Ethiopia

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National Budget Brief

Updated for 2016/17

Key Messages

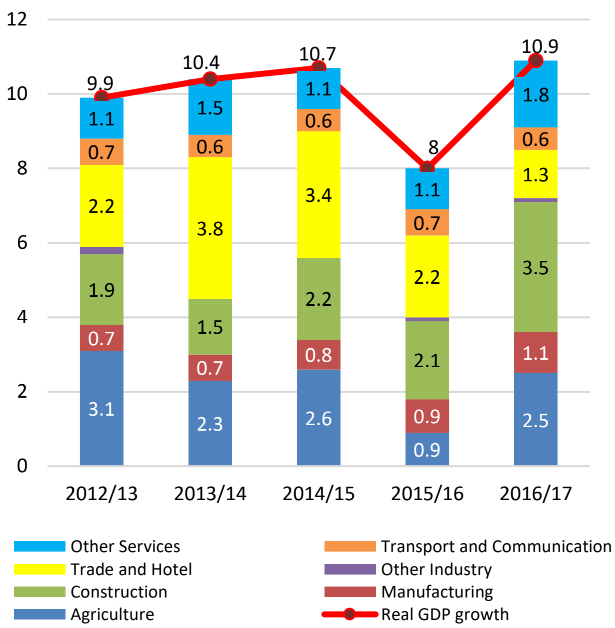
- Aggregate national spending has increased more than two-fold from ETB 163 billion in 2012/13 to ETB 334 billion in 2016/17 (an annual average growth rate of 17 per cent) with most of the spending going to public investments primarily intended to ensure inclusive and equitable development. However, in real terms national spending increased from ETB 163 billion in 2012/13 to only ETB 231 billion in 2016/17 (an annual average growth rate of 6.7 per cent).
- In terms of financing the national budget, although external assistance remains a key source of financing, its falling share in GDP as well as the declining share of this revenue as a percentage of total government revenue over the past several years is resulting in relatively greater reliance on domestic financing.
- The share of total government revenue to GDP was 16.3 per cent in 2016/17, 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.
- Ethiopia's macroeconomic context of a low tax-to-GDP ratio (10.5 per cent), a high saving–investment gap (16.2 per cent of GDP), a high current account deficit (10 per cent of GDP), and a high level of external debt (30.4 per cent of GDP) in 2016/17, will necessitate boosting revenues and strategic spending options. Fostering taxpayer education and sensitization, encouraging voluntary tax compliance and strengthening enforcement efforts can contribute to the tax revenue base.
- 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 being spent on social sectors, such as social protection, health, water and sanitation and education. A shift of off-budget support to on-budget records would enable improved budget assessments vis-à-vis development outcomes.

This national overview budget brief, which is complemented by three further briefs on health, education, and social protection, analyses budget and expenditure that are recorded on-budget for the Federal Ministry of Finance (MoF) and its affiliated sub-national level Bureaus of Finance (BoF) and district-level Woreda Offices of Finance. Highlights of the 2018/19 Federal Budget Proclamation is also provided. The main objective of this budget brief is to synthesize complex budget and expenditure information so that it is easily understood by stakeholders, to foster discourse, and where possible to inform policy and financial decision-making processes.

1. Macro and Socioeconomic Context

Ethiopia 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$863 in 2016/17, which is more than a two-fold increase from the 2010/11 level of US$396 per capita. Economic growth has remained robust, and real GDP grew by 10.9 per cent in 2016/17, up from 8 per cent in 2015/16, as agriculture fully recovered from the drought impact and grew by 14.7 per cent (Figure 1). Overall growth has been driven by massive government investment in infrastructure, as well as wholesale and retail trade services.

Figure 1: Real GDP growth (per cent)

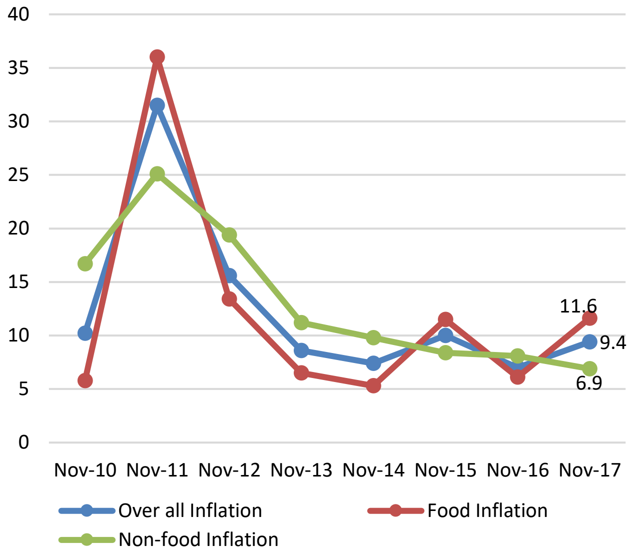


Source: Data from the National Planning Commission (NPC).

Historically, agriculture was the predominant sector in the Ethiopian economy. However, its contribution to GDP has consistently declined. According to the 2016/17 National Planning Commission (NPC) estimate, agriculture was the second highest contributor (35.9 per cent) to the country's GDP and provides employment to almost 80 per cent of the working population. Services and industrial sectors have a 38.9 per cent and 25.2 per cent share in GDP, respectively, in the same year. The contribution of the industrial sector to GDP has been increasing, albeit from a low base. This low level indicates that economic transformation has yet to take shape. To bring sustainable transformation of the economy, the Government of Ethiopia (GoE) needs to promote private investment, particularly in the strategic priority area of the agro-processing manufacturing sector and strengthen the industrial base.

Lowering budget deficits coupled with targeted budget subsidies have contributed to attaining a single digit level of inflation. The overall inflation rate rose to 9.4 per cent in November 2017 from 7 per cent in November 2016, mainly because of high food inflation (Figure 2). Food inflation increased to 11.6 per cent in November 2017, the highest rate since 2013. By contrast, non-food inflation recorded the lowest increase in more than a decade, reaching 6.9 per cent in November 2017. The relative slowdown in non-food inflation is likely due to the lagged effects of declining international prices and tighter monetary policy measures over the past year.

Figure 2: Inflation rate (Consumer Price Index, comparing the current month versus the same month last year)



Source: Data from Central Statistical Agency (CSA).

