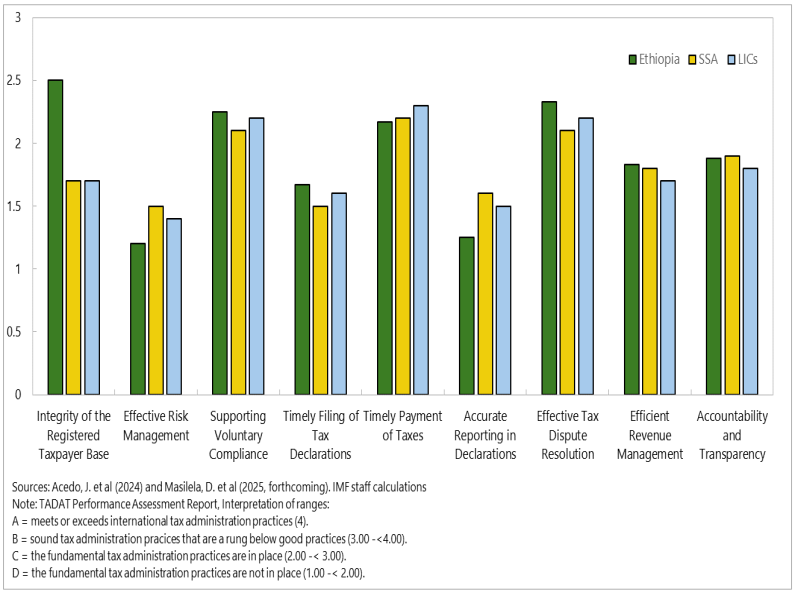
29. The Ethiopian authorities are implementing ambitious reforms to address macroeconomic imbalances and enhance revenue mobilization. The Homegrown Economic Reform Agenda (HGER), supported by the IMF Extended Credit Facility (ECF) program approved in July 2024, aims to strengthen fiscal sustainability and promote economic stability. A key pillar of the fiscal strategy is the National Medium-Term Revenue Strategy (NMTRS), which provides a comprehensive framework for improving tax policy and administration.

30. Recent tax policy measures are designed to broaden the tax base and enhance compliance. The NMTRS prioritizes reforms in VAT, excise, corporate income tax, presumptive income taxes, and property taxation. Notably, the new VAT Proclamation, approved in July 2024, introduces significant changes, including reducing exemptions, limiting zero-rating to exports, expanding voluntary registration, and clarifying federal and regional tax mandates. Additionally, revised excise duties on alcohol and tobacco, alongside stricter enforcement of the excise stamp regime, are expected to boost domestic revenue. Import duty collections have also strengthened following adjustments to align customs declarations with daily exchange rate fluctuations.

31. Ethiopia has made significant progress in tax administration, closing gaps with peer countries, though further improvements are needed to align with international best practices. The 2024 TADAT assessment reflects a marked improvement over the 2016 evaluation, when Ethiopia received predominantly very low scores. Ethiopia has now narrowed gaps across various tax administration performance areas and is more aligned with peer countries, even surpassing them in some evaluated metrics. The latest assessment shows notable advancements in key areas such as dispute resolution, taxpayer registration, and voluntary compliance. These gains underscore the impact of recent investments in revenue administration. Nonetheless, despite this progress, Ethiopia still falls short of international top standards in some areas, particularly in accurate reporting and risk management, signaling the need for continued reforms (Figure 14).

Figure 14. Ethiopia: Tax Administration Performance Comparison

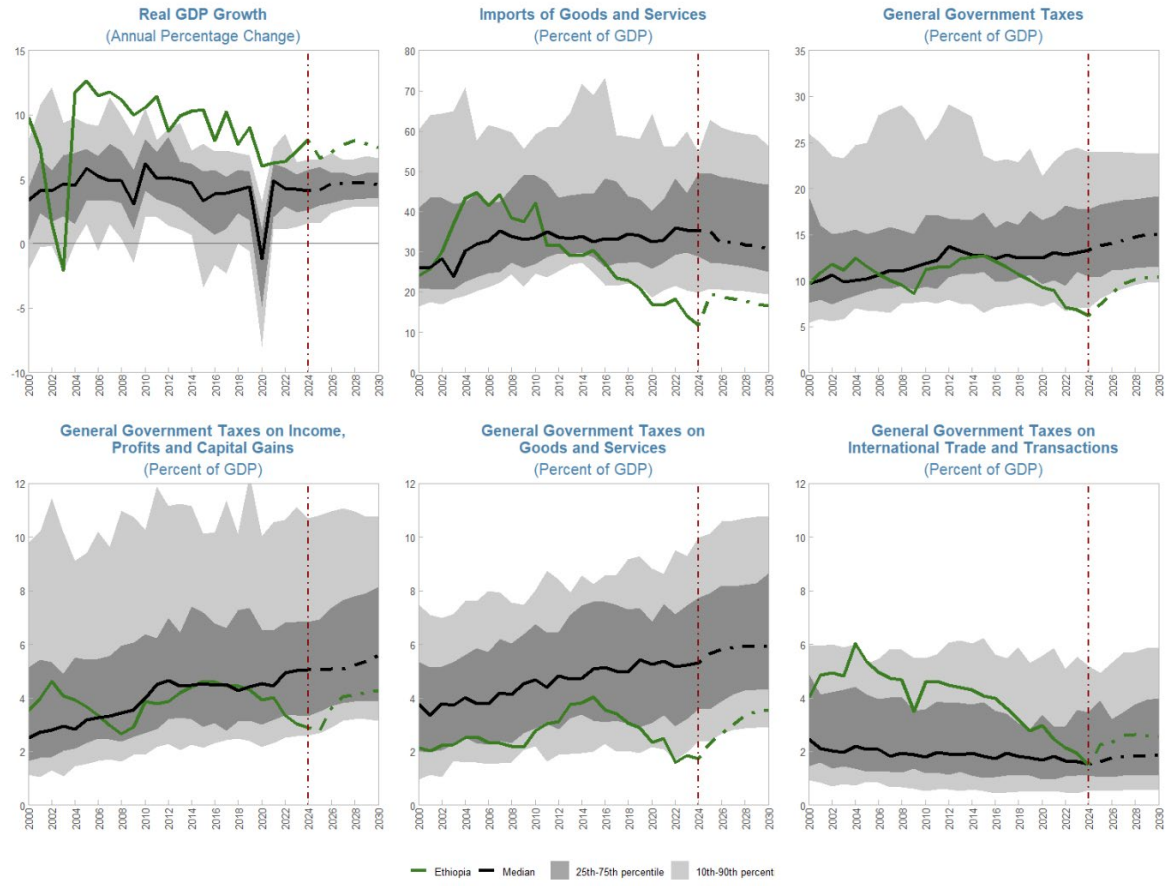
(Average aggregated scores by Performance Outcome Area)



