

Budget Brief



A Synopsis Analysis of 2006-2016 National Trends and the 2017/2018 Federal Budget Proclamation

Key Messages

- **Robust growth:** The economy continues to grow at a strong pace despite a drought related slowdown in 2015/16.
- **Vulnerability to climate change:** Ethiopia is regularly exposed to droughts that threaten the livelihood of millions.
- **Potential demographic dividend:** With 49.9 per cent of the 94.4 million population under 18, and a child monetary poverty rate of 32.4 per cent, there is increasing demand for investments in children and key social services to ensure a healthy, skilled and productive labour force that can meet the ambitious targets of the Growth and Transformation Plan and SDGs.
- **Domestic financing can be improved:** Considering on-budget resources, total Government revenue as a per cent of GDP was 17 per cent in 2015/16 with no improvement in the past few years. Domestic resources make up 86.6 per cent of this national budget while the rest was financed by external resources. More than 82 per cent of domestic resources in 2015/16 have been collected in the form of tax revenue. However, the low tax to GDP ratio of 12.5 per cent in 2015/16 warrants expanding the fiscal space to utilize the growing availability of domestic resources to achieve dependable sources of domestic financing for inclusive and sustainable growth.
- **Reorientation of national expenditure:** Amidst a decentralized fiscal system, two major shifts in the national expenditure patterns have been observed in the last decade with a reallocation of national expenditure from federal to sub-national regional governments, and from recurrent to capital spending.
- **Expenditure aligned to pro-poor sectors:** The Government has leveraged huge resources to boost spending in pro-poor sectors out of which 24.2 per cent and 8.6 per cent of the national expenditure in 2015/16 was spent on education and health respectively.
- **A shift from off-budget to on-budget support of the social sectors is required:** Not all external funding is captured in the national budget with significant resources directed through off-budget channels making it difficult to track how much is actually being spent on the social sectors such as education, health, social welfare, WASH, etc.
- **Budget transparency can be improved:** Better public dissemination of budget information is required to enhance social accountability.

This budget brief is one of four and analyses budget and expenditure that are recorded on-budget by the Federal Ministry of Finance and Economic Cooperation (MoFEC) and its affiliated sub-national level Bureaus of Finance and Economic Cooperation (BoFEC) and district level Woreda Offices of Finance and Economic Cooperation (WoFEC). Audited financial accounts are presented for the years up to 2013/2014 while preliminary financial accounts have been made available for the 2014/2015 and 2015/2016 fiscal years. The highlights of the federal Government's budget proclamation for the 2017-2018 fiscal year are also presented. The main objective is to synthesize complex budget information so that it is easily understood by stakeholders, and to put forth key messages to inform policy and financial decision-making processes.

Key Indicators

- Total population (2017, CSA, projection): 94.4 million
- Population growth rate (EDHS 2011, CSA): 2.6 per cent
- Child population below 18 years of age (2017, CSA, projection): 49.9 per cent
- GDP per capita (2015/16, NPC): US\$794
- Monetary poverty rate (2017, NPC): 23.5 per cent
- Monetary child poverty rate (2010/11 HCES/WMS, CSA): 32.4 per cent
- Rank on Human Development Index (2015, UNDP): 173/186
- Total national expenditure (2015/16, MoFEC): ETB 280.9 billion
- Total national expenditure to GDP ratio (2015/16, MoFEC): 18.4 per cent
- Tax to GDP ratio (2015/16, MoFEC): 12.5 per cent
- Budget deficit (per cent of GDP) (2015/16, MoFEC): -1.8 per cent
- Public debt to GDP ratio (2015/16, IMF): 54.2 per cent
- General inflation rate (2015/16, MoFEC): 9.7 per cent
- Food inflation rate (December 2016, CSA): 5.3 per cent

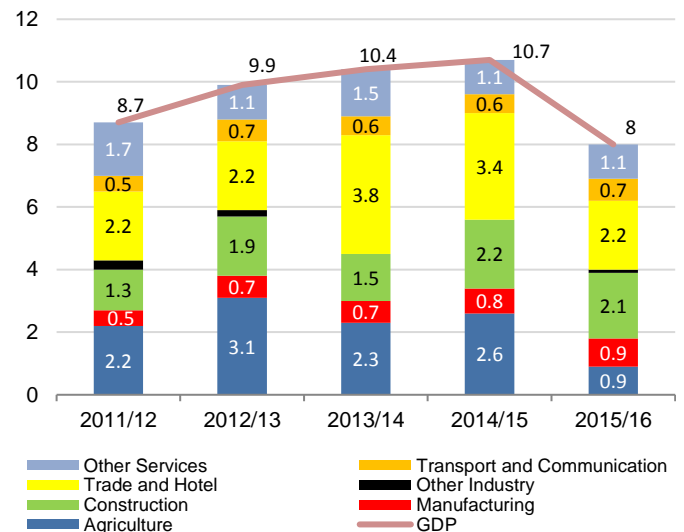
1. Overview of Recent Developments and Prospects

Ethiopia is Africa's second most populous country and has registered fast and broad-based economic growth for the last decade which has provided momentum for accelerated economic development. GDP per capita reached an all-time high of US\$794 in 2015/16 which is a three-fold increase from the 2006/07 level of US\$262 per capita. Economic growth has remained robust, and real GDP grew by 8.0 per cent in 2015/16, some 2.7 percentage points lower than a year before, mainly due to two exogenous shocks – drought caused by El Niño and a slow recovery of the global economy. **Overall growth has been driven by a rapid expansion of public infrastructure and basic services.** According to the 2016 African Economic Outlook¹, the agriculture, services and industry sectors accounted for 38.8 per cent, 46.6 per cent and 15.2 per cent of real GDP respectively in 2014/15.

The growth momentum was however challenged by high inflation, largely fuelled by food inflation (annex – figure A). Fiscal policy has curbed the inflationary pressure by reducing the government budget deficit and including measures such as refraining from financing the budget deficit through direct advance borrowing from the Central Bank. As a result, the share of the budget deficit in GDP has reduced from 3.7 per cent in 2006/07 to 1.8 per cent in 2015/16 (annex – figure B). Financial resources

have been allocated from the government's budget to import and distribute basic food items (such as wheat, edible oil and sugar) at subsidized prices to poor households. Value-added taxes, turnover taxes, and surtaxes were also removed on most food items. Thus, lowering budget deficits coupled with targeted budget subsidies have contributed to attaining single digit inflation in recent years. General inflation at 5.6 per cent in October 2016 is remarkably low in spite of facing the current drought. Regardless, the challenge lies in simultaneously sustaining low inflation and high growth rates amidst changes in the financing landscape with declining ODA budget shares.

Figure 1: Real GDP Growth (per cent)



Source: Data from the National Planning Commission (NPC).

Ethiopia is one of the 10 countries globally that has attained the largest absolute gains in its Human Development Index (HDI) over the last few years. **Ethiopia's strong growth has helped to achieve social gains across sectors and halved poverty over the past decade.** The incidence of poverty declined to 23.5 per cent in 2015/16 from 38.7 per cent in 2004/05². The sharp decline in poverty is partly attributable to the implementation of welfare or social protection programs such as the Productive Safety Net Programme (PSNP) as well as urban food distribution and subsidies³. The PSNP, one of the largest safety net programs in Africa, currently covers almost 8 million households⁴. **Despite the reduction in the poverty gap, food poverty is high with a large share of household spending going to food⁵. Thus, food security is a concern that remains on top of the national agenda.** The incidence and severity of child poverty is also still high in the country. According to poverty estimates based on the 2011

¹ African Development Bank. The 2016 African Economic Outlook (AEO), Ethiopia Country Note.

²National Planning Commission. September 2017. Ethiopia's Progress towards Eradicating Poverty: an Interim Report on 2015/16 Poverty Analysis Study.

³African Development Bank. The 2016 African Economic Outlook (AEO), Ethiopia Country Note.

⁴PSNP Donor Working Group. 30 April 2017. Food Security Coordination Directorate IC Report.

⁵The World Bank. 2014. Ethiopia Poverty Assessment. Report No. AUS6744.