Box 1: Key Macroeconomic Indicators

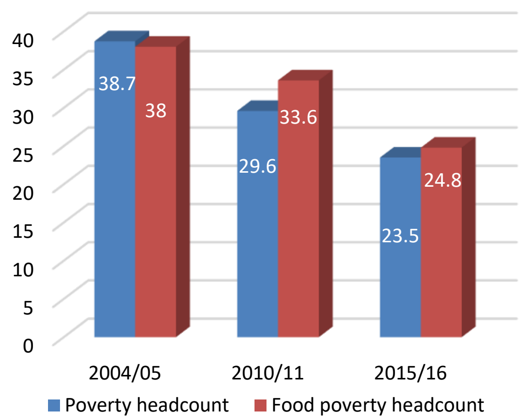
- GDP growth rate (2016/17, NPC): 10.9 per cent.
- GDP per capita (2016/17, NPC): US$863.
- Share of agriculture sector to GDP (2016/17, NPC): 35.9 per cent.
- Share of service sector to GDP (2016/17, NPC): 38.9 per cent.
- Share of industry sector to GDP (2016/17, NPC): 25.2 per cent.
- Public debt-to-GDP ratio (2016/17, IMF): 53.8 per cent.
- Overall inflation rate (November 2017, Central Statistical Agency (CSA)): 9.4 per cent.
- Food inflation rate (November 2017, CSA): 11.6 per cent.
- Non-food inflation rate (November 2017, CSA): 6.9 per cent.

Ethiopia's strong growth has helped to achieve social gains across sectors and halved poverty over the past decade. The incidence of poverty (poverty headcount) declined to 23.5 per cent in

2015/16, from 38.7 per cent in 2004/05[1] (Figure 3). The sharp decline in poverty is partly attributable to the implementation of social protection programmes, such as the Productive Safety Net Programme (PSNP), as well as urban food distribution and subsidies.[2] Despite the reduction in poverty headcount, food poverty is high, with a large share of household spending going on food.[3] **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 Household Consumption and Expenditure Survey (HCES) and the Welfare Monitoring Survey (WMS), the poverty headcount for children was 32.4 per cent,[4] compared to 29.6 per cent[5] 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. These represent 13 million and 2 million children, respectively. Although the poverty headcount figures show a declining trend in overall poverty levels, in terms of multi-dimensional poverty, 88 per cent of children in Ethiopia under the age of 18 (36 million) lack access to basic services in at least three basic dimensions of the nine dimensions studied.[6] Stark geographical inequalities exist, with 94 per cent of children in rural areas multi-dimensionally deprived compared to 42 per cent of children in urban areas, while rates of child poverty range from 18 per cent in Addis Ababa to 91 per cent in Afar, Amhara, and SNNPR. Oromia and Somali (90 per cent each), and Benishangul-Gumuz (89 per cent), also have high rates of poverty.[7]

Figure 3: People living below the national poverty line (per cent)



Source: Household Consumption and Expenditure Surveys, CSA.

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 change, 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 impacts 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.

Box 2: Key Social Indicators

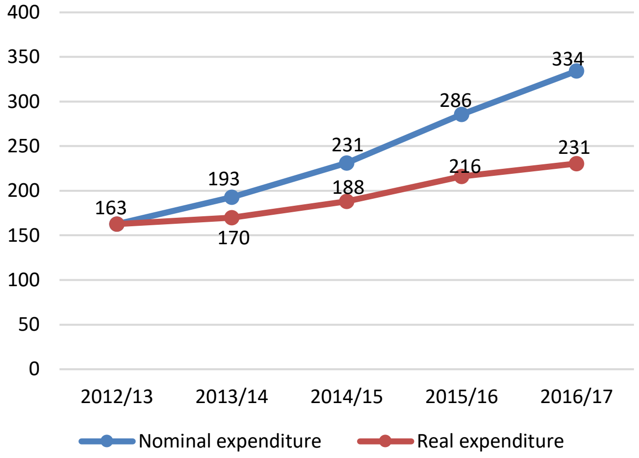
- Total population (2017, CSA, 94.4 million).
- Child population below 5 years of age (2017, CSA, projection): 13.3 million.
- Population growth rate (Census, 2007): 2.6 per cent.
- Poverty headcount rate (2017, NPC): 23.5 per cent.
- Food poverty headcount rate (2017, NPC): 24.8 per cent.
- Child poverty headcount rate (2011 HCES/WMS, CSA): 32.4 per cent.
- Rank on Human Development Index (2017, UNDP): 173/186.
- Infant mortality per 1,000 births;(EDHS, 2016): 48.
- Maternal mortality rate (per 100,000 births EDHS, 2016): 412.
- Stunting prevalence (children <5 years; EDHS, 2016): 38 per cent.
- Female genital mutilation in 15–49 age group (EDHS, 2016): 65.2 per cent.
- Net Attendance Ratio (Primary, G1–8; EDHS, 2016): 71.3 per cent.
- Gender Parity Index (Primary, G1–8; EDHS, 2016): 1.01 per cent.
- Student-to-teacher ratio (G1–8; GESAA, 2015/16): 46.
- Population using improved drinking water sources (EDHS, 2014): 52.7 per cent.
- Households practising open defecation (EDHS, 2014): 34.3 per cent.

[1] National Planning Commission. September 2017. Ethiopia's Progress towards Eradicating Poverty: an Interim Report on 2015/16 Poverty Analysis Study.
[2] African Development Bank. The 2016 African Economic Outlook (AEO), Ethiopia Country Note.
[3] The World Bank. 2014. Ethiopia Poverty Assessment. Report No. AUS6744.
[4] CSA, UNICEF and OPM. 2015. Child Well-Being in Ethiopia: Analysis of Child Poverty using the HCES and WMS 2011 Datasets.
[5] FDRE, Ministry of Finance and Economic Cooperation (MoFEC). 2013. Development and Poverty in Ethiopia 1995/96 to 2010/11.
[6] UNICEF Ethiopia and Central Statistical Agency. 2019. Multi-dimensional Child Deprivation in Ethiopia: First National Estimates. The nine dimensions studied were physical development (stunting), health, nutrition, education, health-related knowledge, information and participation, water, sanitation and housing).
[7] ibid.

2. Aggregate Spending Trends and Priorities

Aggregate national spending has increased more than two-fold, from ETB 163 billion in 2012/13 to about ETB 334 billion in 2016/17, showing an annual average growth rate of 17 per cent and 6.7 per cent in nominal and real terms, respectively (Figure 4). In per capita terms, nominal spending has increased from ETB 3130 in 2015/16 to ETB 3540 in 2016/17. The majority of the budget has been going to public investments, primarily intended to ensure inclusive and equitable development. This demonstrates the government's firm determination to enhance and improve Ethiopia's social and economic infrastructure and build the nation's productive capacity.

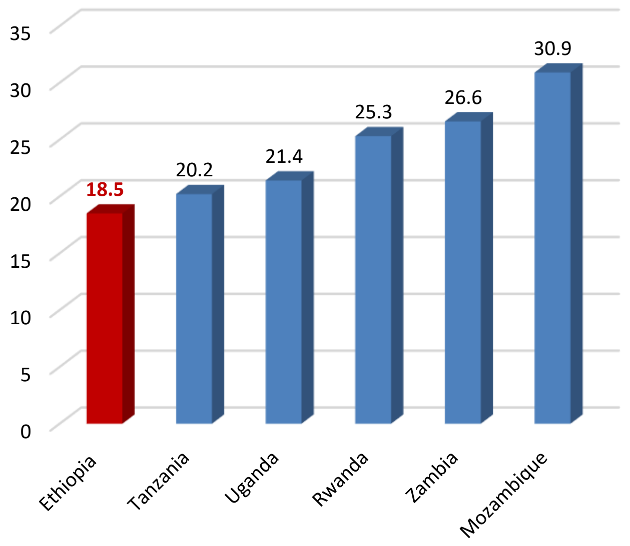
Figure 4: Nominal and real spending (in billion ETB)



Source: Data from Ministry of Finance (MoF). Real values are calculated by the authors, with 2012/13 as the base year.

