BALANCING COMPETING PRIORITIES IN THE ERA OF COVID-19

unicef for every child

Ethiopia

Budget Brief 2020/21

KEY MESSAGES

1 **The national budget for 2020/21 has nominally increased by 57 per cent, from ETB 369 billion in 2016/17 to ETB 582 billion in 2020/21. However, in real terms, the national budget has declined by 12 per cent over the same period due to the high level of inflation.**

Recommendation: The government should take all necessary measures to bring inflation under control to ensure that the real value of the allocated budget is maintained over time.

2 **In 2020/21, 60.7 per cent of the total public budget was directed towards priority sectors (education, health, water and energy, roads, agriculture and food security). The budget share allocated to the education and health sectors has shown an increase from 2019/20 values by 2 percentage points.**

Recommendation: The government should continue prioritizing these sectors by increasing their allocation, coupled with improved spending efficiency.

3 **With regards to the national budget execution, the analysis of budget and expenditure for 2018/19 indicates lower budget credibility compared to previous periods. Budget credibility for capital and recurrent spending were estimated at 88 per cent and 87 per cent, respectively.**

Recommendation: This suggests the need for improved budget planning with special attention to underperforming sub-components, and addressing bottlenecks for the effective utilization of capital and recurrent budgets.

4 **With fiscal devolution, regional governments managed a little more than half of the national budget (52.5 per cent) in 2020/21. In terms of budget composition, regional budgets are predominantly recurrent. Capital budgets account for 32 per cent of regional budgets, compared to 58 per cent for the federal budget. This makes it challenging for regions to make capital investments in the construction of primary and secondary schools, and lower-tier health facilities, which in turn adversely impacts service delivery.**

Recommendation: Increasing capital budget allocation for regions is required for adequate capital investments and improved service delivery.

5 **The ratio of tax revenue to GDP is very low, at 9.2 per cent in 2019/20, and has been declining over the years despite the government's effort to increase domestic resource mobilization.**

Recommendation: The government should continue its concerted efforts to improve domestic resource mobilization to ensure increased government revenue and further reduce donor dependence. Measures such as enhancing tax collection capacity, increasing citizens' awareness, and strengthening enforcement efforts can all contribute towards increased resource mobilization.

6 **Increased expenditure due to the COVID-19 pandemic, the crisis related to the conflict in northern Ethiopia and rising humanitarian needs is expected to result in a widening budget deficit. The pandemic, coupled with increasing security-related and humanitarian response expenditure, could lead to a shortage of funds for child-focused social sectors, and less fiscal space to increase social spending.**

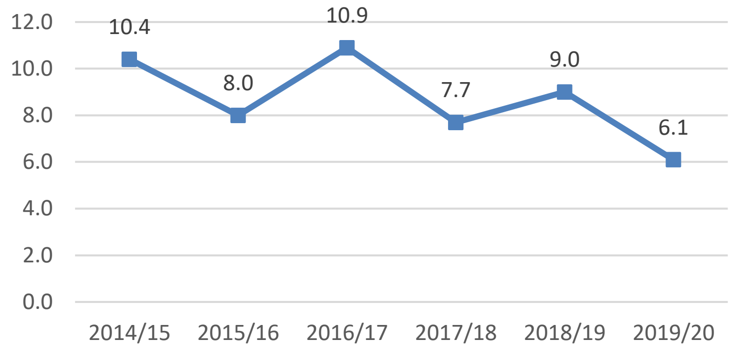
Recommendation: Efficient budget utilization and spending effectiveness in social sectors should be given due attention in situations where the government is unable to expand its spending, such as under the current circumstances. Strong focus should also be placed on ensuring debt sustainability and increasing domestic resource mobilization to secure further investments on children

1. MACROECONOMIC OVERVIEW

The Ethiopian economy has been growing at an average of 9.6 per cent between 2010/11 and 2018/19. In 2019/20, however, the growth rate plummeted to 6.1 per cent, mainly due to the impact of COVID-19 pandemic (Figure 1). Although real GDP growth was at its lowest value in the past 15 years, given the global economic shock caused by the pandemic, it is still one of the highest economic growth rates globally[1]. In recent years, however, growth has been volatile due to various internal and external pressures on the economy. The high economic growth of the previous years has brought in positive results in terms of decreasing the poverty rate, from 29.6 per cent in 2010/11 to 23.5 per cent in 2016 [2]. Life expectancy at birth has also increased, from 61.1 years in 2010 to 66.6 in 2019[3]. Moreover, the average number of years of schooling has increased from 2.3 to 2.9, and the overall human development indicator has increased by 15 per cent between 2010 and 2019, from 0.421 to 0.465. However, the country is still ranking low in human development, occupying position 173 out of 189 countries and territories[4].

[1] IMF (2020) World Economic Outlook Database. Retrieved from https://www.imf.org/en/Publications/WEO/weo-database/2020/October
[2] Planning and Development Commission (2018). Poverty and Economic Growth in Ethiopia: 1995/96-2015/16.
[3] UNDP (2020) Human Development Report 2020, The Next Frontier: Human Development and the Anthropocene Briefing note for countries on the 2020 Human Development Report (Ethiopia), retrieved from http://hdr.undp.org/sites/all/themes/hdr_theme/country-notes/ETH.pdf
[4] Ibid.

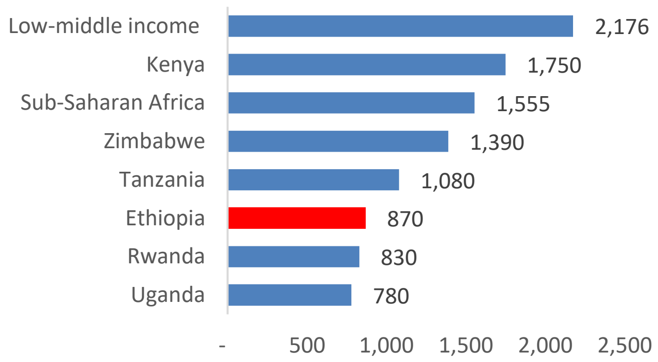
Figure 1: Real GDP growth (per cent)



Source: Data from the Ministry of Finance (2014/15-2019/20).