Household Consumption and Expenditure Survey (HCES) and the Welfare Monitoring Survey (WMS), the poverty headcount for children was 32.4⁶ per cent, compared to 29.6⁷ per cent for the whole population, whereas the extreme poverty headcount was 5.2 per cent for children, compared to 4.5 per cent for the entire population. This represents 13 and 2 million children, respectively.

Moreover, despite the substantial results achieved over the past decade, significant headwinds to growth and socio-economic transformation remain. **According to the 2014 World Risk Report, Ethiopia is subject to increased vulnerability to climate changes, and it is one of the countries with the highest lack of adaptive capabilities worldwide.** Drought represents the main natural threat which affects a significant proportion of the population each time it strikes. In 2015/16, for example, drought exacerbated by El Niño, combined with extensive flooding, disease outbreaks and the disruption of basic public services, continued to have adverse impact on the lives and livelihoods of millions of people. The negative consequences of these regular shocks such as destruction of assets and livelihoods, poverty, food insecurity and displacement adversely affect the supply side of the economy further threatening children's well-being.

2. Budget Cycle in Ethiopia

The budget process in Ethiopia is guided by a directive, known as the Financial Calendar, issued to all public bodies by the Ministry of Finance and Economic Cooperation (MoFEC). The fiscal calendar runs from July to June annually. The state budget preparation is also guided by the Macro-Economic and Fiscal Framework (MEFF) document prepared by MoFEC. The MEFF offers, among others, projections of Government revenue and expenditure, expenditure financing, the division of total expenditure between federal and regional governments, and the division of federal expenditure between capital and recurrent expenditures for the coming three years. These activities take place between August and October each year.

Using the approved formula for a general purpose block grant (also referred to as a subsidy to regions), and based on the approved MEFF, MoFEC prepares a rolling three year estimate of subsidies to each regional government and administrative council, and notifies them of these estimates by the end of November. Simultaneously, MoFEC determines the total resources available to finance Government expenditure in consultation with the central bank, the National Bank of Ethiopia. At the

end of December, the budget requirement and the available resources are compared and the budget deficit is presented to the Council of Ministers which deliberates on the figures for any required changes before approving it and setting a budget ceiling for each line ministry.

Based on the three year MEFF, MoFEC prepares the annual fiscal plan before the end of January.

The annual fiscal plan includes the identification of the resource envelope (domestic and foreign) and the expenditure requirement, setting the block grant amount for regional governments and administrative councils, and splitting the federal Government budget share between capital and recurrent budgets. Table 1 presents the timeline of main activities in the budget year.

By 7 July, the parliament approves the state budget which includes a “general purpose block grant” (or regional subsidy) that is transferred to each region based on an equity formula (Annex 2) that takes into account each region's population size, level of infrastructure development favouring disadvantaged regions, revenue raising potential, and expenditure assessment for the provision of basic services. Based on the principles of fiscal federalism, transfers are made from the federal to the regional governments and from the regional governments to *woredas* through a system of non-earmarked block grants. Regional states obtain most of their financial resources from these transfers. In addition, a “specific purpose block grant” is also transferred to regions to allow for capital expenditures targeted to meet former MDG/current SDG goals, tied to agreed results in selected pro-poor sectors (WASH, education, health, roads and agriculture).

The budget is executed through different ministerial councils and sectors based on their detailed sector plans, and there is an annual independent government audit that is entitled to audit sectoral budget executions and that verifies if the expenditures have followed proper Government financial execution and procurement procedures. The auditor reports directly to the parliament and the execution is reviewed and monitored through joint and independent quarterly reports and verifications made by different permanent committees established by the members of the parliament.

At the federal level, there are detailed public finance management procedures in place where each programme is closely monitored by MoFEC and expenditures cannot go over the approved amount. **Regional governments are autonomous with the regional president as head, and controls in place at the level of the regional parliament, the regional cabinet and the regional auditor.** Once block grant

6 CSA, UNICEF and OPM. 2015. Child Well-Being in Ethiopia: Analysis of Child Poverty using the HCES and WMS 2011 Datasets.

7 FDRE, Ministry of Finance and Economic Cooperation (MoFEC). 2013. Development and Poverty in Ethiopia 1995/96 to 2010/11.

transfers are sent by the federal Government to each autonomous regional government, the regional government decides how much of the region's budget is retained at the regional level (with the regional government deciding the sectoral allocations for expenditures executed at the regional level), versus how much is transferred as block grants to each district (with the district determining the sectoral allocations for expenditures executed at the district level). The details of the budget cycle and budget timeline at the sub-national level is presented in the sub-national budget briefs.

Table 1: Timeline for the annual state budget process

Timeframe	Major Activities
Aug/Sep/Oct	Projections of macroeconomic indicators by MoFEC for the next three years
Nov	Using the approved subsidy formula, and based on the approved MEFF, MoFEC prepares a rolling three year estimate of subsidies to each regional government and public bodies, and notify them of these estimates by 25 November
Dec	MoFEC in consultation with the National Bank, examine the required budget and available resources, and presents the budget deficit to the Council of Ministers by the end of December
Jan	MoFEC prepares the annual fiscal plan before end of January
Feb/Mar	Budget hearing process is convened by MoFEC. Based on the discussion and government policies and priorities, total expenditure ceiling, and allocated ceiling for each public body, the requested state budget will be reviewed, adjusted and consolidated by MoFEC
May	MoFEC presents the revised and consolidated state budget to the Council of Ministers by mid-May
June	Presentation of the state budget to the parliament by the Minister of MoFEC on 7 June
July	The parliament approves the state budget by 7 July, and comes into effect on 8 July
Jan - Jun	Auditing of public bodies

Ethiopia's budgeting system is comprehensive, and policies and priorities are linked to the national budget. However, **the national budget does not include state-owned enterprises, whose investment is increasingly becoming significant, and a significant proportion of external financing that is being directed through off-budget channels (including substantial funding of the social sectors).** The traditional budgeting structure of presenting on-budget expenditures by line item has been officially

replaced by programme-based budgeting at the federal level during the 2011/12 fiscal year, but at the sub-national level, line item budgeting is currently in place with plans being undertaken to gradually shift to programme-based budgeting.

Budget and expenditure information continue to be disclosed to the general public at the federal, regional and local level using mass media such as TV, radio, brochures and newspapers. As a means of accountability and transparency billboards are also set up in public places outlining budgets and expenditures for public view. Besides, taxpayers have easy access to comprehensive, user-friendly and up-to-date information on tax liabilities and procedures, and the revenue authority supplements this with taxpayer education campaigns.

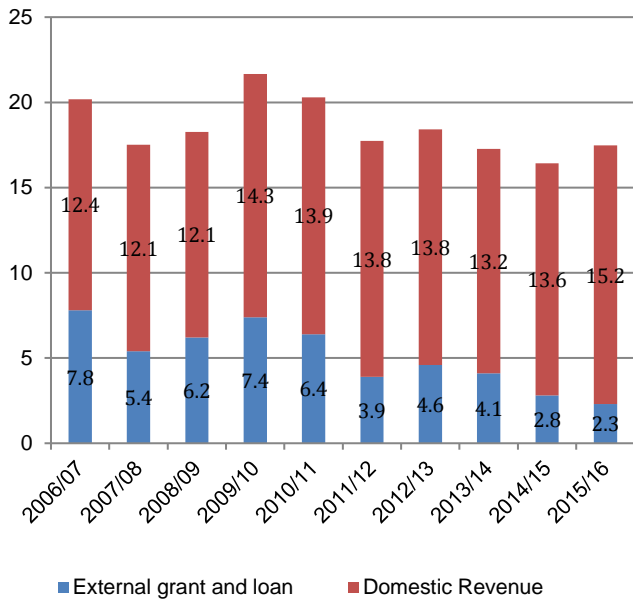
3. Sources of Revenues

The overall government budget is financed from domestic and external sources with the latter consisting of borrowing and assistances in the form of grants from bilateral and multilateral development partners. With increases over time in both domestic and external revenue sources, total revenue (including grants) increased significantly in absolute values from ETB 82 billion in 2009/10 to ETB 266.9 billion in 2015/16. However, **total government revenue (including grants) declined from 21.7 per cent of GDP in 2009/10 to 17.5 per cent in 2015/16 (Figure 2) which is a level much lower than other countries in the eastern and southern Africa region, suggesting the availability of additional fiscal space to increase government revenue that can be channelled towards further investment in the social sectors.** Even though ODA is a key source of financing and there are no stark reductions over time in nominal terms, its falling share in GDP (7.4 per cent in 2009/10 versus 2.3 per cent in 2015/16) as well as the declining share of ODA as a percentage of total government revenue (34 per cent in 2009/10 versus 13.2 per cent in 2015/16) is resulting in **relatively greater reliance on domestic financing.**

In terms of domestic financing, Ethiopia generates the majority of its resources from taxes which amounted to 82 per cent of domestic revenue in 2015/16 compared to 69 per cent in 2008/09. As an agrarian economy that is not fully monetized with the presence of a large, untaxed, non-agrarian informal sector, the contribution of direct tax sources remains relatively limited (4.7 per cent of GDP in 2015/16), and its share remained constant at around 30 per cent of domestic revenue in the past decade. While contributing about 40 per cent of the national GDP, agriculture provides less than 0.5 per cent of tax revenue. Most of the revenues from direct taxes are

generated from payroll tax and taxes on profits of enterprises and individuals.