In terms of allocation of expenditure across the broad categories, on average, the largest share of the national expenditure between 2012/13 and 2016/17 was allocated to finance economic development, followed by social services, and finally administrative and general services. Ethiopia's general government total expenditure was 18.5 per cent of GDP in 2016/17. **Compared to selected sub-Saharan African (SSA) countries, Ethiopia's position is low, as depicted in Figure 5 below**.

Figure 5: Total government expenditure (per cent of GDP), 2016



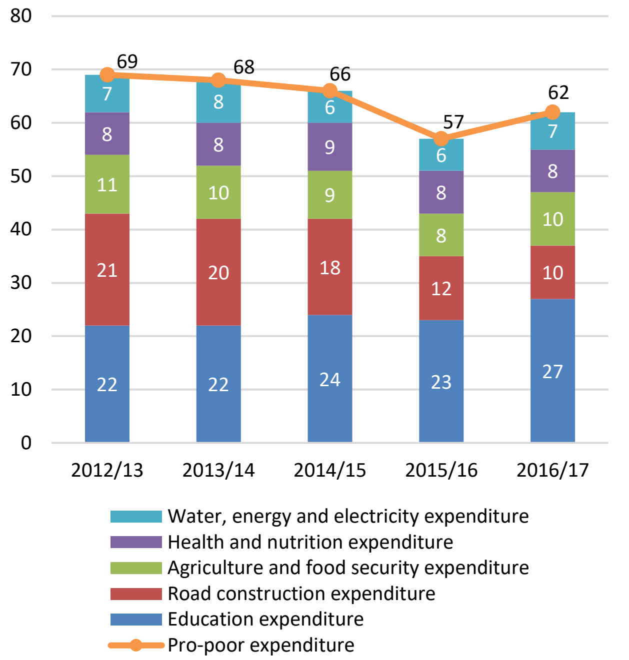
Source: Data from the International Monetary Fund (IMF).

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. In essence, public expenditure has been aligned to poverty reduction priorities in Ethiopia. Sub-national expenditures are also consistent with poverty reduction goals. In this regard, the GoE has leveraged huge resources to boost spending in what it refers to as the 'main pro-poor sectors', 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 PSNP).[8] **National expenditure on these sectors averaged 64 per cent of total national expenditure over the past five years (Figure 6).**

[8] The World Bank. 2014. Ethiopia Poverty Assessment. Report No. AUS6744, p.v.

Figure 6: Distribution of pro-poor expenditure (per cent of total expenditure)



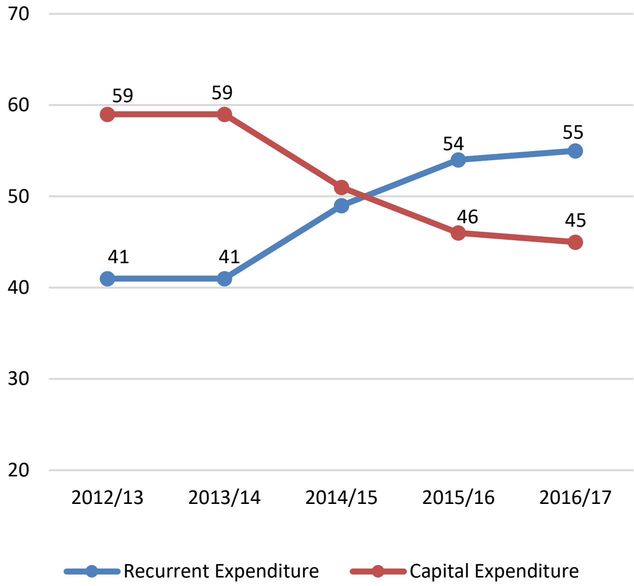
Source: Data from MoF.

As shown in Figure 6 above, the strong commitment to educational development is reflected in expenditure allocated to the sector, which has increased steadily since 2012/13 to reach 27 per cent of total government expenditure in 2016/17. Road construction as well as agriculture and food security each received 10 per cent of national expenditure in 2016/17, while health and nutrition, and water, energy and electricity received 8 per cent and 7 per cent of national spending respectively in the same period. **The disproportionate allocation of budgetary resources to the water sector and specifically to institutional water and sanitation, might negatively affect educational outcomes and child and maternal health.**

Recurrent versus Capital Expenditure

Before 2014/15, the national expenditure pattern mainly focused on allocating more resource for building economic and social infrastructure to provide basic services. To this end, the lion's share of the annual budget was devoted to capital expenditure, which is critical to bringing future benefits through building physical assets and infrastructures, as well as promoting human resources development. Recently, however, capital expenditure as a share of total expenditure declined consistently from 59 per cent in 2013/14 to 45 per cent in 2016/17 (Figure 7). Although both capital and recurrent expenditure are increasing in absolute terms, the share of capital in total expenditure is declining. Past capital spending will also require increased current and future recurrent expenditure to run and maintain the capital investments that had been made.

Figure 7: Capital and recurrent expenditure (per cent of total expenditure)



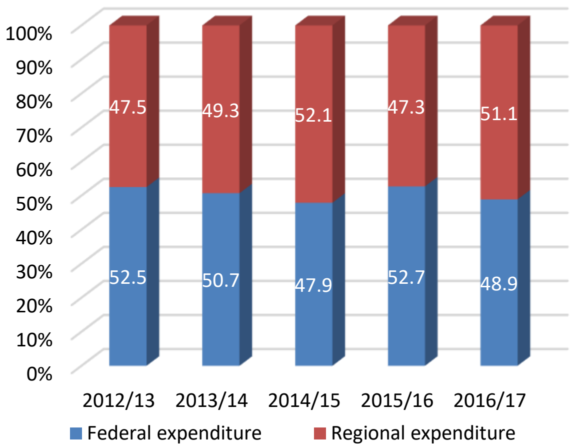
Source: Data from MoF.

Recurrent expenditure as a share of total expenditure increased consistently from 41 per cent in 2013/14 to 55 per cent in 2016/17 (Figure 7). The higher share of recurrent expenditure in 2015/16 and 2016/17 was in part due to the implementation of salary adjustments for public servants and an additional supplementary budget for drought-affected areas. During this period, half of the national recurrent expenditure was channelled towards financing education, health and nutrition, water and energy, roads, as well as agriculture and food security.