Despite notable growth and human development in the past decades, Ethiopia still has a very low gross national income per capita. With a GNI per capita of USD 870 in 2019, the country's aspiration to become a lower middle-income country by 2025 appears to be difficult to reach (Figure 2). The GNI per capita is much below the minimum threshold value for being classified as lower middle-income country (USD 1,026 in 2019, measured using the Atlas method). The per capita income is also much lower than the average of sub-Saharan African countries.

Figure 2: GNI per capita in current USD (the Atlas Method)



Source: World Bank 2019 Data[5].
Note: LMI stands for Lower Middle-Income countries.

Economic growth in 2019/20 was mainly driven by growth in the industry sector, which expanded by 9.6 per cent, with most of the contribution coming from the mining sub-sector. The growth rate in agriculture and services was 4.3 per cent and 5.3 per cent, respectively[6]. When considering specific sub-sectors, the strongest growth came from mining (91 per cent) and health care (13 per cent), while finance, construction, manufacturing and real estate grew by 10 per cent each. Compared to previous years, the growth rates of the education, transport, hotels and tourism, and construction sub-sectors have declined, given the high impact of the pandemic[7]. Overall export performance was not affected as expected, due to the increase in export earnings, mainly from gold.

[5] World Bank (2020). GNI Per Capita Ranking, Atlas Method and PPP Based. Retrieved from https://datacatalog.worldbank.org/dataset/gni-capita-ranking-atlas-method-and-ppp-based
[6] Cepheus Research and Analysis (2020), Macro Research Ethiopia; Quarterly Macroeconomic Review, Third Quarter 2020 retrieved from https://cepheuscapital.com/wp-content/uploads/2020/12/Quarterly-Macro-Review-THIRD-QUARTER.pdf
[7] Cepheus Research and Analysis (2020), Macro Research Ethiopia; Macroeconomic Handbook 2021. retrieved from https://cepheuscapital.com/ethiopia-macroeconomic-handbook-2021-rev1/

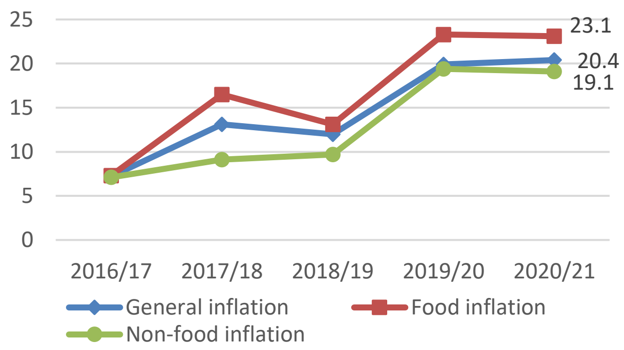
Table 1: Selected Economic Indicators (2019/20)

Indicator	Value	Data Source
GDP growth rate	6.1%	NPC (2020)
Share of agriculture sector to GDP	37.6%	NPC (2020)
Share of service sector to GDP	29.0%	NPC (2020)
Share of industry sector to GDP	39.5%	NPC (2020)
Public debt (% of GDP)	51.4%	MOF (2020)
External Debt (% of GDP)	26.8%	MOF (2020)
Domestic Debt (% of GDP)	24.5%	MOF (2020)
Fiscal Deficit (% of GDP)	26.8%	MOF (2020)
Inflation (12 months moving average)	19.9%	CSA (2020)

The double-digit economic growth rate witnessed in the past decade was mainly driven by public investments financed by external borrowing. This has led to increased macro-economic imbalances and vulnerabilities, such as the foreign exchange crunch and a high debt burden. The economy is also affected by high inflation and an increasing unemployment rate. To address these macro-economic imbalances, the government introduced its ambitious Homegrown Economic Reform Agenda in 2019. The agenda takes a comprehensive approach to address imbalances and ensure the economy stays on its high growth trajectory, with three reform pillars: macroeconomic, structural and sectoral reforms.

In recent years, one of the most significant macroeconomic challenges has been inflation. Average annual inflation for January 2021 was 20.4 per cent, with higher food inflation at 23 per cent, and non-food inflation at 19.1 per cent[8] (Figure 3). Unlike previous year trends, where food inflation was the main driver of general inflation in the country, non-food inflation is also becoming a driver of overall inflation. To curb inflation emanating from the monetary policy side, the National Bank of Ethiopia is moving away from providing direct financing to the government to issuing treasury bills to finance the budget deficit. However, other factors, such as supply side constraints and the higher annual depreciation rate of the Ethiopian Birr (ETB), also contribute to increasing inflation. This issue is a pressing challenge that needs further diving into to clearly understand major drivers and take appropriate action to ensure macro-economic stability in the country.

Figure 3: Inflation trend, 2016-2021 (%, annual averages)



Source: Data from Central Statistical Agency (CSA).

External debt distress is another challenge the economy is facing. With much of investment in previous periods being financed through external borrowing, the debt burden has been steadily increasing over the years. As of June 2020, total public debt as a percentage of GDP stood at 51 per cent, while the external debt-to-GDP ratio is 27 per cent[9]. Debt sustainability is becoming a major macroeconomic issue, with increasing external debt paired with low financing capacity. This has led the World Bank and the IMF to rate the country at high risk of external debt distress. Debt servicing capacity is further negatively affected by the pandemic, due to poor performance in the air transport, tourism and hospitality sectors, as well as declining remittances. To lower the public debt burden, the government is moving away from commercial to concessional loans. There is also an ongoing effort to get debt service relief and debt rescheduling on existing loans.

