FISCAL POLICY IN ETHIOPIA AND RECENT DEVELOPMENTS

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ACRONYMS

CPI  Consumer Price Index
DSA  Debt Sustainability Analysis
EAL  Ethiopian Airlines
EDRI  Ethiopian Development Research Institute
EEA  Ethiopian Economic Association
EEP  Ethiopian Electric Power
EFY  Ethiopia Fiscal Year
EIC  Ethiopian Investment Commission
ERC  Ethiopian Railway Corporation
ETC  Ethiopian Telecommunication Corporation
FA  Fiduciary Assessment
FDI  Foreign Direct Investment
FDRE  Federal Democratic Republic of Ethiopia
GDP  Gross Domestic Product
GTP  Growth and Transformation Plan
IBEX  Integrated Budget and Expenditure system
ICT  Information Communication Technology
IFMIS  Integrated Financial Management Information System
IMF  International Monetary Fund
JBAR  Joint Budget Annual Review
LAC  Latin American and the Caribbean
LIDC  Low-Income Developing Country
<table>
<thead>
<tr>
<th>Acronym</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>LPG</td>
<td>Liquid Petroleum Gas</td>
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<tr>
<td>MDG</td>
<td>Millennium Development Goal</td>
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<tr>
<td>MEFF</td>
<td>Macroeconomic and Fiscal Framework</td>
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<tr>
<td>MoFEC</td>
<td>Ministry of Finance and Economic Cooperation</td>
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<tr>
<td>OPEC</td>
<td>Organization of the Petroleum Exporting Countries</td>
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<tr>
<td>PEFA</td>
<td>Public Expenditure and Financial Accountability</td>
</tr>
<tr>
<td>PFM</td>
<td>Public Financial Management</td>
</tr>
<tr>
<td>PSNP</td>
<td>Productive Safety Nets Programmed</td>
</tr>
<tr>
<td>SNNP</td>
<td>Southern Nations, Nationalities, and People</td>
</tr>
<tr>
<td>SOE</td>
<td>State Owned Enterprise</td>
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<tr>
<td>SSA</td>
<td>Sub-Saharan African</td>
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<tr>
<td>ToT</td>
<td>Turn over Tax</td>
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<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
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<tr>
<td>UNDP</td>
<td>United Nations Development Programmed</td>
</tr>
<tr>
<td>USD</td>
<td>United States Dollar</td>
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<tr>
<td>VAT</td>
<td>Value-Added Tax</td>
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<tr>
<td>YRF</td>
<td>Youth Revolving Fund</td>
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MESSAGE FROM THE MINISTER

I am honored to present this series of publication – “FISCAL POLICY IN ETHIOPIA AND RECENT DEVELOPMENTS” that has been produced by the Ministry of Finance and Economic Cooperation (MoFEC). This publication is a series of flagship reports of the Ministry that will provide snapshots on the overview of fiscal policy and its implementation over the last decade. It will provide an opportunity for readers to understand the broad objectives and direction of the country’s fiscal policy. We envisage that by highlighting some of the recent developments in fiscal policy will reinforce future policy endeavors towards meeting the structural transformational aspirations of the nation, both in the medium and long-term horizons.

I wish to reaffirm the commitment of the Government of Ethiopia to achieve and sustain a fast, inclusive and broad-based economic growth within a framework of macroeconomic stability. This is in line with the objectives of the second Growth and Transformation Plan (GTP II) (2015/16-2019/20), underlining the imperative of sustaining broad based growth through transforming the agriculture sector, building an industrialized, modern and transforming economy that is job-rich.

The Government of Ethiopia is committed to accelerate economic progress by pursuing pro-poor growth-oriented policies underpinned by a stable macro-economic environment, the country’s fiscal policy is aimed at reducing poverty and improving the welfare of our people by heavily investing in education to create human capacity, promoting basic healthcare services, expanding infrastructure, building institutions, promoting governance and pursuing decentralization. The pursuit of macroeconomic stability, pro-poor growth and deepening of structural reforms has significantly contributed to the impressive growth achieved over the past decade.

The double-digit economic growth averaging 10.5% observed over the last 13 years was not only high and sustainable, but inclusive with significant decline in poverty incidence from 44.2% in 2000 to 23.5% in 2016. The fiscal policy was designed and implemented with a view to supporting the above developmental state objectives of the Government. The fiscal policy has been prudent and instrumental in bringing fast, sustainable and broad-based growth and realized through robust taxation, expenditure and financing practices both at federal and regional levels.