Fiscal Decentralization and Sub-national Spending

In view of devolving fiscal decision-making to lower tiers of government, the GoE designed a fiscal decentralization strategy with the specific objective of promoting basic services to citizens. Accordingly, most of the budgetary resources (close to 51.1 per cent) were being managed by the regional governments in 2016/17 (Figure 8). Regional governments are entitled to general and specific sector responsibilities, including basic social service delivery, such as the construction of primary and secondary schools, health posts and health centres, water and sanitation, rural roads, agriculture development and natural resources protection. The federal government, on the other hand, is responsible for investing in highways, universities, power generation and dissemination, natural resources development and food security, which are implemented throughout the country.

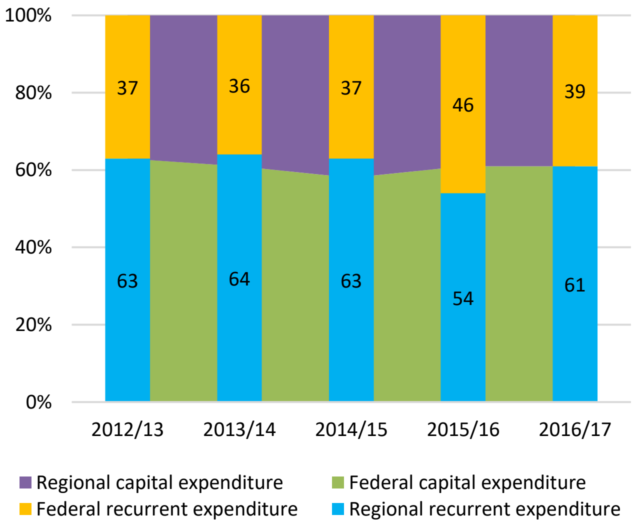
Figure 8: Federal and regional expenditure (per cent of total spending)



Source: Data from MoF.

Compared to the regional governments, the federal government is spending a larger portion of its budgetary resource on capital expenditure in an effort to address the infrastructure gap throughout the country. The federal government's share in total recurrent spending has declined from 46 per cent in 2015/16 to a low of 39 per cent in 2016/17 (Figure 9). Regional governments are primarily undertaking recurrent expenditure, leaving more responsibility for the federal government to finance large, countrywide, capital investment projects. As a result, and as can be seen in Figure 9, regional governments' share of total recurrent expenditure is higher than the federal government's share. This implies that the bulk of the national recurrent expenditure (close to 61 per cent) was allocated to finance regional-level recurrent spending in 2016/17.

Figure 9: Federal and regional capital and recurrent spending (per cent of total capital and recurrent spending)

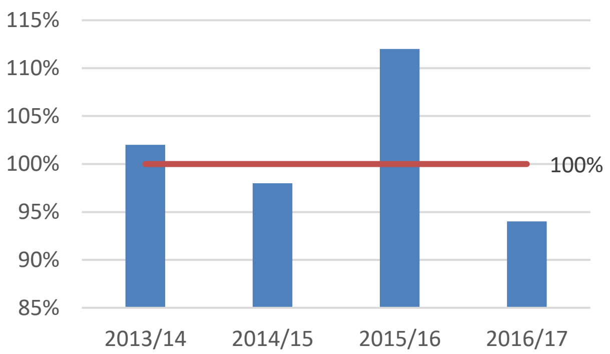


Source: Data from MoF.

Budget Credibility

Within a context of an increasing budget, Ethiopia faces resource constraints to adequately meet its financing needs which can be exacerbated by inefficient budget utilization. **In order for the budget to be an effective instrument of implementation of public policies, it is important that it is realistic and that it is implemented as it was approved.** Budget credibility is measured as actual expenditure as a share of the original approved budget. In this regard, the credibility of the federal government's budget indicates that the actual amounts spent were not very different from the approved budget, except in 2015/16 (Figure 10). Budget credibility would be expected to show deviation as a result of supplementary budgets that are approved halfway through the fiscal year. A budget increase later in the fiscal year would be harder to spend effectively. Other reasons for deviation from the original approved budget could probably be limited capacity for budget preparation and forecasting, and unpredictability of external aid.

Figure 10: Federal government budget credibility



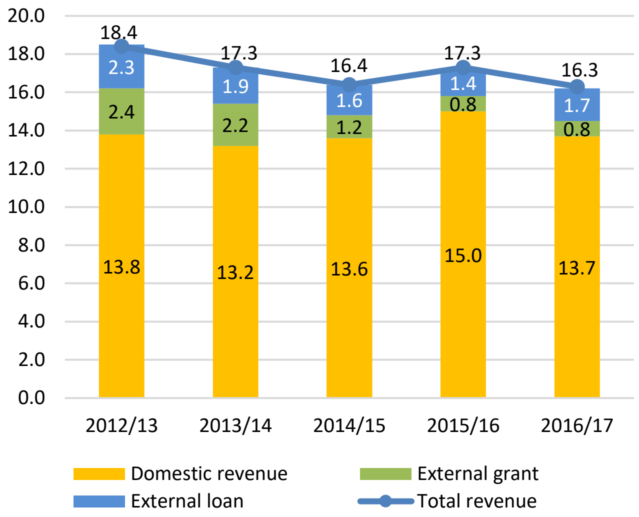
Source: Data from MoF (information for sub-national levels of government has not been made available).

3. Financing the National Budget

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 external grants and loan) increased significantly from ETB 267 billion in 2015/16 to ETB 294 billion in 2016/17. However, **total government revenue declined from 17.3 per cent of GDP in 2015/16 to 16.3 per cent in 2016/17 (Figure 11), 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. External assistance continues to be a key source of financing and its share in GDP has increased from 2.2 percent in 2015/16 to 2.5 percent in 2016/17. However, considering its trend since 2012/13, its share in GDP has been declining indicating **relatively greater reliance on domestic financing.**

Figure 11: Sources of government budget (per cent of GDP)

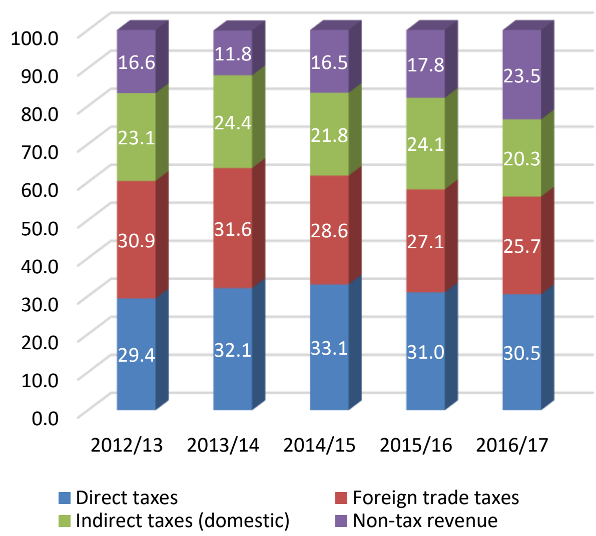


Source: Data from MoF.