Sources: Acedo, J. et al (2024) and Masilela, D. et al (2025, forthcoming). IMF staff calculations
Note: TADAT Performance Assessment Report, Interpretation of ranges:
A = meets or exceeds international tax administration practices (4).
B = sound tax administration pracices that are a rung below good practices (3.00 -<4.00).
C = the fundamental tax administration practices are in place (2.00 -< 3.00).
D = the fundamental tax administration practices are not in place (1.00 -< 2.00).

32. Despite ongoing reforms, Ethiopia's revenue projections indicate a gradual recovery but remain below the tax-to-GDP threshold for sustainable development. Projections suggest increases across all major tax categories, supported by policy measures and administrative improvements. However, total tax revenue is expected to remain below the 15 percent tax-to-GDP benchmark identified as necessary to support long-term economic growth and achieve the Sustainable Development Goals (SDGs) (Figure 15). Further policy and institutional enhancements will be required to sustain revenue mobilization efforts and reach this critical threshold.

Figure 15. Ethiopia and Sub-Saharan African Countries: Selected Indicators Projections



Source: WEO database. IMF Staff Calculations

G. Conclusion

33. Ethiopia's tax revenue performance remains below its potential, with the tax-to-GDP ratio among the lowest in Sub-Saharan Africa. Despite having statutory tax rates broadly aligned with regional peers, actual revenue collection is constrained by structural factors, including a narrow tax base, high informality, and administrative challenges, including those linked to the distinct features of Ethiopia's intergovernmental tax system. Compared to similar economies, Ethiopia's tax effort is among the lowest, indicating considerable scope to enhance revenue mobilization through improved efficiency and policy adjustments.

34. A closer comparison with peer countries highlights key areas for improvement. While income and profit tax rates are relatively high, their contribution to total revenue remains limited, reflecting challenges and need to reform. VAT revenues, though a crucial source of indirect taxation, are significantly lower than in peer economies, pointing to administrative inefficiencies and exemptions that narrow the tax base. Trade taxes, historically an important revenue stream, have declined as Ethiopia's trade openness has contracted, further underscoring the need for policies that support a more robust and diversified tax system.

35. The authorities are implementing a revenue-led strategy guided by the NMTRS, aiming to restore long-term fiscal stability. A National Tax Reform Taskforce has been established to steer this agenda and ensure comprehensive implementation and monitoring of both tax policy and tax administration reforms, including reflecting the findings of the recent TADAT assessment. These efforts seek not only to boost revenue but also to improve fairness, transparency, and efficiency across the system. The authorities will continue to rely on technical assistance from the IMF, World Bank, and other development partners to support the design and effective implementation of these reforms.

36. Addressing these challenges will require a combination of tax policy refinements and strengthened administration. Broadening the tax base, formalizing the economy, improving compliance, and enhancing governance will be essential to aligning Ethiopia's revenue performance with its economic potential. A well-functioning tax system is critical for long-term fiscal sustainability and economic development, ensuring the necessary resources to support infrastructure, social programs, and inclusive and sustainable growth.

Annex I. Stochastic Frontier Model

Stochastic Frontier Model Estimation Results
TRE with Half-Normal Inefficiency

	Tax Revenue
GDP per capita	2.060***
	(0.368)
GDP per capita sq.	-0.103***
	(0.021)
Agriculture share in GDP	-0.087***
	(0.032)
Trade share in GDP	0.102***
	(0.031)
Public Sector Corruption	-0.032***
	(0.011)
Constant	-16.885***
	(1.476)
Usigma	-0.776**
	(0.330)
Vsigma	-4.838***
	(0.715)
Theta	1.102***
	(0.033)
Obs.	3025.000
Log-Likelihood	943.828
AIC	-1881.657
BIC	-1863.613

Standard errors in parentheses
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

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