I must recognize that a lot of efforts have been put into the preparation of the report. It is therefore, vital to extend profound thanks and appreciation to all those who were directly or indirectly involved in the production of this report. Special thanks go to the staff of the Fiscal Policy Directorate and especially Ato Mezgebu Amha, the Director, of Fiscal Policy.
Directorate who superbly coordinated and provided pertinent guidance in the finalization of the report. Special thanks also goes to Ato Fantahun Belew, Ato Firehiywot Handamo, Ato Tesfahun Bitew and Ato Lisanework Yirsaw, all from the Fiscal Policy Directorate, for their significant contribution in drafting this report.

I would also like to thank both Dr. Tadele Ferede and Dr. Getinent Alemu of the Addis Ababa University and Ethiopian Economic Association (EEA), as well as Dr. Andualem Telaye from Ethiopian Development and Research Institute (EDRI) who provided invaluable inputs and comments on the draft report. I would like to commend UNDP for the financial and technical support provided during the production of this report. I would like to thank also other staff members of the Ministry of Finance and Economic Cooperation Directors, senior officials and experts who provided their specific sector data and constructive comments to enrich the draft report. I trust you will enjoy reading this report and looking forward to your valuable feedback on how we could further improve the future editions.

Abraham Tekeste (PHD)
Minister,
Ministry of Finance and Economic Cooperation
February 2018
INTRODUCTION

As could be recalled, ten years back the Ethiopian Government and its people celebrate their second millennium with great hope and aspiration. Events of the millennium festivities have instilled motivation and hope to the rising of Ethiopia. Since then the Country has implemented its first Growth and Transformation Plan and continued to build on it through its successor plan GTP II.

During the first GTP period Ethiopia registered an annual average growth rate of 10.1%. This trend has continued even in the midst of slow global financial and economic developments resulted in low commodity prices and demand as well as the impact of “El Niño”-induced drought to the economy. In this regard, the economy continued to register impressive growth during the first two years of the Second GTP. The prudent fiscal policy pursued by the Government stands out among the critical policy and strategic anchors that contributed to the country’s impressive economic growth. Although most of the macroeconomic and sectoral developments accounted for the sustainable and inclusive growth realized over the past decade, some vital economic dynamics such as inflation, domestic resource mobilization and export performance were not supportive. With regard to inflation the Government has managed to reduce and stabilize the double digit figure to a single one for the last three years. The domestic resource mobilization particularly the low tax to GDP ratio and low export earnings continue to pose a downside risk to the economy.

This edition which is a series of flagship reports on fiscal policy has the objective of documenting the overall economic performance of the economy and major contributors as well as challenges faced during the first decade of the country’s third Millennium. The report lays emphasis on fiscal policy aspects of the economy.

Accordingly, part I of the report focuses on the features, roles and functions of the country’s fiscal policy. Part II has the aim of reviewing developments on fiscal policy performance over the last decade. Accordingly, the first section of part II highlights macroeconomic aggregates, including economic growth performance, inflation, foreign debt, export, import, employment, private sector development and tax incentives. Part II of the report devoted to fiscal developments. In this section developments on revenue, expenditure, and fiscal deficit and Government expenditure contribution for growth and poverty reduction have been reviewed succinctly. Further, the report looks at the progress made in public finance management over the last decade.
PART ONE

Fiscal Policy in Ethiopia
1. FEATURES, ROLES AND FUNCTIONS OF FISCAL POLICY IN ETHIOPIA

Fiscal policy is one of the major macroeconomic policies in which a Government uses its spending and taxation powers to monitor and influence a nation’s economy. The way government uses its spending and taxation power characterises the type of the government. Most governments use this power to promote stable and sustainable growth while pursuing its income redistribution effect to reduce poverty. Fiscal policy therefore plays an important role in influencing the behaviour of the economy as monetary policy does. The choice of the government fiscal policy can have both short and long term influences. The most important tools of implementing the Government fiscal policy are taxes, expenditure and public debt.

Fiscal policy is potent instrument of bringing inclusive growth. A study conducted by UNDP on Income Inequality Trends in sub-Saharan Africa asserts that fiscal policy is an important tool that governments throughout the world use to promote macroeconomic stability, allocate resources to priority projects and activities, provide public goods to correct market failures, and redistribute incomes and wealth to the marginalized and underprivileged. The study further noted that if well-formulated and implemented, fiscal policy is crucial for driving economic growth, social stability and national development. Taxes, expenditures and transfers are key instruments for achieving these objectives (UNDP: 2017).