Figure 2: Sources of government budget (per cent of GDP)



Source: Data from MoFEC.

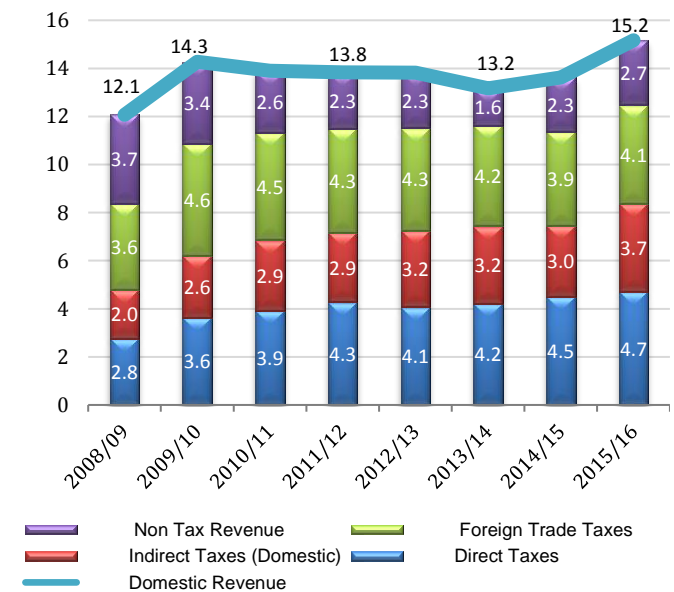
The Income Tax Proclamation of July 2016 has amended the legislation regulating income taxes from employment, from rental of buildings and from businesses. According to the new proclamation, a monthly income from employment below ETB 585 is exempted from income tax, while the maximum 35 per cent tax rate (which used to be applicable to monthly salaries of ETB 5,000 and above) now only applies to monthly salaries above ETB 10,900. **Intermediate taxes have similarly been spaced out to higher income brackets compared to the past tax law resulting in a more equitable income distribution benefiting lower income earners.** As far as income from businesses and income from the rent of buildings is concerned, annual income below ETB 7,000 is free from income tax.

Among the major revenue sources, indirect tax such as the Value Added Tax (VAT) has become an important and growing source of revenue to the national government. The share of domestic VAT revenue reached 3.7 per cent of GDP in 2015/16, which was twice the share in 2007/08 (Figure 3). Foreign trade taxes entirely collected from imported goods make up the largest share of the total domestic revenue next to direct tax, amounting to 27 per cent in 2015/16. On the other hand, domestic revenue collected from non-tax sources, mainly generated from government fees and charges, contribute less to government finance. Less reliance on non-tax sources

indicates the low level of fees and charges attached to government basic services. **The share between tax and non-tax revenue sources show a relatively constant trend over time implying protection for the vulnerable,** as government fees and charges that make up non-tax revenues are similarly applied across all income groups for the most part, while tax rates are somewhat progressively applied to higher income groups.

Tax revenue is growing at a rate that exceeds GDP growth, yet the tax to GDP ratio remains low (12.5 per cent of GDP) compared to the sub-Saharan average of 18 per cent. Thus, fostering tax payer education and sensitization, encouraging voluntary tax compliance and strengthening enforcement efforts can contribute to the tax revenue base. Ethiopia's macroeconomic context of a low tax to GDP ratio, a high saving-investment gap (21.3 per cent of GDP), a high current account deficit (12.7 per cent of GDP), and a high level of external debt (30.2 per cent of GDP), will necessitate boosting revenues and strategic spending options⁸.

Figure 3: Revenue Generated from Domestic Sources (per cent of GDP)

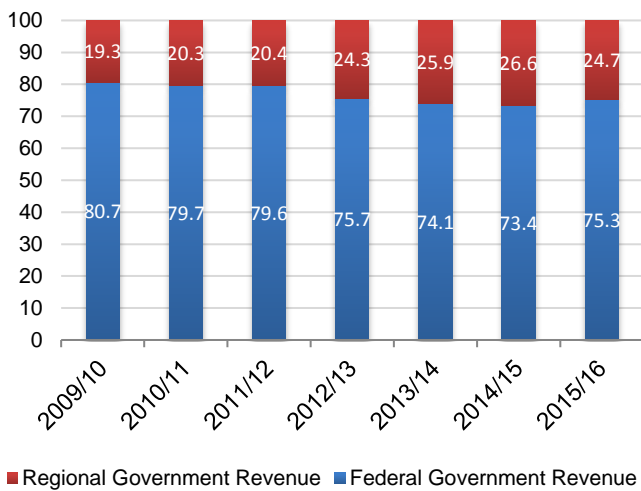


Source: Data from MoFEC.

In terms of ownership, **while the federal Government collects the lion's share of the national revenue (averaging 76 per cent for the last decade), the regional governments are entitled to collect their own revenue in their respective regions from individual businesses, farmers, land and property.** As can be seen from Figure 4, the share of revenue generated by the regional governments is gradually increasing over time.

⁸IMF Article IV, Ethiopia Country Note, 2016.

Figure 4: Federal and Regional Governments Revenue (per cent of total domestic revenue)



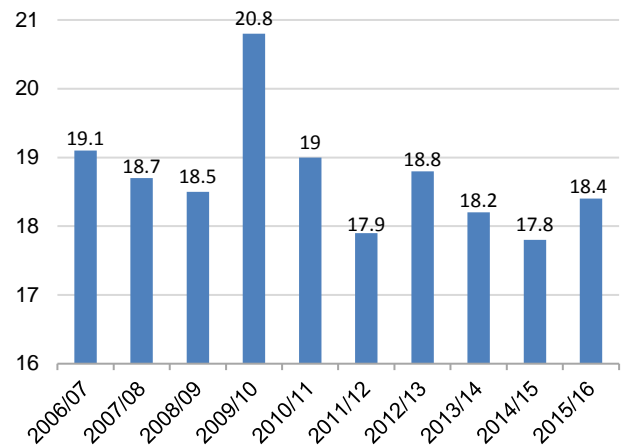
Source: Data from MoFEC.

4. Expenditure Composition

Though total national expenditure has increased more than eight-fold in absolute terms between 2006/07 and 2015/16, it declined from 20.8 per cent of GDP in 2009/10 to 18.4 per cent in 2015/16 (Figure 5). A relative increase in expenditure has been witnessed in recent years, due to rising spending on pro-poor and growth enhancing sectors. **The level of public investments, primarily intended to insure inclusive and equitable development, has been increasing as a share of total national expenditure.** This demonstrates the government’s firm determination to enhance and improve Ethiopia’s social and economic infrastructure and build the nation’s productive capacity.

Moreover, two major shifts in the national expenditure patterns have been observed in the last decade. These include: a reallocation of national expenditure from federal to regional governments, and from recurrent to capital spending. Accordingly, since 2006/07, the share of national capital expenditure reached more than 50 per cent of the total. Likewise, while the share of the federal Government expenditure declined from 63.4 per cent in 2009/10 to 47.9 per cent in 2014/15, the share of regional government expenditure increased from 36.6 per cent to 52.1 per cent of the total respectively.