In terms of domestic financing, Ethiopia generates the majority of its resources from taxes, which amounted to 76.5 per cent of domestic revenue in 2016/17, lowering from 88.2 per cent in 2013/14. As an agrarian economy that is not fully monetized, with a large, untaxed, non-agrarian informal sector, the contribution of direct tax sources remains relatively limited, and its average share remained constant at around 31 per cent of domestic revenue in the past five years (Figure 12). While contributing about 35.9 per cent of the national GDP, agriculture provides less than 0.5 per cent of tax revenue in 2016/17. Most of the revenues from direct taxes are generated from payroll tax and taxes on profits of enterprises and individuals.

The Income Tax Proclamation of July 2016 amended the legislation regulating income taxes from employment, rental of buildings and businesses. According to the proclamation, a monthly income from employment below ETB 585 is exempt 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. As far as income from businesses and the rent of buildings are concerned, annual income below ETB 7,000 is free from income tax.

Figure 12: Domestic revenue sources (per cent of domestic revenue)



Source: Data from MoF.

Among the major domestic revenue sources, indirect tax such as Value Added Tax (VAT) has become an important and growing source of revenue to the national government. The share of domestic VAT revenue averaged 22.8 per cent of domestic revenue for the past five years (Figure 12). Foreign trade taxes entirely collected from imported goods make up the largest share of the total domestic revenue next to direct tax, averaging 28.8 per cent for the past five years. 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 basic government services. The share between tax and non-tax revenue sources shows a relatively constant trend over time.

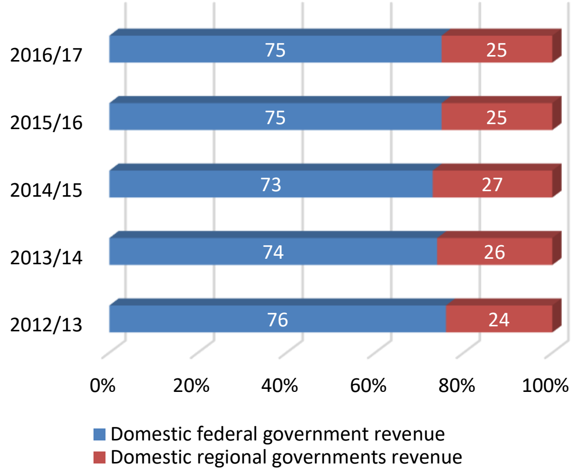
The tax-to-GDP ratio remains low (10.5 per cent of GDP in 2016/17) compared to the sub-Saharan average of 18 per cent. Thus, fostering taxpayer education and sensitization, encouraging voluntary tax compliance and strengthening enforcement efforts can contribute to the tax revenue base. Ethiopia's macroeconomic context of a low tax-to-GDP ratio, a high saving–investment gap (16.2 per cent of GDP), a high current account deficit (10 per cent of GDP), and a high level of external debt (30.4 per cent of GDP) in 2016/17, will necessitate boosting revenues and strategic spending options.[9]

In terms of ownership, **while the federal government collects the lion's share of the national revenue (averaging 74.6 per cent for the past five years),**

[9] International Monetary Fund (IMF) Article IV, Ethiopia Country Note, 2018.

the regional governments are entitled to collect their own revenue in their respective constituencies from individual businesses, farmers, land and property. As can be seen from Figure 13, the share of revenue generated by the regional governments has remained consistent over time.

Figure 13: Federal and regional government revenue (per cent of total domestic revenue)



Source: Data from MoF.

4. Public Financial Management

Over the past two decades, the GoE has made meaningful strides in most visible areas of Public Financial Management (PFM). The PFM reform of the government intended to improve the transparency, accountability, efficiency and effectiveness of public financial management processes. Reforms in this area aimed at managing the budgetary process in a medium-term perspective and redirecting government expenditure to poverty-oriented sectors, enhancing the quality of public service delivery by public institutions. Strengthening the financial management processes and systems, and providing timely, transparent and accurate financial information across the public sector, remained critical in the reform endeavour, though further improvements are required. The Expenditure Management and Control Programme (EMCP) of the Ministry of Finance, has undertaken several reform measures to help modernize the country's public finance management.

Ethiopia's budgeting system is comprehensive, and policies and priorities are linked to the national budget. 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.

Moreover, the government has placed great emphasis on the efficiency and effectiveness of public expenditure. To this end, directives aimed at creating fiscal space through budgetary saving have been issued. Public bodies are requested to identify potential budget saving areas, and to focus on efficiency in their budgetary execution. However, **the national budget does not include state-owned enterprises**, whose investment is increasingly becoming significant, and **a significant proportion of external financing being directed to them through off-budget channels.**

The traditional budgeting structure of presenting on-budget expenditures by line item has been officially replaced by programme-based budgeting at the federal level, but at the sub-national level line item budgeting is currently in place with plans to gradually shift to programme-based budgeting.

The GoE, in collaboration with its development partners, designed indicators as a base for regularly assessing public financial management in the country. In this regard, since 2004, the Fiduciary Assessment (FA) and Joint Budget Annual Review (JBAR) of the country's financial management have been conducted regularly. Both exercises evaluate the federal as well as sub-national governments' PFM in terms of transparency, accountability and efficiency. According to the 2015 federal government Public Expenditure and Financial Accountability (PEFA) report, some of the indicators the country is performing on well include the consistency of aggregate expenditure to the original approved budget, legislative scrutiny of the annual budget law, budget classification, comprehensiveness of information included in budget documentation, orderliness and participation in the annual budget process, transparency of taxpayer obligations and liabilities, timeliness and regularity of accounts reconciliation as well as effectiveness of internal audits. Areas identified as needing more focus and improvement include public access to key fiscal information, predictability of funds, and the quality of annual financial statements. Lack of legislative scrutiny of external audit reports, inadequate financial information provided by donors for budgeting and reporting on project and programme aid, and the lower proportion of aid being managed by the use of national procedures were identified as challenges. The upcoming PEFA report in 2019/20 is expected to reveal the up-to-date assessment of the country's public financial management system.

Highlights of the 2018/19 Federal Government Budget Proclamation

Key Messages

- The total federal budget for the 2018/19 fiscal year (FY) is ETB 346.9 billion, which represents about an 8.1 per cent nominal increase compared with the previous fiscal year. Close to 85 per cent of the budget is planned to be mobilized from domestic sources, with the remaining 15 per cent from external sources.

- Approximately ETB 113.6 billion is planned to be allocated to capital spending, while some ETB 91.7 billion is scheduled for recurrent spending.

- ETB 135.6 billion (39.1 per cent) will be allocated to subsidies for regional states. About ETB 6 billion will also be made available as additional support for the implementation of the Sustainable Development Goals (SDGs), which represents a significant decline compared to ETB 12 billion in the 2016/17 FY.

- More than 58 per cent of the federal budget is planned to be allocated to pro-poor and growth-enhancing sectors in 2018/19. This suggests that the government continues to prioritize investing in the access of basic services.