In view of this, the objective of fiscal policy in Ethiopia is promoting sustainable, fast and inclusive economic development in addition to its function of promoting macroeconomic stability. The fiscal policy has an imperative role of streamlining the allocation and distribution of the public resources to achieve the development and stabilization objectives of the country’s economy. The principal functions of the fiscal policy are realized through the implementation of policy choices of taxation, spending and fiscal deficit management. Apparently, the ultimate goal of the Government’s fiscal policy is to attain Ethiopia’s ambition to reach a middle income country by 2025 through bringing sustainable, rapid and inclusive growth.
Box: 1.1 Four Major Functions of Fiscal Policy

**Allocation:** The first major function of fiscal policy is to determine exactly how funds will be allocated. This is closely related to the issues of taxation and spending, because the allocation of funds depends upon the collection of taxes and the government using that revenue for specific purposes. The national budget determines how funds are allocated. This means that a specific amount of funds is set aside for purposes specifically laid out by the government. The budget allocation is done on the basis of aggregated development objectives such as recurrent vs capital expenditures or sectoral allocation (economic and social developments).

**Distribution:** The distribution functions of the fiscal policy are implemented mainly through progressive taxation and targeted budget subsidy. Virtually allocation determines how much will be set aside and for what purpose, the distribution function of fiscal policy is to determine more specifically how those funds will be distributed throughout each segment of the economy. For instance, the government might apportion a share of its budget toward social welfare programs, such as food security and asset building for the most vulnerable and disadvantaged in society. It might also allocate for low-cost housing construction and mass transportation.

**Stabilization:** Stabilization is another important function of fiscal policy in that the purpose of budgeting is to provide stable economic growth. Government expenditure needs particularly in developing countries such as Ethiopia are unlimited. But its source of financing is limited. Thus without some restraints on spending or limiting the level of expenditure with available financial resources the economic growth of the nation could become unstable, creating imbalances in external sector as well as resulting in high prices.

**Development:** The fourth and most important function of fiscal policy is that of promoting development. Development seems to indicate economic growth, and that is, in fact, its overall purpose. However, fiscal policy is far more complicated than determining how much the government will tax citizens in a given year and then determining how that money will be spent. True economic growth occurs when various projects are financed and carried out using budgetary finance. This stems from the belief that the private sector cannot grow the economy by itself. Instead, government input and influence are needed. The government is responsible for providing public goods, reduce externalities and correct market distortions in order to pave the way for private sector development.

2. TAXATION POLICIES

Tax is defined as a monetary charge imposed by the Government on persons, entities, transactions or properties to yield revenue. Although the primary purpose of taxation is to finance government expenditure, the tax system is expected to play multiple roles in the economy. Ethiopia does not have a dedicated tax policy document. However, the tax policies of the country are included as part of the tax legislations in the Federal Constitution. The Constitution stipulates that the Federal Government and the States to share revenue taking the Federal arrangement into account\(^1\). It also specifies that, in exercising their taxation power, Regional States and Federal Government shall ensure that any tax is related to the source of revenue and it is determined following proper considerations. Both the Federal and State Governments are required by the Constitution to ensure that the tax does not adversely affect their relationships and that the rate and amount of taxes shall be commensurate with services the taxes help deliver.

Consistent with the Constitution and the various tax laws and regulations the underlying principles of the tax policies of the country are as follows:

- To introduce taxes that enhance economic growth, broaden the tax base and increase government revenue;
- To introduce taxes that are helpful to implement social policies that discourage consumption of substances that are hazardous to health and social problems;
- To introduce tax system that accelerate industrial growth and achieve transformation of the country and to improve foreign exchange earnings, as well as create conducive environment for domestic products to become competitive in the international commodity markets;
- To ensure modern and efficient tax system that supports the economic development;
- To make the tax system fair and equitable;
- Minimizing the damage that may be caused by avoidance and evasion of tax; and
- To promote a tax system that enhances saving and investment;

Over the past decades, Ethiopia introduced a number of taxes with various rates in congruent with the above principles. According to the existing legislations, the major current tax types and rates of the country are summarized in Table 1.