Figure 5: Total National Expenditure (per cent of GDP)

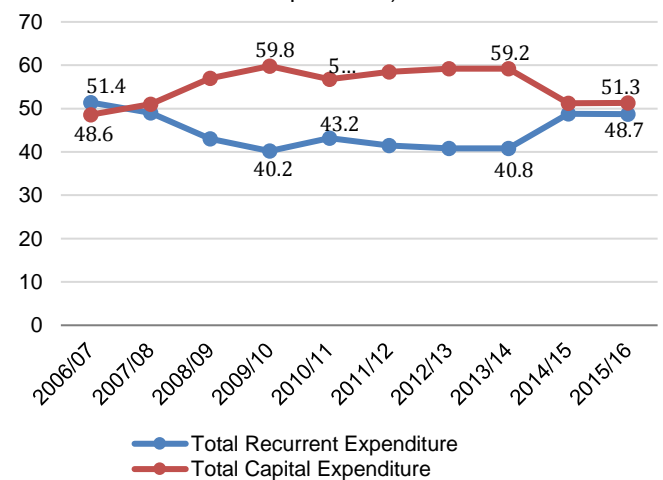


Source: Data from MoFEC.

Recurrent versus Capital Expenditure

National recurrent expenditure as a share of total expenditure declined consistently from 51.4 per cent in 2006/07 to 40.8 per cent in 2013/14 and levelled around 48.7 per cent in 2014/15 and 2015/16. Half of the national recurrent expenditure was channelled towards financing pro-poor sectors including education, health and nutrition, water and energy, roads as well as agriculture and food security. On the other hand, national capital expenditure is much larger than recurrent expenditure and averaging at 55.2 per cent of total national expenditure for the last decade. The higher capital expenditure in 2015/16 relative to the previous fiscal year (Figure 6) was in part due to a larger investment on pro-poor and growth enhancing sectors.

Figure 6: Capital and Recurrent Expenditure (per cent of total national expenditure)

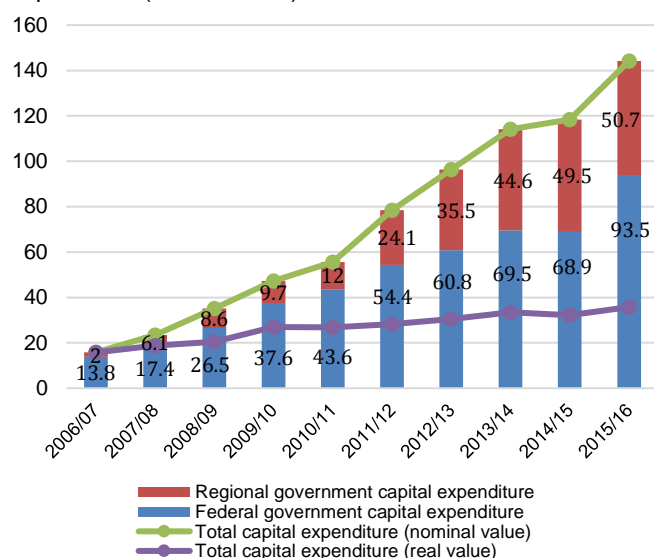


Source: Data from MoFEC.

Federal versus Regional Expenditure

In view of devolving fiscal decision making to lower tiers of government, the Government designed a fiscal decentralization strategy with specific objectives of promoting basic services to citizens. **Regional governments are entitled to general and specific sectors responsibilities including basic social service delivery** such as the construction of primary and secondary schools, health posts and centres, water and sanitation, rural roads, agriculture development and natural resources protection. **The federal Government is spending a large portion of its budgetary resource on capital expenditure in an effort to address the infrastructure gap throughout the country.** It is responsible in investing in highways, universities, power generation and dissemination, natural resources development and food security, which are implemented throughout the country.

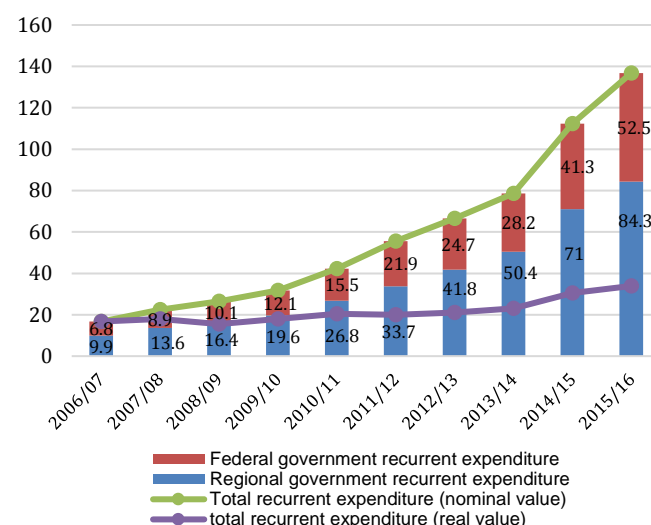
Figure 7: Federal and Regional Distribution of Capital Expenditure (in billion ETB)



Source: Data from MoFEC. Real values are calculated by the authors with 2006/07 as the base year.⁹

Regional governments are primarily undertaking recurrent expenditures, leaving more responsibility for federal Government to finance large countrywide capital projects. As a result, and as can be seen in Figure 8, the share of regional governments in national recurrent expenditure has been higher than the share of the federal government.

Figure 8: Federal and Regional Distribution of Recurrent Expenditure (in billion ETB)



Source: Data from MoFEC. Real values are calculated by the authors with 2006/07 as the base year.

Pro-poor National Spending

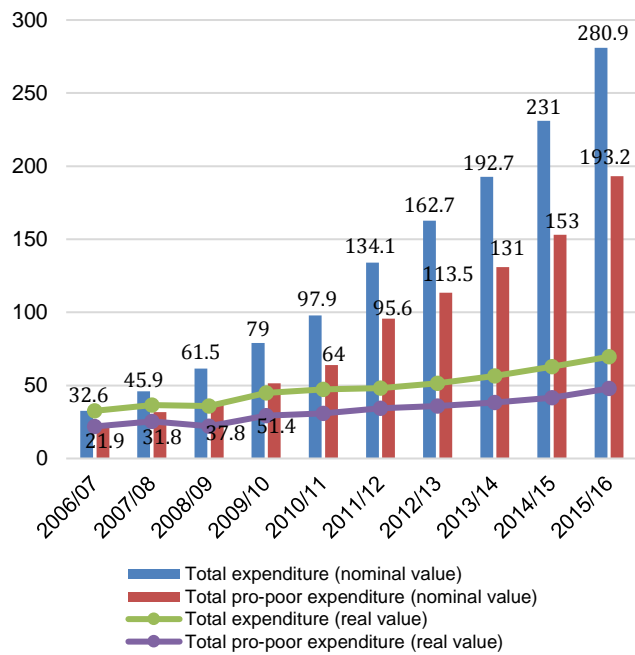
It is evident that investments in social sectors are vital in the fight against poverty and even more essential for children's wellbeing. **Public expenditure has been essentially aligned to poverty reduction priorities in Ethiopia. Sub-national expenditures are also consistent with poverty reduction goals.** In this regard, the government has leveraged huge resources to boost spending in what it refers to as the main pro-poor sectors (Figure 9), namely health, education, water and energy (which includes all energy projects such as the construction of mega dams and power plants), roads, as well as agriculture and food security (with approximately half of the agriculture budget allocated to the PSNP¹⁰).

National expenditure headed to these pro-poor sectors averaged 66.4 per cent of total national expenditure for the last decade (Figure 10). By targeting interventions to assist the poorest and the most vulnerable groups through the PSNP and the Urban Consumer Society (UCS), redistributions contributed to poverty reduction efforts along with the commitment to use public investment for the expansion of basic services.

⁹ "Real" value refers to the adjustment of monetary values by taking into account "the rise of consumer prices (i.e. inflation)" over time.

¹⁰The World Bank. 2014. Ethiopia Poverty Assessment. Report No. AUS6744, p.v.