- The government budgeted to borrow over ETB 32.8 billion from bilateral and multilateral sources in 2018/19. Though this amount of funds is directly associated with significant growth-enhancing public investments, it will be challenging to maintain macroeconomic stability assuming sluggish export performance and close to ETB 22.5 billion amortization and debt servicing.

1. Background and Context

In addition to the federal-level parliament, there are nine autonomous sub-national regional governments and two city administrations, each with their 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), the budget allocations from the federal government, as well as from all the regional governments and city administrations for the respective sector, need to be aggregated.

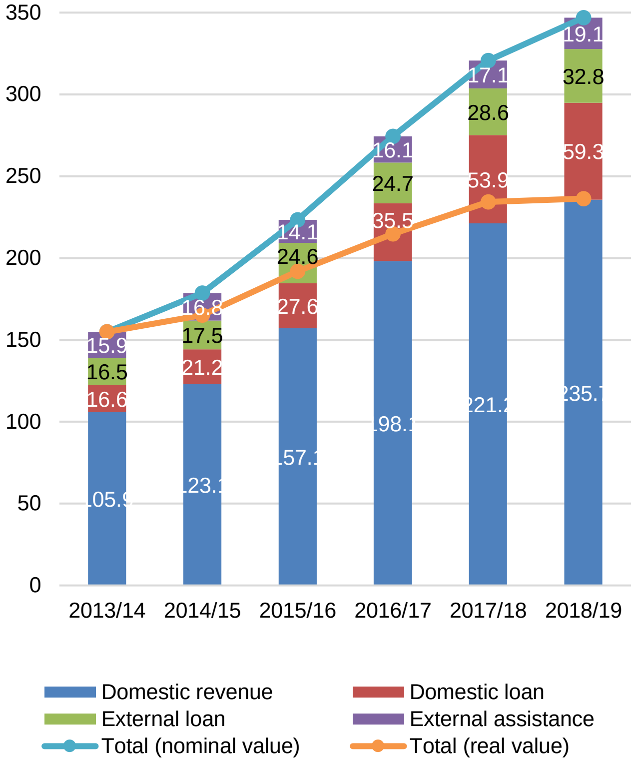
As data is currently only available for the federal government's budget proclamation, sector budget allocations analysed in this section leave out the majority of the national budget allocated to key social sectors, given that the bulk of social sector spending is undertaken at the sub-national level. 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; these represent significant amounts of money that would be missed if solely considering sector allocations made at the federal level. With this caveat, the highlights of the federal government's 2018/19 budget are presented below.

2. Revenue Budget

Total federal budget for the 2018/19 fiscal year (FY) is ETB 346.9 billion, which represents increases of about 8.1 per cent and 0.9 per cent in nominal and real terms, respectively, compared with the budget of ETB 320.8 billion approved in the previous fiscal year[10] (Figure 1). This budget will be financed from domestic and external sources, with the latter comprising of borrowing and assistance in the form of grants from development partners. In 2018/19, the government forecast to collect ETB 295 billion (85 per cent of the total budget) from domestic sources and the remaining ETB 51.9 billion from external sources.

- ETB 235.7 billion (68 per cent of the total budget) is planned to be mobilized from domestic revenue, of which tax revenue accounts for 89.6 per cent.
- ETB 59.3 billion (17 per cent of the total budget) is intended to be mobilized from domestic borrowing.
- ETB 32.8 billion (9.5 per cent of the total budget) is forecasted to be collected from external sources in the form of loans.
- ETB 19.1 billion (5.5 per cent of the budget) will come from bilateral and multilateral development partners in the form of external grants/assistance.

Figure 1: Sources of finance for federal budget (in billon ETB)



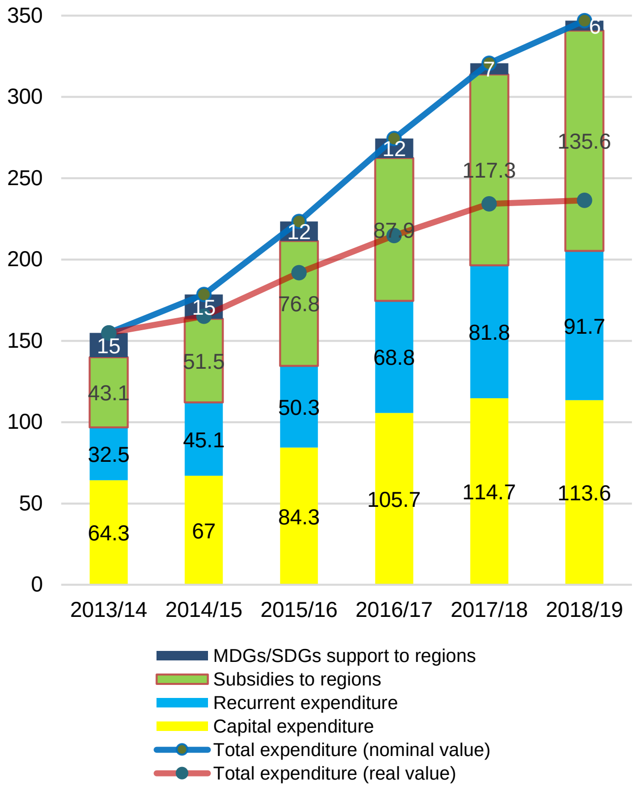
Source: Data from MoF. Real values are calculated by the authors, with 2013/14 as the base year.

3. Expenditure Budget

Of the total revenue budget, approximately ETB 113.6 billion (1 per cent less than last year) will be allocated to capital spending, while some ETB 91.7 billion is scheduled for recurrent expenditure for the 2018/19 FY (Figure 2). Over ETB 135.6 billion (around 39.1 per cent) will be allocated to subsidies to regional states. This indicates the government's commitment to devolving fiscal decision-making to lower tiers of government, and a fiscal decentralization strategy, with the specific objective of promoting basic services to citizens. Moreover, about ETB 6 billion will be made available for the implementation of the Sustainable Development Goals (SDGs) for 2018/19.

[10] This budget does not include budgets of state-owned enterprises and regional governments' budgets from their own sources.