The Ethiopian tax system has undergone major reforms over the past couple of decades. The tax rates for almost all tax types have been significantly reduced to the current prevailing

\(^1\) Article 96 and 97 of the Constitution stipulate the Federal and States power of taxation.
levels. For instance, the corporate rate was reduced from 50% to 30%, the individual and employment maximum tax rate was reduced from 85% to 35%, while the maximum import duty rate has been reduced from 230% to 35%. All export taxes (except taxes on semi-processed hides and skin) have been abolished while Value Added Tax was introduced as a new modern tax to replace the general sales tax as a result of the reforms undertaken. As it stands now, most of the tax rates are comparable to the regional and international standards.

Table 1: Major Taxes in Ethiopia by type and rates

<table>
<thead>
<tr>
<th>No.</th>
<th>Type of tax</th>
<th>Maximum Rate (%)</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Corporate Profit income tax</td>
<td>30</td>
<td>25% on income profits of natural resource companies and 30% for the others</td>
</tr>
<tr>
<td>2</td>
<td>Unincorporated Business Profit Income tax</td>
<td>0-35</td>
<td>The exempted threshold is Birr 7200 while the maximum rate applied on the annual profit income &gt;= Birr 130,800</td>
</tr>
<tr>
<td>3</td>
<td>Employment monthly income tax</td>
<td>0-35</td>
<td>The exempted threshold is Birr 600 while the maximum rate applied on the monthly profit income &gt;= Birr 10,900</td>
</tr>
<tr>
<td>4</td>
<td>Value Added Tax</td>
<td>15</td>
<td>Only two rates (0 (export) &amp; 15). Moreover, there are certain exempted items.</td>
</tr>
<tr>
<td>5</td>
<td>Turnover taxes</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• On goods</td>
<td>2</td>
<td>Tax rates are different on goods and services. ToT is calculated on the overall annual sales.</td>
</tr>
<tr>
<td></td>
<td>• Services</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Excise tax on list of items</td>
<td>10-100</td>
<td>Excise taxes are levied on selected list of locally produced and imported goods.</td>
</tr>
<tr>
<td>7</td>
<td>Tax on Interest Income on Deposits</td>
<td>5</td>
<td>Tax on income derived from interest on deposits. The payer shall withhold the tax and account to the Tax Authority</td>
</tr>
<tr>
<td>8</td>
<td>Import duty</td>
<td>0-35</td>
<td>The customs tariff applies to all imports. Items are classified according to a schedule of 97 chapters, based on the Harmonized System of Tariffs Classification Code.</td>
</tr>
<tr>
<td>9</td>
<td>Royalty</td>
<td>5</td>
<td>Tax collected from Royalty</td>
</tr>
</tbody>
</table>

For the complete information on the taxes in Ethiopia, reference can be made from either the laws or the Tax Synopsis (WWW.MoFED.Gov.et….)
### Rental income tax

- **30 for incorporated business and 0-35 individuals**
- Tax on income derived from the rent of houses or office buildings, manufacturing plants, materials and goods, etc. The tax is computed on the basis of annual rent income after deducting allowable expenses.

### Dividend tax

- **10**
- Tax on income derived from dividends from a share company or withdrawals of profits from a private limited company.

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**One important aspect of the tax policy that should be mentioned is harmonization.**

Even though the Federal constitution has granted revenue and expenditure powers to both Federal and Regional Governments, it also emphasises the importance of creating one economic space, in such areas as macro economy policy. Pursuing a harmonized tax policy across the country ensures macroeconomic stability. By virtue of such developments, the tax policy-making process in the past years was successful in placing uniform tax principles, procedures and implementation across the country, albeit some gaps still remain in the tax administration and harmonization that will need to be addressed.

The intention of the tax policy is to shift government revenue dependence from foreign trade taxes to the domestic taxes. As the economy broadens its base, it is also expected to incline more revenue to be generated from domestic taxes. Moreover, the tax policy is very instrumental for the government of Ethiopia to stimulate and sustain the economic growth by broadening the base and reducing the tax burden on the businesses as well as encouraging investment by providing fiscal incentives.