[8] The inflation rate for 2020/21 is the annual average inflation rate as of January 2021.
[9] Ministry of Finance (2020). Public Sector Debt Statistical Bulletin No. 34 (2015/16-2019/20).

Higher expenditure due to the COVID-19 pandemic, the crisis related to the conflict in northern Ethiopia and increasing humanitarian needs is expected to result in a widening budget deficit. In 2019/20, the fiscal deficit as a share of GDP was 2.6 per cent.[10] This is expected to widen, given the high expenditure burden related to COVID-19 (both increased health expenses and economic stimulus packages), as well as the current crisis due to the conflict in northern Ethiopia and in other parts of the country, which made increased spending on health and emergency assistance the government's immediate priority. The pandemic, coupled with the increasing security-related and humanitarian response expenditure, could lead to a shortage of funds for child-focused social sectors and less fiscal space to increase social spending. Efficient budget utilization and spending effectiveness in social sectors should be given due attention especially where the government is unable to expand its spending on these sectors. Strong focus should also be placed on ensuring debt sustainability and increasing domestic resource mobilization efforts.

To mitigate the effects of the COVID-19 pandemic, Ethiopia received assistance from the IMF and the World Bank in 2020. To address the economic slowdown and urgent balance of payment needs, the IMF approved USD 411 million in emergency assistance for the country under the Rapid Financing Instrument in April 2020[11]. Ethiopia will also be benefiting from IMF debt service relief under the Catastrophe Containment and Relief Trust. The World Bank too has approved USD 82.6 million (USD 41.3 million grant and USD 41.3 million credit) for the COVID-19 Emergency Response and Health Systems Preparedness Project, designed to help the country counter the devastating effects of the pandemic[12].

A new ten-year prospective development plan (2021-2030) was launched in 2020[13]. The plan aims to identify strategic objectives and goals to develop proper institutions for long-term development. GDP is projected to grow by an annual average rate of 10 per cent during the ten-year period, which is considered adequate to reduce the poverty rate to 7 per cent by 2029/30. In terms of fiscal policy, increasing tax collection efforts and expanding the tax base to reduce the country's dependence on external financing are included in the plan. Domestic revenue is projected to grow at an annual average rate of 26 per cent, resulting in an increase in the tax revenue-to-GDP ratio from 9.2 per cent to 18 per cent. The government expenditure-to-GDP ratio is also expected to reach 23 per cent by 2029/30.

With a devolved government structure, Ethiopia has a highly decentralized Public Financial Management system. The national budget is made up of the budget executed by the federal government and the general-purpose grants (also referred to as block grants) that go to the ten regions and two municipal cities (city administrations). The responsibility of deciding the general-purpose grant allocation to regional states is constitutionally vested in the House of the Federation (HoF). Federal transfers are made to the regions based on a general-purpose grant distribution formula adopted by the HoF (see Annex 2 for further details). The Federal budget consists of capital and recurrent expenditure for the federal government. The regions have their budgets approved by their respective sub-national parliaments, with their resource envelope consisting of the subsidies they receive from the Federal government and domestic resources mobilized in their respective regions.

In presenting the federal budget for the fiscal year 2020/21 FY (EFY 2013), some assumptions on major macroeconomic indicators were outlined. The government's economic growth rate forecast for 2020/21 is 8.5 per cent. This is much higher than the IMF's estimated growth rate of 2 per cent for the 2020/21 fiscal year[14]. The IMF forecasted a lower growth rate due to expected lingering impacts of the pandemic, although it expects the economy to rebound to 8.7 per cent growth in 2021/22, in line with the global recovery trajectory[15]. The government also stated its plans to bring the inflation rate down to single digit levels in 2020/21. Accordingly, the government forecasted the inflation rate for 2020/21 to be 9.8 per cent. However, data for the first half of the EFY 2020/21 indicate that this target may not be attainable, as inflation is expected to remain in the double digits until the economy recovers from the impacts of the pandemic and conflict. Total revenue for 2020/21 is forecasted to increase by 20 per cent from its 2019/20 value. Revenue performance for the 2019/20 fiscal year was not strongly affected by the pandemic. This is mainly because revenue collection for the first three quarters of the year was high, offsetting the lower revenue collection in the fourth quarter, which was affected by COVID-19.

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[10] Cepheus Research and Analysis (2020), Macro Research Ethiopia; Quarterly Macroeconomic Review, Third Quarter 2020 retrieved from https://cepheuscapital.com/wp-content/uploads/2020/12/Quarterly-Macro-Review-THIRD-QUARTER.pdf.

[11] IMF (2020). Press Release No. 20/199. Retrieved from https://www.imf.org/en/News/Articles/2020/04/30/pr20199-ethiopia-imf-executive-board-approves-emergency-assistance-to-address-the-covid-19-pandemic

[12] World Bank (2020). Retrieved from https://www.worldbank.org/en/news/press-release/2020/04/02/world-bank-group-provides-emergency-support-to-ethiopia-to-manage-health-economic-impacts-of-covid-19

[13] Planning and Development Commission (2020). Ten Years Development Plan: A Pathway to Prosperity (2021-2030).

[14] IMF (2021) Press Release No. 21/46 retrieved from https://www.imf.org/en/News/Articles/2021/02/23/pr2146-ethiopia-imf-reaches-a-staff-level-agreement-for-1st-and-2nd-reviews-of-ecf-and-eff#:~:text=%E2%80%9CLooking%20forward%2C%20economic%20growth%20is,consistent%20with%20a%20global%20recovery

[15] Ibid.