Figure 2: Trends of federal expenditure budget (in billion ETB)

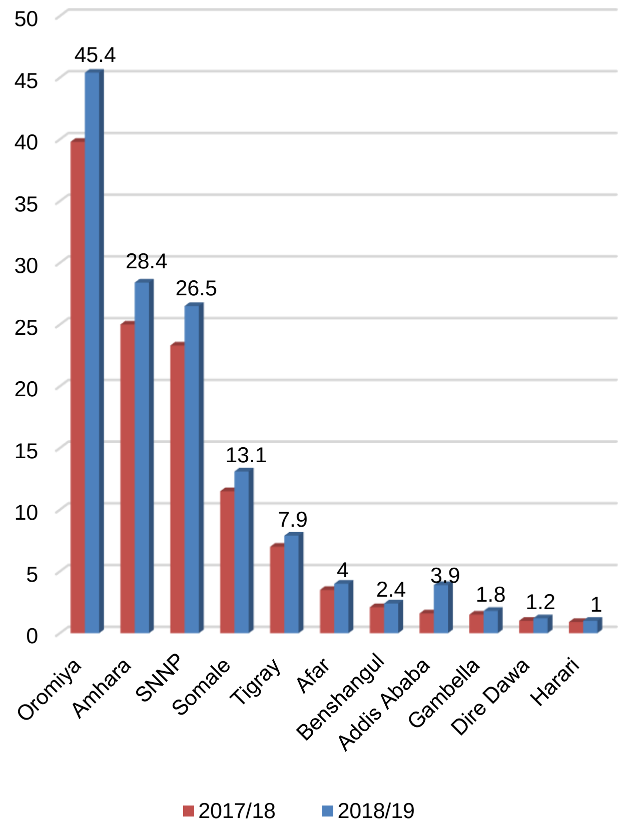


Source: Data from MoF. Real values are calculated by the authors, with 2013/14 as the base year.

3. Federal Subsidies (non-earmarked block grants) to Regional Governments

Fiscal decentralization and local governance are two of the government's main priorities. As a result, federal transfers[11] to regions have more than doubled from ETB 51.5 billion in the 2014/15 FY to 135.6 billion in the 2018/19 FY, of which 33.5 per cent (ETB 45.4 billion) goes to Oromia regional state (Figure 3). Amhara, SNNP, Somali, Tigray and Afar regions will receive ETB 28.4 billion, 26.5 billion, 13.1 billion, 7.9 billion, and 4 billion, respectively. The share of Benishangul-Gumuz, Gambella and Harari regions, as well as Dire Dawa, from the total federal subsidies, remained almost the same in 2017/18 and 2018/19. Moreover, the federal subsidy transferred to Addis Ababa has increased by 144 per cent this year compared to the previous fiscal year. Note that in an attempt to redress the imbalances among the developed and the less developed regions, 1 per cent of the total subsidy budget usually goes to Somali, Benishangul-Gumuz, Afar and Gambella regional states unconditionally.

Figure 3: Trends of federal subsidies across regions (in billion ETB)



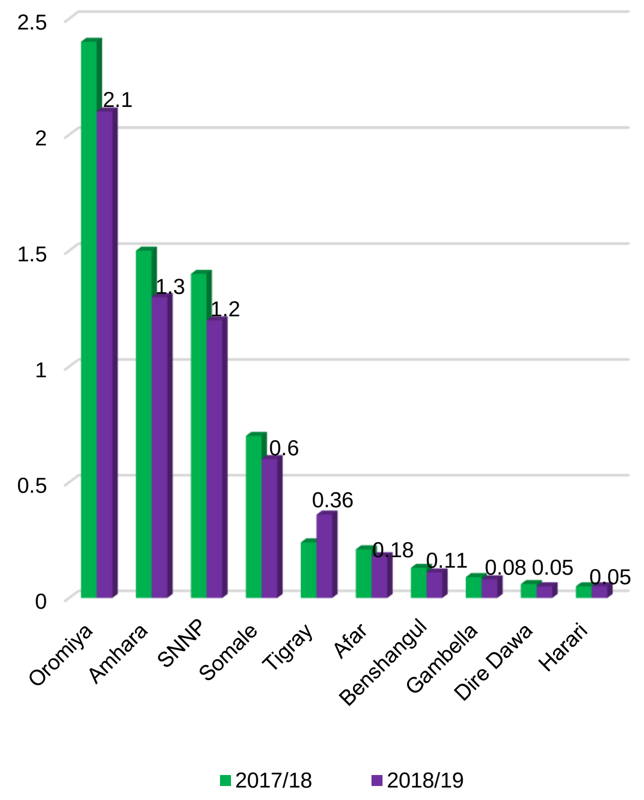
Source: Data from MoF.

4. Support for Regions' Implementation of SDGs

Since 2011/12, it has been proclaimed that additional budgetary support will be provided for regional governments to finance capital projects that help achieve the targets of the Millennium Development Goals (MDGs) and in the post 2015 era this support has continued to help achieve the Sustainable Development Goals (SDGs). In 2018/19, ETB 6 billion will be transferred to regional states, as per the grant formula for the implementation of the SDGs. This will help to address the needs of poor and vulnerable groups, including equitable access to services and to productive resources. However, ETB 6 billion represents a significant decline in the federal transfer to support implementation of SDGs compared to ETB 12 billion in 2017/18 (Figure 4).

[11] The federal government transfers unearmarked block grants (also referred to as subsidies) to regional governments using a General-Purpose Grant Distribution Formula that is further elaborated in Annex 2.

Figure 4: Budget support for the implementation of SDGs across regions (in billion ETB)

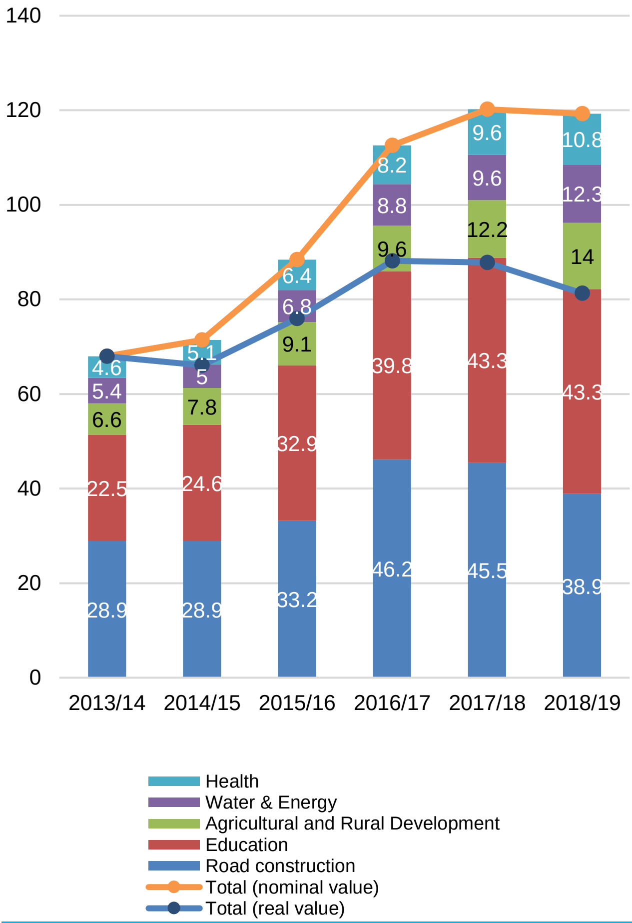


Source: Data from MoF.