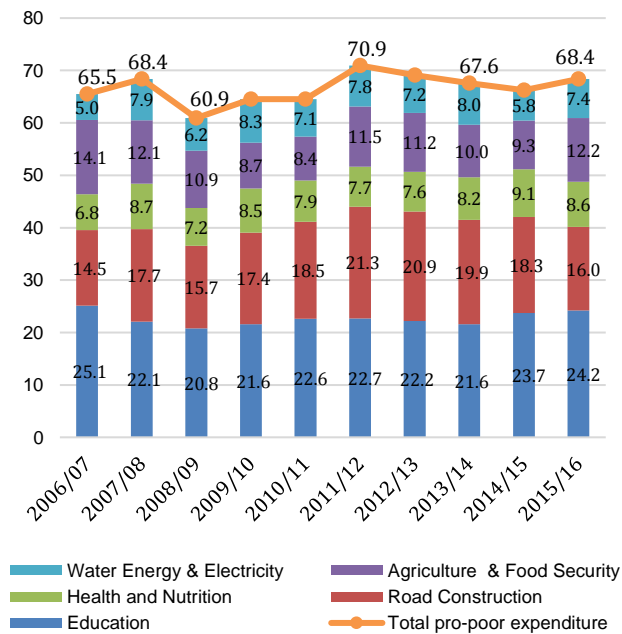
Figure 9: Total and Pro-poor Expenditure (in billion ETB)



Source: Data from MoFEC. Real values are calculated by the authors with 2006/07 as the base year.

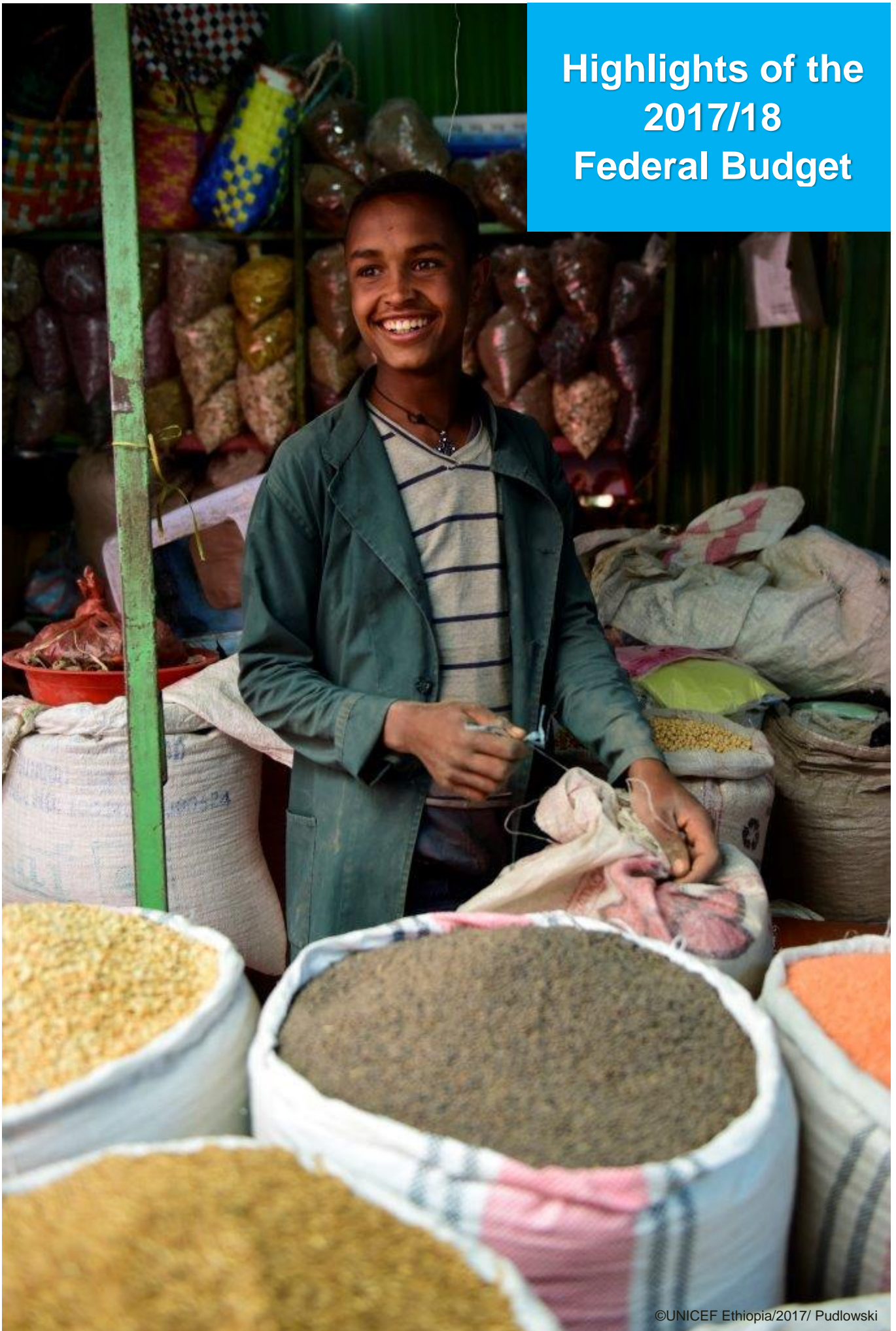
As shown in Figure 10, the strong commitment to educational development and health service access is reflected in expenditure allocations to these sectors, which have increased steadily since 2008/09 to reach 24.2 per cent and 8.6 per cent of total government expenditure respectively in 2015/16. Over the past decade, the bulk of the financing is skewed towards general education and primary health care services. This directly benefits children and is vital for building the country's human capital base. The share of road construction in general government expenditure ranges from 14.5 per cent in 2006/07 to 16 per cent in 2015/16. Road networks, especially rural roads, contribute towards preventing maternal deaths through timely access to childbirth-related care, boost children's enrolment in school, increase and diversify farmers' incomes by connecting them to transportation and markets, as well as allow better interaction and the economic linkages essential for generating long-term growth.

Figure 10: Distribution of Pro-poor Expenditure (per cent of total expenditure)



Source: Data from MoFEC.

Highlights of the 2017/18 Federal Budget



Background and context

In addition to the federal level parliament, there are 9 autonomous sub-national regional governments and 2 city administrations each with its own independent parliament that reviews, determines and approves budgets for its respective region or city administration. To obtain budgetary allocations for Ethiopia at the national level for a given social or economic sector (for example education, health and nutrition, social welfare, or water and sanitation, etc.) the budget allocations from the federal Government as well as all the regional governments and city administrations for the respective sector will need to be summed up. As data is currently only available for the federal government's budget proclamation, sector budget allocations analysed in this section leave out the majority of the national budget allocated to key social sectors given that the bulk of social sector spending is undertaken at the sub-national level. For instance, in 2015/16 about 60 per cent of the national health and nutrition on-budget expenditure and 47 per cent of the national education expenditure were expended by sub-national regional governments, amounts that would be missed if solely considering sector allocations made at the federal level. Making a note of this caveat, the highlights of the federal government's 2017/18 budget are presented as follows.

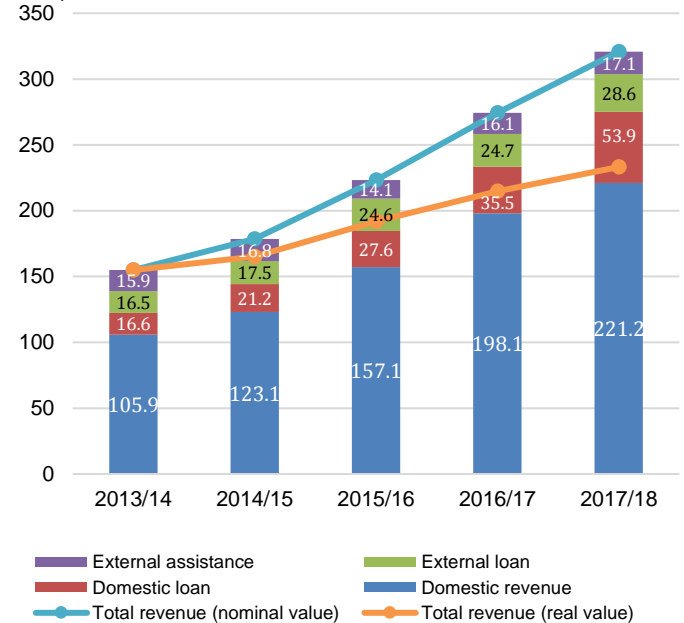
Revenue sources for the federal budget

The total federal budget for the 2017/18 fiscal year amounts to ETB 320.8 billion¹¹, about a 16.9 per cent and 8.6 per cent increase in nominal and real terms respectively compared with the budget of ETB 274.4 billion approved in the previous 2016/17 fiscal year (Figure 11). About 86 per cent of the 2017/18 federal budget will be financed from domestic sources while external sources will finance the remaining 14 per cent as outlined below.