Table 2. Key Social Indicators (Latest available data)

Indicator	Value	Data Source
Total Population (million)	100.8	CSA Projection (2007 census)
Life expectancy at birth (years)	66.6	UNDP (2019)
Poverty headcount rate	23.5%	NPC (2017)
Food poverty headcount rate	24.8%	NPC (2017)
Multi-dimensional child Poverty rate	88%	CSA and UNICEF Ethiopia (2016)
Rank on Human Development Index	173/189	UNDP (2019)
Infant mortality (per 1,000 births)	48	EDHS (2016)
Maternal mortality rate (per 100,000 births)	412	EDHS (2016)
Stunting prevalence (children <5 years)	38%	EDHS (2016)
Female genital mutilation in 15-49 age group	65.2%	EDHS (2016)
Population using improved drinking water sources	61.8%	EDHS (2016)
Households practicing open defecation	32.3%	EDHS (2016)

Key Takeaways:

- Due to the impact of the COVID-19 pandemic, economic growth in 2019/20 was 6.1 per cent, much lower than the average growth rate of 9.4 per cent in the past decade. The hardest hit sectors are air transport, tourism and hospitality. Remittances also declined significantly. Export diversification should be given due attention to fend off external shocks.

- The high inflation rate continues to adversely impact the economy. Unless immediate policy measures are taken, high inflation will keep eroding public finances and household income.

- The surge in financing needs due to COVID-19 and increasing humanitarian needs means that the government should seek international assistance in the short term, in the form of concessional loans and grants to finance its fiscal deficit.

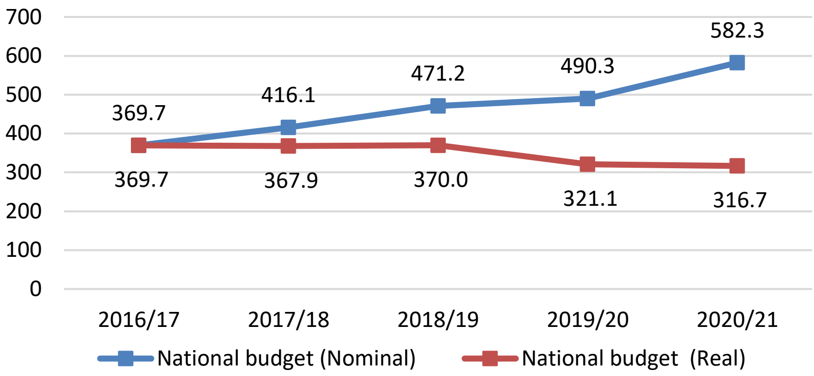
2. National Aggregate Budget

The following section presents an analysis of the consolidated budget, which is the aggregate of the federal budget and regional budgets.

Budget Trends and Priorities

The national budget has been increasing over the years in nominal terms, from ETB 368 billion in 2016/17 to ETB 582 billion in 2020/21 (Figure 4). The budget's average annual growth rate for the past five years was 14 per cent. A higher than average growth rate was observed in 2020/21, with the budget increasing by 18 per cent from its 2019/20 value. However, in real terms, the budget only showed a marginal increase in 2017/18 and 2018/19, followed by a decline afterwards. Between 2016/17 and 2020/21, its real value declined by 12 per cent. This is mainly due to the double-digit inflation rate prevalent since 2017/18, which has become one of the most challenging macro-economic issues the country is facing, and significantly undermining the real value of the public budget. Similarly, while the nominal per capita budget has increased by 44 per cent between 2016/17 and 2020/21, real per capita budget has declined by 16 per cent for the same period.

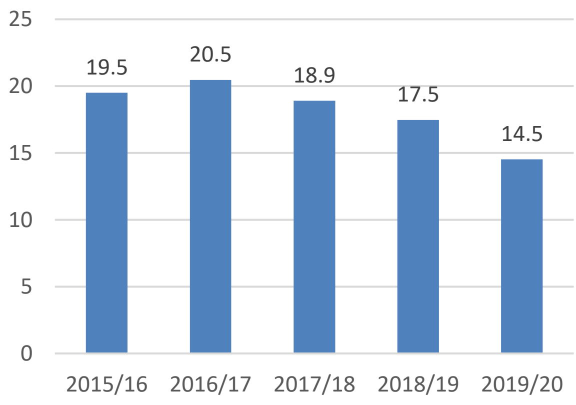
Figure 4: Nominal and real budget (in billion ETB)



Source: Data from Ministry of Finance (2016/17-2020/21).

The share of total government budget to GDP is declining over time. The declining trend indicates that the increase in budget is not keeping pace with GDP growth (Figure 5) and is a reflection on the low domestic resource mobilization capacity, which is not growing at the same rate as GDP growth. Although government total budget has been increasing, the share of government spending to GDP remains low and is among the lowest when compared to other African countries. For instance, the public expenditure-to-GDP ratio was 21 per cent in Uganda, 29 per cent in Kenya and 27 per cent in Tanzania in 2018, much higher than Ethiopia's 18.9 per cent for the same period.[16]

Figure 5: Public budget as a share of GDP (per cent)



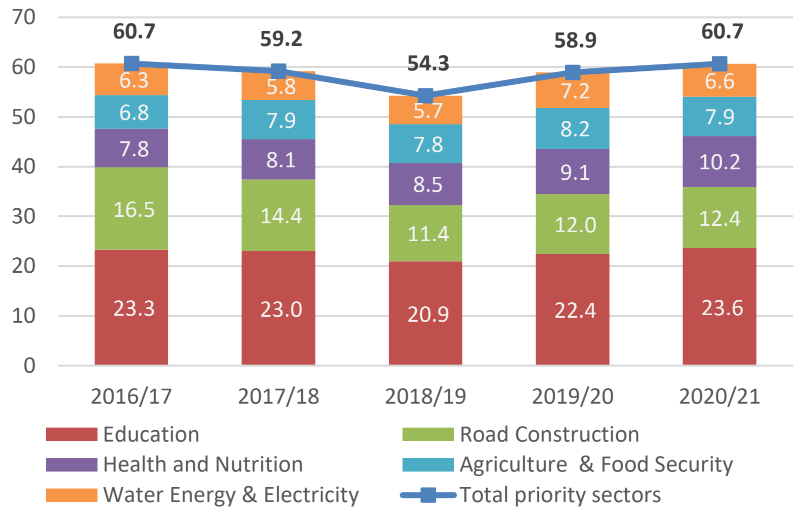
Source: Data from Ministry of Finance (2015/16-2019/20).