The Tax laws and regulations are important tools used to implement the Government tax policy. The following are the most pertinent tax laws and regulations enacted to implement the tax policy of Ethiopia:

- The Revenue and Expenditure powers given to federal and regional governments as stipulated in the Constitution;
- Federal Income Tax Proclamation No. 979/2016;
- Federal Income Tax Regulation No 410/2016;
- Tax Administration Proclamation No. 983/2016;
- Value Added Tax Proclamation No. 285/2002 and its Amendment Proclamation No 609/2008;
- Excise Tax Proclamation No 307/2002 and its Amendment Proclamation No. 610/2008;
• Turn Over Tax Proclamation No. 308/2002 and its Amendment Proclamation No. 611/2008;
• Council of Ministers VAT Regulations No. 79/2002; and
• Customs Duty and Tariff Regulation 80/2002

Regular reviews and updating of the tax laws and the tax policy is an essential element of building a good tax system. In this regard, most of the Ethiopian tax laws were not subject to revision for long time which as a result created some gaps in the tax system. It is in this sprit that recently; the income tax law revision was done. The revised Federal Income Tax Proclamation has the objectives of rationalizing the Government tax policy, removing some of the articles that contributed to non-compliance, update and create clarity around some of the income tax components, and generally to make the tax law commensurate with the tax administration. The proclamation was supported by a Federal Income Tax Regulation. Both the Proclamation and the Regulations were redesigned with a view to reinforcing the functions of the fiscal policy.

The overriding objective of the tax policy is to fairly and equitably mobilize the government revenue needed to realize fast, sustainable and inclusive economic development. The main purpose of the government tax policy is mobilizing financial resources needed to finance government budget for the realization of national and holistic Government development agenda. The annual budget is the major fiscal instrument by which the federal government mobilize resources and finance it’s recurrent and capital expenditure. The level, composition and quality of public expenditure are subject to the magnitude of financial resources the government can generate with in the budget year. In the case of Ethiopia, tax contributes the lion share of government revenue. As a result, the allocation function of the fiscal policy is highly influenced by the amount of tax to be collected.

The tax policy, therefore, plays a significant role in providing the necessary financial resources required to run the functions of the Government and attain its development objectives. Over the past decade the government tax system annually generates over 80% of the domestic revenue.

To reinforce the role of fiscal allocation, the Federal Income Tax Proclamation and Regulation introduced in 2015/16, incorporated a number of legal and procedural mechanisms that are important to broaden the tax base and encourage tax compliance. Such measures help mobilizing financial resources needed to finance government expenditure through the allocation of the annual budget. However, the tax revenue collection remains very low
compared to the economic performance, the GTP II target and the regional performance. This is significantly due to the weak tax administration.

The tax policy plays a redistributive function of ensuring equity among group of citizens. It serves to promote income redistribution among various groups of citizens: from high to low–income groups; which ultimately promotes inclusive growth in the economy. The redistribution goals are usually sought through the use of progressive rate structures of the tax policy. In other words, the ability to pay is the underlying principle when crafting the tax policy. At the time when all the Ethiopian tax laws were enacted, attempt has been made to make all the rates to be progressive. However, since all the laws were not reviewed for quite some time, it may be the case that some of the tax rates for some tax types could already be regressive. However, this should be affirmed by study and cannot be an established conclusion.

Box: 2.1 Ten Principles of Good Tax Policy

**Equity and Fairness:** Similarly, situated taxpayers should be taxed similarly.

**Certainty:** The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.

**Convenience of Payment:** A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.

**Economy in Collection:** The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

**Simplicity:** The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.

**Neutrality:** The effect of the tax law on a taxpayer’s decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.

**Economic Growth and Efficiency:** The tax system should not impede or reduce the productive capacity of the economy.

**Transparency and Visibility:** Taxpayers should know that a tax exists and how and when it is imposed upon them and others.

**Minimum Tax Gap:** A tax should be structured to minimize non-compliance.

**Appropriate Government Revenues:** The tax system should enable the government to determine how much tax revenue will likely be collected and when.

The income tax law is a case in point where the recently revised law and regulation fixed the redistribution problem of the income tax policy. In doing so, besides maintaining the progressive tax rates from 10-35%, the revised Federal Tax proclamation and regulation introduced the following:

- Raised the minimum tax free income from Birr 150 to Birr 600 per month or from Birr 1200 to Birr 7200 per year, which is in favour of low income groups;
- Raised the maximum taxable income subject to the highest rate from Birr 5000 to Birr 10,900 per month or from Birr 60,000 to Birr 130,800 per year;