- **Domestic revenue:** ETB 221.2 billion (69 per cent of the total budget) from domestic revenue of which tax revenue accounts for 88.8 per cent of the domestic revenue to be mobilized.
- **Domestic borrowing:** ETB 53.9 billion (16.8 per cent of the total budget) is intended to be generated from domestic borrowing.
- **External loans:** ETB 28.6 billion (8.9 per cent of the total budget) is forecasted to be collected from external sources in the form of loans.
- **External grants/assistance:** ETB 17.1 billion (5.3 per cent of the budget) from bilateral and multilateral development partners in the form of external grants/assistance.

¹¹ This budget does not include budgets of state-owned enterprises, and own resources generated by regional governments. However it includes both non-earmarked and earmarked block grants (or subsidies) transferred by the

Figure 11: Sources of finance for federal budget (in billion ETB)



Source: Data from MoFEC. Real values are calculated by the authors with 2013/14 as the base year.

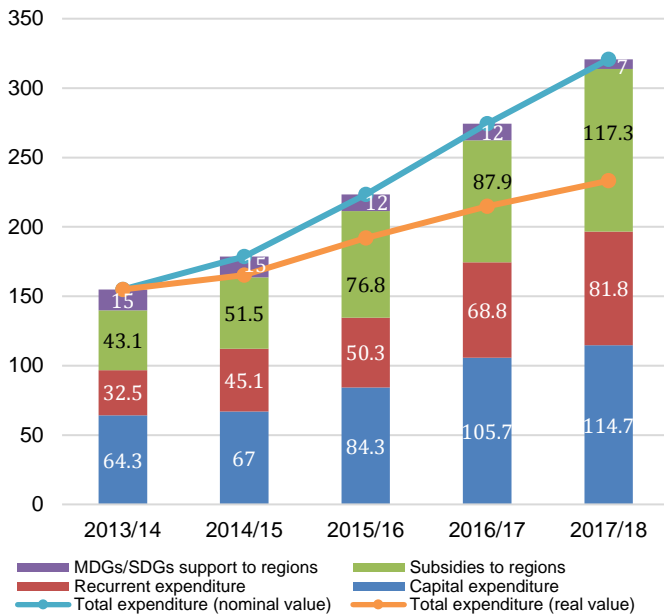
Federal budgetary allocations

In 2017/18, the total federal budget of ETB 320.8 billion has been allocated towards the following categories (Figure 12):

- **For federal capital expenditures:** ETB 114.7 billion (39.7 per cent of which will be directed to finance road construction).
- **For federal recurrent expenditures:** ETB 81.8 billion.
- **For block grants (or subsidies) to regional governments:** ETB 117.3 billion (around a 33 per cent increase from 2016/17 levels) indicating the government's commitment to decentralization and devolving fiscal decision-making to lower tiers of government.
- **For supporting the achievement towards the Sustainable Development Goals (SDGs) in regions:** ETB 7 billion. The declining trend in the regional transfers earmarked for supporting the SDGs in regions is thought to be compensated by the steady and substantial rise in block grants being transferred to regional governments.
- The remaining amount is set aside for the repayment of public debt (almost ETB 17 billion), provisions (ETB 6.5 billion), transfers (almost ETB 4 billion) and miscellaneous expenditures (ETB 5 billion).

federal to regional governments making up a substantial amount of regional governments' total budgets.

Figure 12: Trends of federal expenditure budget (in billion ETB)

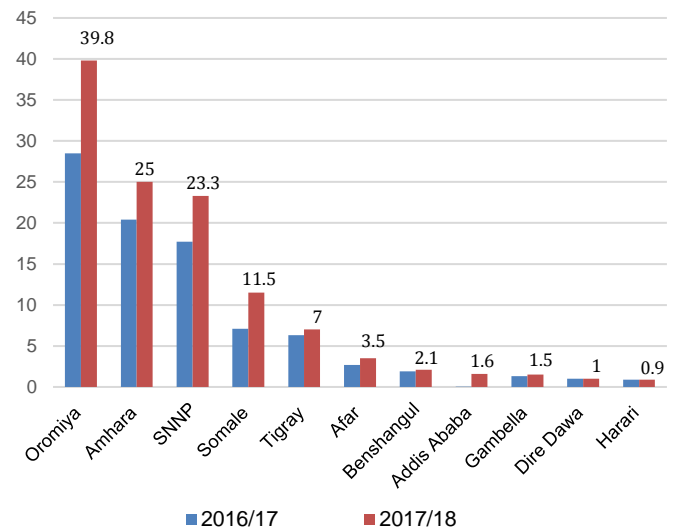


Source: Data from MoFEC. Real values are calculated by the authors with 2013/14 as the base year.

Federal subsidies (non-earmarked block grants) to regional Governments

Fiscal decentralization and enhancement of local governance are a priority for the GoE. As a result, federal transfers to regional governments have more than doubled over a three year period from ETB 51.5 billion in 2014/15 to ETB 117.3 billion in 2017/18, with marked increases in real value terms as well (Figure 12). As previously stated, transfers are made to regional governments based on an equity formula that takes into account each region's population size, level of infrastructure development favouring disadvantaged regions, revenue raising potential, and an expenditure assessment for the provision of basic services (Figure 13). In an attempt to redress the imbalances among the relatively more developed and relatively less developed regions, 1 per cent of the total regional subsidy budget usually goes to Afar, Benishangul-Gumuz, Gambella and Somali regional states unconditionally. The 160 per cent increase in the federal transfers to Addis Ababa region in 2017/18 compared to the preceding year reflects a specific external loan provision to the city administration for the purpose of road construction.

Figure 13: Trends of federal subsidies across regions (in billion ETB)

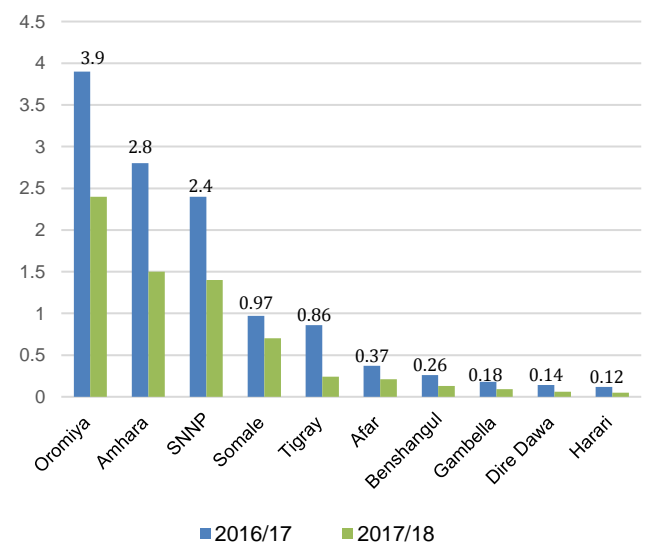


Source: Data from MoFEC.

SDGs implementation support to regions

With the purpose to support the financing of regional governments' capital expenditures towards achieving the targets of the SDGs, the federal government has in 2017/18 transferred as per the grant formula ETB 7 billion to regional governments (Figure 14). The SDG grant transferred to regions has declined from last year's levels of ETB 12 billion given the general block grant provided to regions has significantly increased.