5. Federal Allocations to Pro-Poor and Growth-Enhancing Sectors

For the past two decades, government allocations have been aligned to poverty-reduction priorities. Accordingly, more than 58 per cent of the federal budget is planned to be allocated to pro-poor and growth-enhancing sectors (education, health, water and energy, agriculture and rural development, and road construction) in 2018/19 (Figure 5). It is worthwhile to note the relatively large increase in the education budget over the past several years with slow but steady increases in other social sectors. Furthermore, the increase in the share of the social sector budget (mainly in education, health, and water and sanitation) in the past few years suggests that the government is giving more attention and emphasis to improving the access and quality of public service delivery at both federal and regional administration levels. Up until 2017/18, the largest investment was in road construction and the decline in the share of the budget allocated to road construction in 2018/19 would explain the reduction in the overall budget allocated to the pro-poor and growth-enhancing sectors.

Figure 5: Federal budget allocations to pro-poor sectors (in billion ETB)



Source: Data from MoF. 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 sector, as well as social protection, are presented in accompanying budget briefs. In analysing the composition of public expenditures, the issue is not only to assess which sectors are underfunded or not funded at all, but to appraise levels of 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: Ethiopia Total National On-budget Records 2012/13–2016/17

Gregorian Calendar Fiscal Year	2012/13	2013/14	2014/15	2015/16	2016/17
Ethiopian Fiscal Year	**2005**	**2006**	**2007**	**2008**	**2009**
Population (in million)	84.8	87	89.1	91.2	94.4
GDP at Current Market Price (in million ETB)	866,921	1,060,825	1,297,961	1,541,277	1,806,656
GDP Growth Rate	9.9	10.3	10.4	8	10.9
GDP Per Capita (USD)	559	640	725	801	863
General Inflation Rate (CPI growth rate)	13.5	8.1	7.7	9.7	7.2
Exchange Rate (period weighted average)	19.3	19.9	20.1	21.1	22.4
National Revenue (in million ETB)					
Total National Revenue	**159,827.6**	**183,238.6**	**213,488.8**	**266,898.4**	**294,043.7**
Domestic Revenue	119,834.9	139,677.7	176,795.8	231,789.5	247,517.9
Tax Revenue	99,940.0	123,179.4	147,540.2	190,519.6	189,338.7
Direct Taxes	35,229.3	44,855.1	58,554.6	71,843.9	75,547.1
Indirect Taxes (Domestic)	27,715.9	34,150.7	38,487.8	55,952.8	50,156.7
Foreign Trade Taxes	36,994.8	44,173.6	50,497.8	62,722.9	63,635.0
Non-Tax Revenue	19,894.9	16,498.4	29,255.7	41,269.9	58,179.2
Domestic Federal Government Revenue	90,733.6	103,514.3	129,756.2	174,427.9	185,513.7
Domestic Regional Government Revenue	29,101.3	36,163.4	47,039.7	57,361.6	62,004.2
External Assistance and Loans	**39,992.7**	**43,560.9**	**36,692.9**	**35,108.9**	**46,525.8**
External Assistance	20,447.3	23,142.6	15,794.7	12,884.4	15,275.3
External Loans	19,545.3	20,418.3	20,898.2	22,224.5	31,250.5
National Expenditure (in million ETB)					
Total National Expenditure	**162,705.7**	**192,673.6**	**231,015.5**	**285,471.1**	**334,176.8**
Total National Recurrent Expenditure	66,444.1	78,630.6	112,685.2	154,747.0	183,667.1
Total National Capital Expenditure	96,261.6	114,043.0	118,330.3	130,724.1	150,509.8
Total Federal Government Expenditure	**85,414.6**	**97,720.1**	**110,585.7**	**150,508.0**	**163,565.6**
Federal Government Recurrent Expenditure	24,650.7	28,239.5	41,731.3	70,491.8	71,585.2
Federal Government Capital Expenditure	60,763.9	69,480.6	68,854.4	80,016.2	91,980.4
Total Regional Government Expenditure	**77,291.1**	**94,953.5**	**120,429.7**	**134,963.1**	**170,611.3**
Regional Government Recurrent Expenditure	41,793.4	50,391.2	70,953.9	84,255.2	112,081.9
Regional Government Capital Expenditure	35,497.7	44,562.4	49,475.9	50,707.9	58,529.4
National Pro-Poor Expenditure (in million ETB)					
Total National Poverty-Oriented Expenditure	**113,446.2**	**131,008.6**	**152,341.0**	**166,451.1**	**204,576.4**
Total National Education Expenditure	36,054.5	41,548.5	54,667.6	65,696.5	88,590.0
Total National Health and Nutrition Expenditure	12,484.9	15,865.3	21,123.7	22,706.2	25,828.2
Total National Agriculture and Food Security Expenditure	18,529.5	19,429.1	21,370.0	24,234.4	33,106.1
Total National Water, Energy and Electricity Expenditure	11,912.0	15,492.9	13,434.6	18,318.5	22,217.6
Total National Road Construction Expenditure	34,465.3	38,672.8	41,745.2	35,495.6	34,834.6
Federal Government Expenditure (Original Budget, Adjusted Budget, and Actual Expenditure)					
Total Federal Expenditure	**85,414.6**	**97,720.1**	**110,585.7**	**150,508.0**	**163,565.6**
Original Budget	81,277.2	95,851.7	111,045.5	133,889.2	173,701.5
Adjusted Budget	93,489.9	102,759.5	115,532.5	182,511.4	201,115.4
Actual Expenditure	87,680.1	97,794.0	109,105.6	150,508.0	163,567.1
Total Federal Capital Expenditure	**60,763.9**	**69,480.6**	**68,854.4**	**80,016.2**	**91,980.4**
Original Budget	54,466.2	63,321.7	65,990.2	83,600.7	104,908.6
Adjusted Budget	66,658.4	71,106.2	73,304.7	105,077.0	124,749.3
Actual Expenditure	60,833.5	67,638.9	67,374.4	80,016.2	91,980.4
Total Federal Recurrent Expenditure	**24,650.7**	**28,239.5**	**41,731.3**	**70,491.8**	**71,585.2**
Original Budget	26,811.0	32,530.0	45,055.3	50,288.4	68,792.9
Adjusted Budget	26,831.4	31,653.3	42,227.9	77,434.4	76,366.0
Actual Expenditure	26,846.5	30,155.1	41,731.2	70,491.8	71,586.7

Source: Data from MoF.

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

The responsibility of deciding the proportion of the general-purpose grant allocation to the regional states has been constitutionally vested in the House of Federation (HoF) since 1994/95. Federal transfers are distributed based on the relative fiscal gaps of regional states, and the HoF has adopted a grant allocation formula in order to capture the gaps as accurately as possible. The HoF revises 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 have been 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; the expenditure needs are estimated using the representative expenditure system; and 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 have also been made to 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, which represents 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 by 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 was 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 good-quality data on some essential variables of interest have been the most important challenges faced in estimating the revenue-generating capacities and expenditure needs of regional states. Moreover, it is impossible in this revision to capture some of the concerns raised by regional governments, such as the variation in the quality of public services provided and the efficiency differential across regional states.

As a result of this computation, from 2017/18 to 2019/20, the total amount of the federal general purpose block grant is divided 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.

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

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