Another function of the tax policy is to maintain macroeconomic stability. Virtually, taxes reduce disposable income of consumers and foster the revenue of the government. This has dual effect. First, it negatively impacts the aggregate demand and in turn contributes to match with aggregate supply. Second, increased tax revenue enhances financing capacity of the government. This allows the government to limit its borrowing from the banking sector. The tax policy therefore pursues mobilization of the necessary government revenue to finance its expenditure budget. A shortfall in revenue tends to force the government to mobilize resources from borrowing. Excessive borrowing from domestic sources, largely from the banking sector, destabilizes the price level which is a threat for macroeconomic instability. On the extreme, inflation hits the fixed income classes, especially the low-income segments of the population, while benefiting speculators and traders. The tax policy through mobilizing the necessary revenue, therefore, helps maintain a reasonably stable price level thereby benefiting all sections of society.

Tax policy is an important instrument used to stimulate domestic production and employment creation. In this connection the tax laws and regulations apart from mobilizing the necessary revenue to government, they play multiple roles in supporting the economic growth. The tax law and regulation protect domestic industries from foreign competition. The custom duties and tariffs have the objective of protecting infant industries. The custom duty rates generally ranges from 5-35%. The rates vary based on the type of commodities. Finished goods are liable to high rates, while intermediate goods, raw materials and capital goods are charged zero and very low rates. The intention is protecting local producers from imported goods competition and supports their production process.

The tax policy also supports private investment and export. The investment law and regulation provide incentives to allure both foreign and domestic private investment in boosting the economic growth. They incorporate variety of incentives mechanisms such as tax holidays which allows exemption on businesses profit income taxes up to 5-10 years depending on the type and area of investment. Investors are also entitled to import duty and
duty-free machinery, raw materials and spare parts. Additionally, the law provides a loss-carry forward privilege for investments. In promoting export earnings, the export sector is exempted from any indirect taxes except exporting raw hides and skins. To discourage the export of raw hides and skins and in order to promote value addition, the Government of Ethiopia introduced a 150 percent export tax on the export of raw and semi-processed hides and skins.

**Tax policy is also used to ensure balanced regional development.** To encourage investors to set up industries in areas with infrastructure deficit and in far flung areas of the country, the Government provides special tax incentives. Such enterprises are given extended tax holidays during the initial stages of their operation. Investments in areas with slow economic activities get over 15 years of tax holidays, including import duty exemption on import of capital goods.

**Taxes are also used as a social policy tool by discouraging consumption of substances hazardous to health.** Tax policy helps controlling the consumption of some specific commodities through imposing excise taxes. Such type of taxes has dual purposes. They generate revenue to finance the government budget and at the same time used to discourage the consumption of unnecessary or harmful items like liquors, and tobacco.

The tax policy on the other hand reduces the tax burden on basic items and services to support the consumption of low income citizens. A number of food items such as bread, injera, milk, and medicine are exempted from VAT. Basic services including education, health, and transport are similarly not liable to the VAT.

**The Fiscal policy supports Ethiopia’s climate-resilient green economy.** Ethiopia aims to achieve carbon-neutral middle-income status by 2025. It has developed Climate-Resilient Green Economy strategy and put in place the building blocks necessary to implement the strategy. In support of implementing the strategy, the fiscal policy focused on designing permanent financial mechanism, promoting stakeholder engagement process, and prioritising and sequencing sector specific initiatives in detail. The government mobilizes significant resources to develop and implement the green economy strategy and welcomes partnerships with development partners engaged in combating climate change as well as contributions by the private sector. The green economy fiscal policy of the country focuses on reducing the country’s dependency on fossil fuel imports through expanding electric power supply, and increasing energy efficiencies in the transport, industry, and construction sectors.
The tax policy follows Federal Taxation system. Ethiopia adopts Federal systems in which fiscal powers are devolved to the lower sub-national Governments, including tax legislation and collection. The FDRE Constitution stipulates sharing of taxation and expenditure assignment powers among the tiers of Governments. The Federal and Regional Governments exercise their taxation powers as granted by the Constitution.

The tax policy also provides emphasis in modernizing the tax administration. Over the past decade and a half, enormous work has been done to improve the tax system. The measures undertaken include institutional strengthening, bringing a large number of businesses into the tax net, strict tax enforcement and education.
3. **EXPENDITURE POLICIES**

Government of Ethiopia uses its fiscal policy tools to play decisive role in transforming the socio-economic development of the country. One of the instrumental tools is government spending, where optimal allocation of the government budget can have more direct influence on the level and quality of economic activities than taxes. The ever increasing public spending and its composition over the past years demonstrated how the expenditure policy realized the multiple functions of fiscal policy.