Figure 14: Trends of SDGs implementation support across regions (in billion ETB)

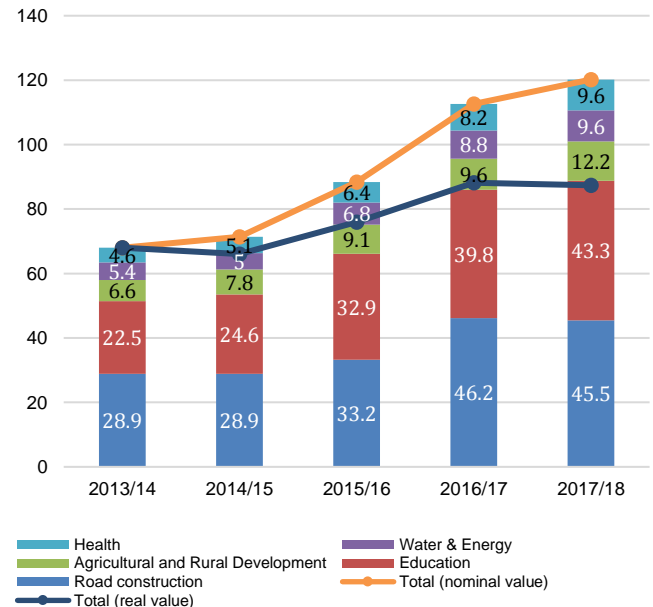


Source: Data from MoFEC.

Federal allocations to pro-poor sectors

For the last two decades, government allocations have been essentially aligned to poverty reduction priorities. **The Government’s budget for 2017/18 remains pro-poor oriented and aligned with the SDG agenda of “leave no one behind”**. In this regard, more than 65 per cent of the federal budget is planned to be allocated to pro-poor and growth enhancing sectors (education, health, water, agriculture and rural development, and road construction) during the 2017/18 fiscal (Figure 15). The increase in the share of the social sector budget (mainly in education, health and nutrition, as well as water and sanitation) in the past few years suggests that the government is giving more attention and emphasis to improving the quality of public service delivery both at federal and the regional administration levels. Furthermore, **the significant increase in domestic financing towards the PSNP through the 2017/18 budget proclamation is commendable (rising from ETB 193 million in the 2016/17 fiscal year to ETB 2.7 billion in 2017/18)**. This demonstrates the GoE’s clear commitment to **social protection** to fill the PSNP funding gap to ensure the 12 months of transfers for the Permanent Direct Support Beneficiaries.

Figure 15: Federal budget allocations to pro-poor sectors (in billion ETB)

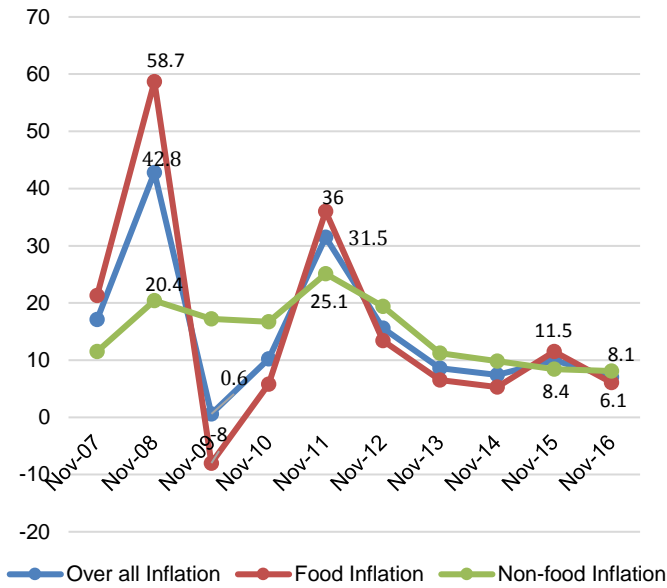


Source: Data from MoFEC. Real values are calculated by the authors with 2013/14 as the base year.

A more detailed look at budget and expenditure trends for the education sector, health and nutrition sector, as well as social protection are presented in accompanying budget briefs. Overall, in analysing the composition of public expenditures, the question is not only that of assessing which sectors are underfunded or not funded at all, but in addition **the focus needs to be on appraising efficiency and effectiveness. Assessing the absorptive capacity of sectors is a prerequisite for allocating resources in the most efficient manner to minimize fund wastage and leaks in both the budgetary and spending system and process.** Addressing these issues can enable Ethiopia to increase equity, better tackle upcoming challenges such as climate change and pressures from urbanization, as well as enhance its investment in children for a healthy, educated, skilled and productive labour force that is key to the path of attaining middle income country status and achieving the Sustainable Development Goals.

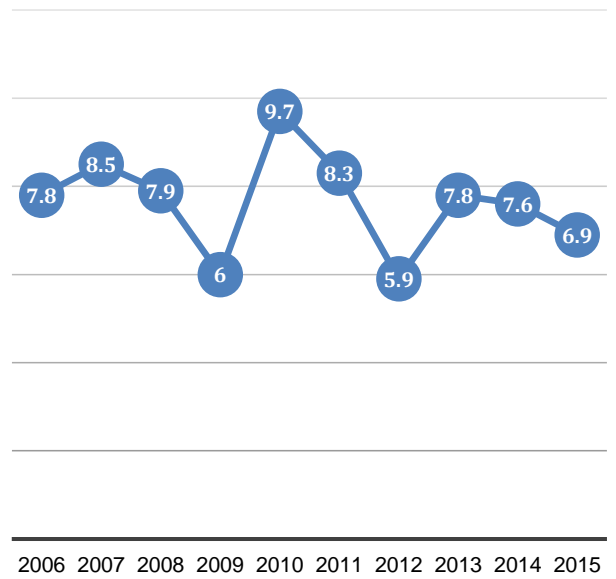
Annex 1

Figure A: Inflation rate (CPI movements, current versus last year's similar months at country level)



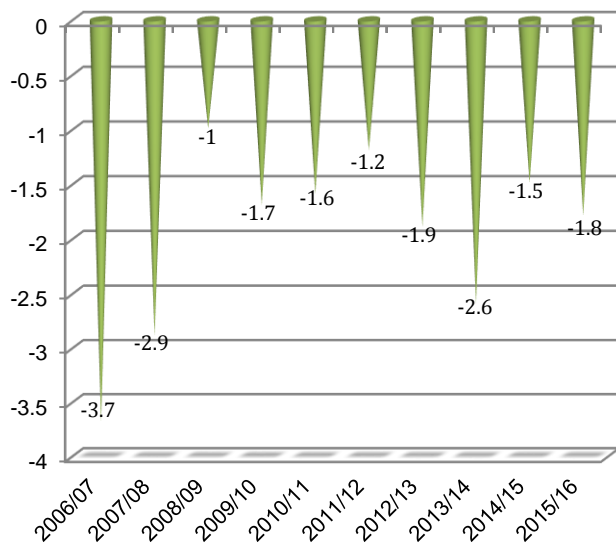
Source: Data from CSA.

Figure C: Real GDP per capita growth (per cent)



Source: Data from World Bank; WDI, 2017.

Figure B: Budget Deficit (per cent of GDP)



Source: Data from MoFEC.

Annex 2: The Federal General–Purpose Grant Distribution Formula (2017/18-2019/20)

The responsibilities of deciding the proportion of the general-purpose grant allocation to the regional states is constitutionally vested on the House of Federation (HoF) since 1994/95. Federal transfers are distributed based on relative fiscal gaps of regional states, and the HoF has been adopting a grant allocation formula in order to capture the relative fiscal gap of the regional states as accurately as possible. The HoF has been revising the grant allocation formula periodically so as to adjust the federal grant allocation to the changes in the socio-economic conditions of each regional state, and a number of formulae were developed and used since the country adopted fiscal federalism.

In 2017, the HoF adopted a revised grant allocation formula (for use in the coming three years) to accommodate the allocation of federal grants to the changes in population size, levels of development, revenue collection capacities, employment, and poverty among other factors across the regional states. The new approach of federal transfer is calculated on the basis of the representative revenue and representative expenditure estimates. In this approach, the revenue raising capacity is estimated using the representative revenue system, then the expenditure needs are estimated using the representative expenditure system, and then the fiscal gaps are calculated accordingly for each regional state. The grant is therefore distributed based on the relative fiscal gaps of the regional states.