[16] International Monetary Fund Data Mapper: data on Government expenditure, percent of GDP retrieved in March 2021 from https://www.imf.org/external/datamapper/exp@FPP/USA/FRA/JPN/GBR/SWE/ ESP/ITA/ZAF/IND/TUR

The government has clearly focused on investment in social sectors, with public expenditure mostly aligned to poverty reduction priorities. Over the last five years, on average 58.8 per cent of public budget was directed towards what the government considers priority sectors: education, health, water and energy, roads, agriculture and food security (Figure 6). The share of these priority sectors in the total national budget slightly declined, from 61 per cent in 2016/17 to 54.3 per cent in 2018/19 (even if their nominal allocation has increased by 27 per cent), while their share of budget increased again to 60.7 per cent in 2020/21.

The increase in budget share of the selected government priority sectors was mainly driven by spending on health and education. For all periods under consideration, the education sector had the highest share of government budget allocation. In 2020/21, the share of budget allocated to education is 23.6 per cent of total public budget. The second priority sector was road construction, followed by the health sector with 12.4 per cent and 10.2 per cent shares, respectively. Agriculture and food security received 7.9 per cent of the national budget, while 6.6 per cent of the budget was allocated for water, energy and electricity. Compared to the 2019/20 budget, allocation for the education and health sectors increased by 1 per cent for each of the sectors, while it marginally declined for agriculture, and water, energy and electricity. The increase in the health sector's share is mainly driven by higher expected spending and investment due to the COVID-19 pandemic.

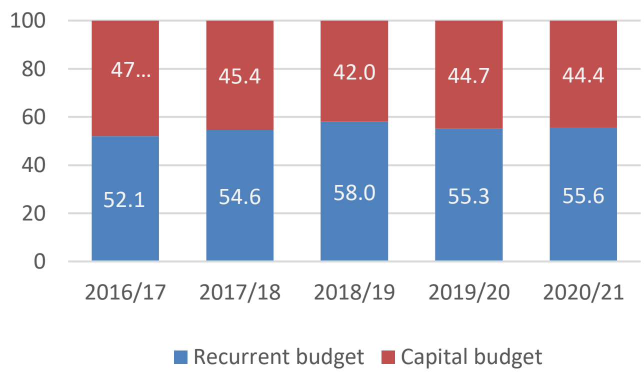
Figure 6: Distribution of budget on selected sectors (per cent of total budget)



Source: Data from Ministry of Finance (2016/17-2020/21).

The majority share of national government budget (56 per cent) was allocated to recurrent spending in 2020/21 (Figure 7). Prior to 2014/15, the share of capital budget was higher, as the government focused on building physical infrastructure for basic service provision. These capital investments require recurrent expenditure for their maintenance, staff salaries and operational costs to ensure continued service delivery. This has resulted in the share of recurrent budget allocation increasing over the years. However, although the share of budget allocation going to capital expenditure is declining, its allocation has increased in absolute terms by 46 per cent between 2016/17 and 2020/21.

Figure 7: National capital and recurrent budget (per cent of total budget)



Source: Data from MoF. (2016/17-2020/21).

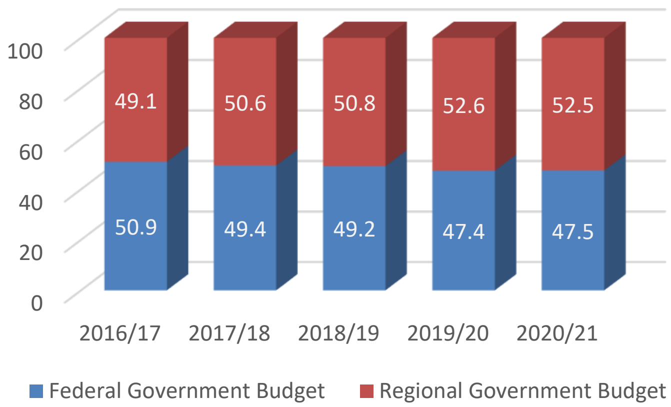
Key Takeaway:

- The national budget and the national budget per capita showed a declining trend in real terms due to high inflation undermining the nominal increase. The government should prioritize tackling the high level of inflation to increase, or at least preserve, the real value of the public budget.

Fiscal Decentralization and Sub-National Spending

The regional budget share out of total national government expenditure has increased between 2016/17 and 2020/21 (Figure 8)**.** With fiscal devolution, regional governments manage a little more than half of the national budget (52.5 per cent) in 2020/21. Basic service delivery, including general education, the construction and management of primary and secondary schools, health posts and health centres, water and sanitation, rural roads, agriculture development and natural resources protection lie under the jurisdiction of regional governments. The federal government, on the other hand, is responsible for investing in tertiary level hospitals, universities, roads, power generation and dissemination, natural resources development and food security, all of which are implemented throughout the country.

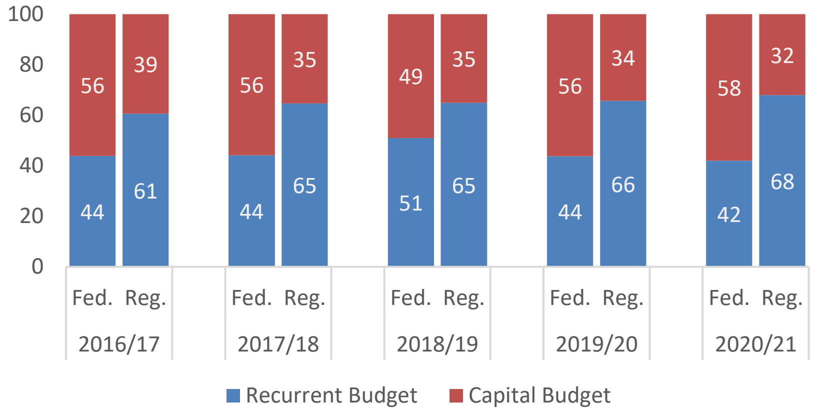
Figure 8: Federal and regional budget (per cent of total budget)



Source: Data from MoF (2016/17-2020/21).