The Government expenditure policy that involves the planning, budgeting, funding, accounting, auditing and reporting activities, is properly and efficiently managed by the Financial Administration Laws, Regulations and Directives. The Government has introduced the first Financial Administration Law in the country in 1996. In order to incorporate new developments several amendments have been made since its inception and the recent amendment is Proclamation No. 970/2016 (The Federal Financial Administration Law). The same is done in the regulations. For the smooth implementation of the Financial Administration laws and regulations a number of directives have been introduced and being implemented. There are also Federal Public Procurement and Property Law and Regulation which determine the procedures of public procurement of the Federal Government.

Among the principal instruments of realizing the Government expenditure policy are the Medium Term Macroeconomic and Fiscal Framework (MEFF) and the annual budget rationalized through program-based budgeting.

3.1 **MEDIUM TERM MACROECONOMIC AND FISCAL FRAMEWORK (MEFF)**

Most of the Government development policies are realized through implementation of programs which are designed and implemented over the medium–term horizon. The implementation of such policies and programs require sustainable commitment of government funding while they yield benefits over a period of years. The annual budget alone is hardly an appropriate tool to implement such policies and programs which have medium to long-term scope. To address such issues the Government has introduced the Medium Term Macroeconomic and Fiscal Framework (MEFF) to implement its programs.

The MEFF recognizes that the one-year time horizon of the annual budget process is too short to enable the government to assess current spending decisions in the light of future claims on resources. Budgeting on short-term perspective encourages incremental decisions, where the next budget is built on the previous one, with only marginal adjustments. The MEFF seeks to counter this tendency by extending the time horizon to the medium-term (typically,
Box: 3.1 Objectives of MEFF

- To improve macroeconomic balance, including fiscal discipline, through good estimates of the available resource envelope, which are the bases of the annual budget;
- To promote inter- and intra-sectoral resource allocation by effectively prioritizing all expenditures (on the basis of the government’s socio-economic program) and dedicating resources only to the most important ones;
- To promote greater budgetary predictability, which is expected as a result of commitment to more credible sectoral budget ceilings;
- To ensure budgetary decision-making legitimacy, and political accountability for expenditure outcomes;
- To enhance public expenditure efficiency and effectiveness through allowing budgetary institutions flexibility in managing their budgets in the context of hard budget constraints and agreed upon policies and programs.

Source: World Bank: Beyond the Annual Budget: Global Experiences with Medium-Term Expenditure Frameworks: 2013

3-5 years) and imposing a fixed constraint. The World Bank claims that MEFF is a rolling plan that is updated each year to accommodate changes in the economic fundamentals and adjust the expenditure carry-over of programs and projects not implemented in the previous fiscal year (World Bank: 2013).

When MEFF was introduced in Ethiopia in the late 90s, it was a three-year rolling budget planning tool. Currently, it is extended to be a five-year budget plan, to align it to the GTP planning period. MEFF is mainly used in setting fiscal targets which would be a basis for the preparation of the annual budget. It broadly identifies, the medium-term Federal Government resource envelope, it shows broader ceiling of expenditure allocations and more importantly sets the medium-term fiscal deficit. In doing so it sets the recurrent and capital expenditure of the Federal Government and the regional block grant. It also provides a medium-term (five year) perspective to fiscal management. The framework includes the underlying macroeconomic assumptions, an assessment of sustainability relating to the balance between revenue receipts and expenditure and the use of deficit financing. The MEFF serves as a legal document in which sets fiscal ceilings which serves as a framework for the annual budget preparation and should be approved by the Council of Ministers and contains five-year forecasts. The assumptions and forecasts include the following economic and fiscal aggregates:

- Economic Growth and GDP;
- External sector (Import and Export);
• Inflation;
• Exchange Rate;
• Government revenues projections;
• The allocation to capital and recurrent expenditures for the federal government;
• The allocation to the total block grant transfers for the regional governments; and
• The fiscal deficit.

The purpose of MEFF is to introduce predictability and transparency in the fiscal system and reflect the Government commitment to implement its overall and sectoral policies. It assures sector ministries’ commitment in the funding of priority programs and projects which are vital to achieve the government goals as stipulated in the Growth and Transformation Plan (GTP).