Though there are different approaches used to estimate the revenue generating capacities of sub-national governments, the federal transfer formula of Ethiopia uses the Representative Tax System (RTS) to estimate the revenue generating capacities of each region. This system employs the main tax revenue sources of regional states including agricultural income tax, land use fee, payroll tax, business income tax, turnover tax, and value added tax. The current grant allocation formula considers new developments in tax rates, particularly for payroll tax. Improvements are also made on the previous computation method by using weighted averages rather than simple average tax rates. Moreover, a new method is followed in the calculation of business income tax and value added tax with a major departure from the method used in the previous formula.

According to the new grant allocation formula, the expenditure need of each regional state is calculated taking into consideration the unit of measurement (which is different across each expenditure category), representative expenditure (per unit average expenditure for each expenditure category), and adjustment index (constructed from factors explaining unit cost differentials across sub-national governments). The current grant allocation formula employs a regression approach to estimate the adjustment index for each expenditure category, which was not the case in the previous formula (previously the adjustment index used to be subjectively determined by an expert and then finally settled through consultation with the regional governments). The expenditure categories incorporated in the calculation include: general services and administration, primary and secondary education including Technical and Vocational Education and Training (TVET), public health, agriculture and rural development, drinking water development, rural road construction and maintenance, urban development, and micro and small-scale enterprises.

However, in the current revised grant allocation formula, the lack of adequate and quality data on some essential variables of interest have been the most important challenges faced to estimate the revenue generating capacities and expenditure needs of regional states. Moreover, it is impossible to capture some of the concerns raised by regional governments like the variation in the quality of public services provided and the efficiency differential across regional states in this revision.

As a result of this computation, the total amount of the federal general purpose block grant is divided among the regional states and transferred as follows: Tigray 6.03 per cent, Afar 3.02 per cent, Amhara 21.6 per cent, Oromia 35.38 per cent, Somali 10.32 per cent, Benishangul Gumuz 1.54 per cent, Southern Nations, Nationalities and Peoples 20.41 per cent, Gambella 1.1 per cent, Harari 0.21 per cent and Dire Dawa 0.38 per cent. These proportions will be in effect during 2017/18 to 2019/20.

Adapted from the “*Federal Democratic Republic of Ethiopia House of Federation. June 2017. The Federal General-Purpose Grant Distribution Formula 2017/18 – 2019/20*”.

Annex 3: Ethiopia Total National On-budget Records 2006-2016 (Source: MoFEC)

Gregorian Calendar Fiscal Year	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Ethiopian Fiscal Year	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Population (in million)	72.0	75.0	77.0	79.0	80.7	82.7	84.8	87.0	89.1	91.2
GDP at Current Market Price (in million ETB)	170280.6	245836.0	332060.3	379134.5	515079.0	747326.0	866921.0	1060825.0	1297961.0	1528044.0
General Inflation Rate (CPI growth rate)	15.8	25.3	36.4	2.8	18.1	34.1	13.5	8.1	7.7	9.7
Exchange Rate (period weighted average)	9.0	9.6	11.8	13.7	16.5	18.0	19.3	19.9	20.1	21.1
National Revenue (in million ETB)										
Total National Revenue	34433.0	43020.5	60794.0	82019.8	104466.7	132169.6	159827.6	183238.6	213488.8	266898.5
Domestic Revenue	21089.7	29773.7	40076.4	54115.1	71582.6	103393.3	119834.9	139677.7	176795.8	231789.57
Tax Revenue	16776.9	22550.8	27822.3	41212.1	58348.0	86042.2	99940.0	123179.4	147540.2	190519.68
Direct Taxes	5030.8	7024.0	9231.2	13812.2	20215.2	32031.5	35229.3	44855.1	58554.6	71843.9
Indirect Taxes (Domestic)	3499.7	4405.9	6704.8	9773.3	15139.0	21505.7	27715.9	34150.7	38487.8	55952.8
Foreign Trade Taxes	8246.4	11120.9	11886.4	17626.6	22993.8	32505.0	36994.8	44173.6	50497.8	62722.9
Non - Tax Revenue	4312.8	7222.9	12254.1	12903.0	13234.6	17351.1	19894.9	16498.4	29255.7	41269.9
Domestic Federal Government Revenue	16705.9	24286.3	31775.1	43688.3	57027.0	82279.8	90733.6	103514.3	129756.2	174427.9
Domestic Regional Government Revenue	4383.8	5487.4	8301.3	10426.8	14555.6	21113.5	29101.3	36163.4	47039.7	57361.6
External Assistance and Loan	13343.3	13246.8	20717.5	27904.7	32884.1	28776.4	39992.7	43560.9	36692.9	35108.9
External Assistance	11380.9	11379.0	16130.7	18854.7	21433.1	16820.4	20447.3	23142.6	15794.7	12884.4
External Loan	1962.4	1867.8	4586.9	9050.0	11451.0	11956.0	19545.3	20418.3	20898.2	22224.5
National Expenditure (in million ETB)										
Total National Expenditure	32581.1	45937.5	61543.6	78990.6	97857.2	134065.0	162705.7	192673.6	231015.5	280892.7
Total National Recurrent Expenditure	16728.8	22490.1	26457.9	31712.0	42245.1	55664.2	66444.1	78630.6	112685.2	136708.7
Total National Capital Expenditure	15852.3	23447.4	35085.6	47278.6	55612.1	78400.8	96261.6	114043.0	118330.3	144184.1
Total Federal Government Expenditure (in million ETB)	20633.0	26243.3	36545.7	49700.5	59054.8	76270.2	85414.6	97720.1	110585.7	145929.7
Federal Government Recurrent Expenditure	6789.3	8883.8	10058.1	12137.1	15478.4	21920.1	24650.7	28239.4	41731.3	52453.5
Federal Government Capital Expenditure	13843.7	17359.5	26487.6	37563.4	43576.4	54350.1	60763.9	69480.7	68854.4	93476.2
Total Regional Government Expenditure	11948.1	19694.2	24997.9	29290.1	38802.4	57794.8	77291.1	94953.5	120429.7	134963.1
Regional Government Recurrent Expenditure	9939.5	13606.3	16399.9	19574.9	26766.7	33744.1	41793.4	50391.2	70953.9	84255.2
Regional Government Capital Expenditure	2008.6	6087.9	8598.1	9715.2	12035.7	24050.7	35497.7	44562.4	49475.9	50707.9
Regional Block Grant	9966.2	14204.1	17307.4	20511.6	26165.0	43736.6	53833.3	57370.3	77335.6	84850.1
MDGs/SDGs Support to Regions						15000.0	20000.0	15000.0	15000.0	12000.0
National Poverty-Oriented Expenditure (in million ETB)										
Total National Poverty-Oriented Expenditure	21928.0	31786.1	37787.2	51412.5	63983.7	95631.6	113446.2	131008.6	152954.8	193214.95
Total National Education Expenditure	8173.5	10133.2	12794.3	17033.1	22157.5	30377.3	36054.5	41548.5	54667.6	67871.76
Total National Health and Nutrition Expenditure	2402.6	4053.0	4509.8	6777.0	7858.7	10348.6	12484.9	15865.3	21123.7	24475.7
Total National Agriculture & Food Security Expenditure	4775.6	5644.8	6788.4	6982.3	8354.3	15569.9	18529.5	19429.1	21370.0	34556.507
Total National Water Energy & Electricity Expenditure	1683.9407	3699.2182	3893.2081	6648.0671	7112.8803	10533.163	11911.994	15492.9	13434.589	21013.762
Total National Road Construction Expenditure	4892.3	8255.8402	9801.4867	13972.016	18500.335	28802.712	34465.308	38672.797	42359	45297.222



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This budget brief was written by Zeleka Paulos (Social Policy Specialist, UNICEF Ethiopia) and Ademe Zeyede (Consultant, UNICEF Ethiopia) under the guidance of Remy Pigois (Chief Social Policy and Evidence for Social Inclusion, UNICEF Ethiopia). The provision of MoFEC budget and expenditure data and explanations presented for MoFEC data related questions by Ato Fantahun Belew (Technical Expert, MoFEC) is highly appreciated. This budget brief has been reviewed by Jean Dupraz (Social Policy Regional Adviser, Eastern and Southern Africa Regional Office (ESARO)) and Matthew Cummins (Social Policy Specialist, ESARO).

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