In terms of budget composition, the federal government allocates a larger budget share for capital spending than regional governments. This is mainly because the federal government budget is used for addressing the country's infrastructure gaps. In 2020/21, the share of capital budget in the federal government budget was 58 per cent, while the regions had only 32 per cent of their budgets allocated to capital spending (Figure 9). The share of recurrent expenditure from total regional government spending was 68 per cent in 2020/21 and has been increasing over the years. This is expected, as much of the new infrastructure requires staffing/salary costs and other operational expenses, which are mainly incurred at the service delivery site and therefore fall under the jurisdiction of regional governments. The growing burden of salaries and running costs has resulted in a shortage of resources to be allocated for capital expenditure at the regional level. This is concerning, as the capacity of regions to invest in service delivery infrastructure is being compromised. Since regions and woredas are tasked with financing the construction of primary, secondary schools and lower-tier health facilities, their inability to find adequate financing for these capital investments has an adverse impact on service delivery.

Figure 9: Capital and recurrent budget at regional versus federal levels (per cent of total capital and recurrent budgets)

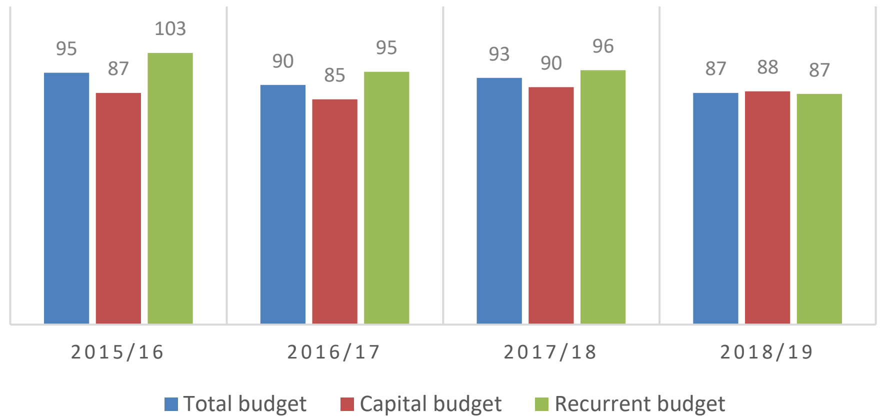


Source: Data from MoF (2016/17-2020/21).

Budget Credibility

Total government expenditure was significantly below target with respect to the original budget allocated for the year 2018/19 (Figure 10). Budget credibility is the proportion of actual expenditure at the end of the fiscal year relative to the budget that was approved at the beginning of the year. The latest budget credibility analysis was conducted for the year 2018/19, as actual expenditure data has a two-year lag. Analysis of budget and expenditure for 2018/19 indicates lower budget credibility compared to previous periods. Recurrent budget credibility was lower in 2018/19 compared to previous years, with 87 per cent credibility, while capital budget registered 88 per cent credibility. The shortage of foreign exchange and lack of proper project management for capital investments are the main reasons for the under-utilization of the capital budget. This was particularly true in 2018/19, as the country was experiencing reform and widespread instability, leading to lower budget credibility even for the recurrent budget.

Figure 10: National government budget credibility (per cent)



Source: Data from MoF (2015/16-2018/19).

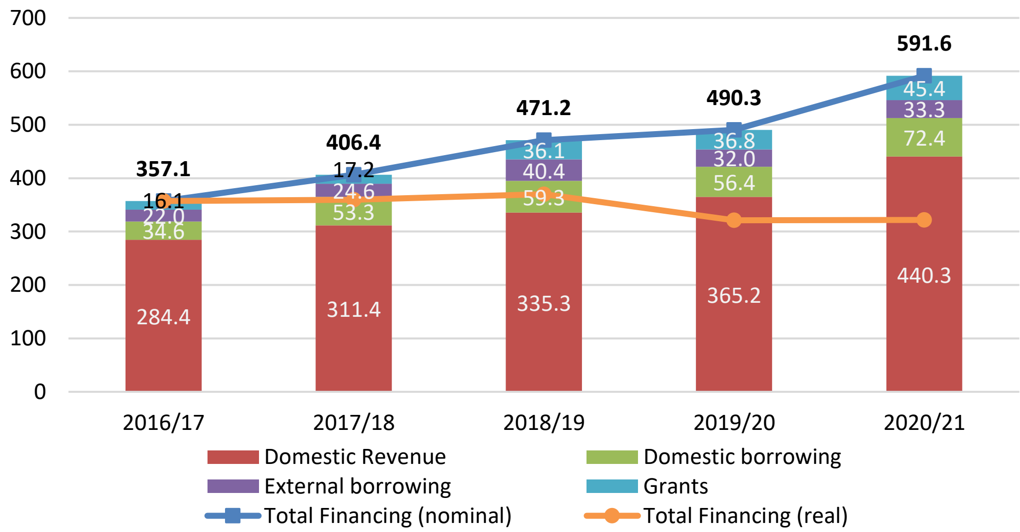
Key Takeaways:

- Regional budgets are predominantly recurrent, making it difficult for regions to make capital investments such as the construction of primary and secondary schools and lower-tier health facilities. This has an adverse impact on service delivery. Increasing the capital budget for regions is of paramount importance to ensure service delivery at the lower levels of government.
- The government should pay close attention to the utilization of capital budgets. The public sector's project execution capacity should be enhanced to ensure the capital budget is efficiently and effectively utilized.

3. Financing the National Budget

With an increasing national budget, the financing requirements of the government have also been increasing, from ETB 357.1 billion in 2016/17 to ETB 591.6 billion in 2020/21 (Figure 11). Compared to 2019/20 values, the nominal financing requirement for 2020/21 budget increased by 20 per cent. Domestic revenue requirements also increased by 20 per cent, while domestic borrowing is expected to increase by 29 per cent compared to 2019/20. External borrowing and grants are also planned to increase by 4 per cent and 23 per cent, respectively.

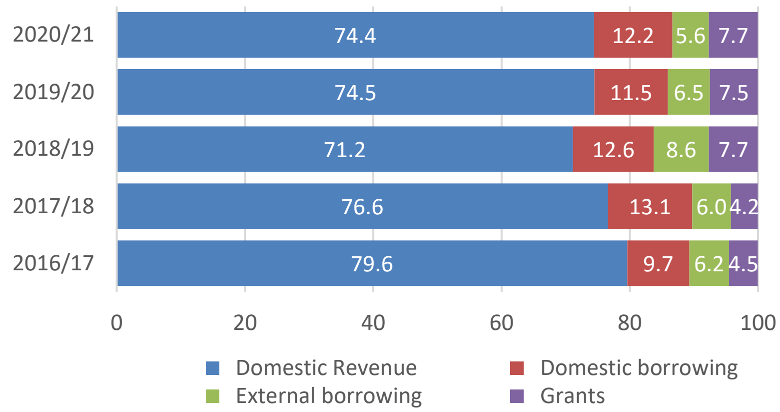
Figure 11: Total government revenue by source (ETB billion)



Source: Data from MoF (2016/17-2020/21).

In 2020/21, 74.4 per cent of government revenue needed to finance the national budget is planned to be generated from domestic revenue, 12 per cent from domestic borrowing, 12 per cent from external loans, and 8 per cent from external assistance (Figure 12). The share of domestic revenue out of total financing need has shown a decline by 5 percentage points compared to 2016/17. On the other hand, the share of domestic borrowing has increased, while the share of the budget to be financed through external borrowing slightly declined from 6.2 per cent in 2016/17 to 5.6 per cent in 2020/21. It should also be noted that, in addition to what is reflected in the government budget, there is an increasing amount of off-budget donor support being injected into the economy. With 13 per cent of government revenue expected to be generated from external loans and assistance, the country is still highly dependent on external sources to finance its spending. Donor dependence continues to be unsustainably high, especially for development costs in key sectors such as health, for which external development partners finance 86 per cent of federal health expenditure. This puts the country in high debt and threatens the long-term sustainability of key development interventions.

Figure 12: Sources of government revenue as reflected in the budget (Share from total revenue)

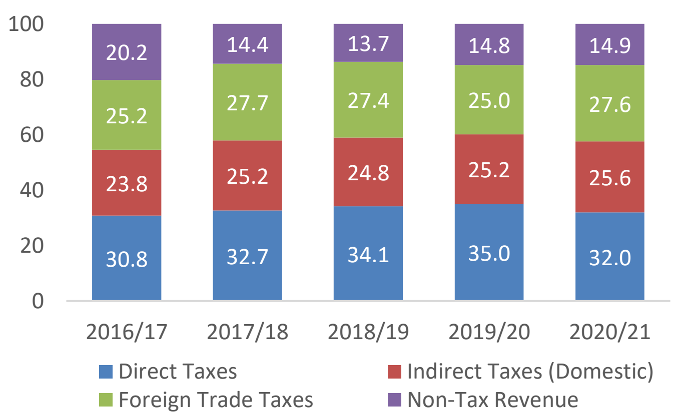


Source: Data from MoF (2016/17-2020/21).

In terms of domestic financing, Ethiopia generates most of its fiscal resources from tax, which is expected to finance 85 per cent of domestic revenue in 2020/21 (Figure 13). The share of non-tax revenue to total revenue (excluding grants) is expected to decline from 24 per cent in 2016/17 to 14 per cent in 2020/21. As an agrarian economy, which is not fully monetized, and with a large, untaxed, non-agrarian informal sector, the contribution of direct tax sources remains relatively limited. The average share of direct tax was around 32 per cent of domestic revenue for the past five years.

The contribution of direct taxes to domestic revenue is expected to decline by 3 percentage points between 2019/20 and 2020/21. The share of revenue from foreign trade taxes is expected to increase by 2 percentage points for the same period. Most of the revenue from direct taxes is generated from payroll tax and taxes on profits of enterprises and individuals. Foreign trade taxes make up the next largest share of total domestic revenue. On the other hand, domestic revenue collected from non-tax sources, such as government fees and charges, contribute less to government finance, reflecting the low level of fees and charges attached to basic government services.

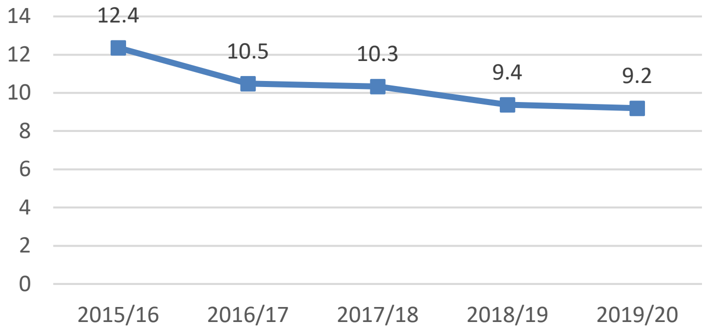
Figure 13: Sources of domestic revenue (percentage from total revenue)



Source: Data from MoF (2016/17-2020/21).

The tax revenue-to-GDP ratio has been declining over the years, despite the government's effort to increase domestic resource mobilization. The low ratio indicates that tax revenue collection is not on par with the increase in GDP, despite concerted domestic resource mobilization efforts. Not only is the ratio low, it is also declining, from 12.4 per cent in 2015/16, to 10.5 per cent in 2016/17, and further to 9.2 per cent in 2019/20 (Figure 14). It is also much lower compared to the sub-Saharan average of 15.1 per cent in 2018.[17] This issue is given attention in the newly endorsed ten-year development plan. The plan envisages increased tax collection efforts and an expansion of the tax base to boost domestic resource mobilization, with a plan to increase the tax revenue-to-GDP from its current level of 9.2 per cent to 18.2 per cent by 2030[18].

Figure 14: Ratio of tax revenue to GDP



Source: Data from MoF (2015/16-2019/20).

Key Takeaways:

- Expansion in domestic revenue is necessary to meet increasing financing requirements as well as reduce donor dependence and guarantee sustainable financing.
- To raise the low and declining tax revenue-to-GDP ratio, the government needs to closely follow through with its plan to increase domestic resource mobilization through modernized and enhanced tax collection capacity and increased citizen awareness.

[17] https://www.iol.co.za/business-report/international/tax-revenue-to-gdp-ratio-at-151-pct-in-sub-saharan-africa-in-2018-imf-19318715
[18] Planning and Development Commission (2020). Ten Years Development Plan: A Pathway to Prosperity (2021-2030).

Annex 1: Ethiopia Total National On-Budget Records 2016/17–2020/21

Gregorian Calendar Fiscal Year	2016/17	2017/18	2018/19	2019/20	2020/21
Ethiopian Fiscal Year	**2009**	**2010**	**2011**	**2012**	**2013**
Population (in million)	94.4	96.5	98.67	100.83	103.00
GDP at Current Market Price (in Billion ETB)	1,806.7	2,202.4	2,696.2	3,375.0	
Real GDP growth rate	10.9	7.7	9	6.1	
General Inflation Rate (CPI growth rate)	7.2	13.1	12.6	19.9	
Exchange Rate (period-weighted average)	22.4	26.1	28.1	31.2	
Financing Source (in million ETB)					
Total Financing	**357,144**	**406,421**	**471,196**	**490,326**	**591,564**
Domestic Revenue	284,386	311,403	335,334	365,204	440,329
Tax Revenue	226,894	266,609	289,521	311,068	374,730
Direct Taxes	87,619	101,769	114,488	127,778	140,803
Indirect Taxes (Domestic)	67,594	78,503	83,200	91,956	112,548
Foreign Trade Taxes	71,681	86,338	91,834	91,333	121,380
Non - Tax Revenue	57,491	44,794	45,812	54,136	65,598
Grants	16,108	17,177	36,141	36,794	45,440
Grants in kind/earmarked	13,988	14,913	16,814	18,795	24,780
CPF/ DBS grant	2,121	2,263	19,328	17,999	20,660
External borrowing	22,030	24,557	40,414	31,965	33,350
Domestic borrowing	34,620	53,284	59,307	56,363	72,446
National Budget (in million ETB)					
Total National Budget	**369,704**	**416,121**	**471,196**	**490,326**	**582,258**
Total National Recurrent Budget	192,634	227,108	273,442	271,054	323,935
Total National Capital Budget	177,070	189,013	197,754	219,272	258,323
Total Federal Government Budget	**188,290**	**205,626**	**231,767**	**232,367**	**276,432**
Federal Government Recurrent Budget	82,581	90,923	118,131	101,656	116,103
Federal Government Capital Budget	105,709	114,704	113,636	130,711	160,330
Total Regional Government Budget	**181,414**	**210,495**	**239,429**	**257,959**	**305,826**
Regional Government Recurrent Budget	110,053	136,186	155,311	169,398	207,832
Regional Government Capital Budget	71,362	74,309	84,118	88,561	97,993
National Poverty-Oriented Budget (in million ETB)					
Total National Poverty-Oriented Budget	**224,439**	**246,248**	**255,707**	**289,009**	**353,339**
Total National Agriculture & Food Security	25,114	32,776	36,565	40,160	45,955
Total National Water Energy & Electricity	23,368	24,036	27,056	35,086	38,676
Total National Road Construction	61,023	60,006	53,513	58,999	72,147
Total National Education	86,230	95,674	98,585	110,067	137,192
Total National Health and Nutrition	28,704	33,757	39,988	44,698	59,369
National Government Budget and Expenditure (Original Budget, and Actual Expenditure)					
Total national budget	**334,177**	**387,050**	**411,809**		
Original Budget	369,704	416,121	471,196		
Actual Expenditure	334,177	387,050	411,809		
Total national Capital Expenditure	**150,510**	**169,186**	**173,955**		
Original Budget	177,070	189,013	197,754		
Actual Expenditure	150,510	169,186	173,955		
Total national Recurrent Expenditure	**183,667**	**217,864**	**237,855**		
Original Budget	192,634	227,108	273,442		
Actual Expenditure	183,667	217,864	237,855		

Source: Data from MoF (2016/17-2020/21).

Annex 2: The Federal General-Purpose Grant Distribution Formula (2017/18–2020/21)

The responsibility for 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 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 changes in population size, levels of development, revenue collection capacities, employment and poverty, among other factors, across regional states. The new approach to federal transfers is calculated on the basis of representative revenue and 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 2020/21, 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; Sidama plus 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.

This national level budget brief was produced by Fanaye Tadesse Techane ftechane@unicef.org with guidance and contributions provided by Zeleka Paulos zpaulos@unicef.org. 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 to inform policy and financial decision-making processes. The analysis presents budget and expenditure that are recorded on-budget by the Ministry of Finance. The report was reviewed by Bob Muchabaiwa from the Regional Office. UNICEF's work on Public Finance for Children is undertaken under the leadership of Samson Muradzikwa.

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