3.2 PROGRAM BASED BUDGETING

Public finance has played a significant and active role in the implementation of Ethiopia’s economic development strategy and in the achievement of the rapid economic growth achieved over the last two decades. The state-led development strategy is coordinated through a series of poverty reduction and development plans, which set priorities and targets for national economic development.

As discussed earlier, the Government introduced MEFF to incorporate macro-economic forecasts and fiscal targets, identify the overall government resource envelop, and indicate expenditure budget ceilings on multi-year basis, and provide basis for annual budget formulation. The allocation within MEFF is done following the policy and strategic priorities set in the subsequent national development plans of the country.

Since the beginning of modern government budgeting system, Ethiopia’s budget used to follow the line item budgeting. The line-item or traditional budget is simply based on historical needs. To make the annual budget more efficiently and effectively serve the above purposes, a program budgeting has been introduced to support the broader PFM reform agenda since 2011/12. Program budgeting in Ethiopia is primarily designed to act as a basis for supporting PFM reforms by enhancing performance management and accountability, enabling a stronger linkage between the annual budget and policy objectives, and improving transparency and accessibility of information.

Program budgeting has the potential to inject more strategy into budgeting and more fiscal constraint into planning. It makes budgeting a more strategic (and less incremental) process by focusing on government objectives and shifting the basis of decision from what was spent in the past to what is wanted for the future. The basic idea is that budget information

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3 Line item budget is a budget initiated by governments in which budgeted financial statements are grouped by administrative entities and objects. These budget item groups are usually presented in an incremental fashion that is in comparison to previous time periods.
and decisions should be structured according to the objectives of the government. Program budget in Ethiopia is designed to attain four basic objectives. These are:

- To facilitate comparison and evaluation of the cost-effectiveness of alternative spending options that have the same objectives;
- To improve government performance by giving public bodies operating discretion.
- To facilitate accounting for the full cost of government activities.
- To enable the government to plan ahead and set spending priorities.

In Ethiopia the program budgeting was fully introduced in 2011/12 at Federal level. It was implemented on piloting basis in selected Federal public bodies between 2005/06 and 2008/09. In fiscal year 2009/10 all public bodies started implementing the program budget on experimental basis and since 2011/12 it has been operational in its full-fledged form.

**Table 2: Differences between Program and Line Item Budgeting**

<table>
<thead>
<tr>
<th>No.</th>
<th>Program Budgeting</th>
<th>Line Item Budgeting</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Outcome focused</td>
<td>Input focused</td>
</tr>
<tr>
<td>2</td>
<td>Based on the public body’s vision, mission and strategic plan</td>
<td>Disregard public bodies vision, mission and strategic plan</td>
</tr>
<tr>
<td>3</td>
<td>Link budget with development plan</td>
<td>The budget is not linked with development plan</td>
</tr>
<tr>
<td>4</td>
<td>Integrate the recurrent and capital budget</td>
<td>The recurrent and capital budget are not integrated</td>
</tr>
<tr>
<td>5</td>
<td>Provide flexibility, responsibility and accountability to public bodies</td>
<td>It is control focused and does not put in place accountability for outcomes</td>
</tr>
<tr>
<td>6</td>
<td>Facilitate the implementation of performance budgeting</td>
<td>While it has no indicators and outputs, it is not possible to conduct performance audit</td>
</tr>
<tr>
<td>7</td>
<td>Measuring input, output and outcome of the budget</td>
<td>It measures inputs not outputs and outcomes</td>
</tr>
</tbody>
</table>

*Source: MoFEC, Program Budgeting Manual*

The Ministry designed the first program budgeting manual in 2011/12 and improved it over time based on feedbacks from implementation and training of budget officials. The enhanced version of the manual was developed in 2014/15. A road map is being developed to roll out program budgeting at regional level and the SNNP region has started piloting it.
The annual budget which is implemented based on the medium-term tools is the Government’s principal fiscal policy tool to create the enabling mechanism that would lead to economic transformation underpinned by the Second Growth and Transformation Plan (GTP II). The budget process is an integral part of the overall budget planning therefore, MEFF is the beginning in the process and ensures the linkage of the policy objectives of the GTP and the annual budget. The annual Federal aggregate budget should correspond to the aggregates of the first year of the MEFF.

The MEFF provide a comprehensive basis of the funding of the Federal Government budget, where all the government revenue sources are planned accordingly. Hence, the annual appropriation is committed only on the basis of availability of the resource envelop identified in the MEFF. In terms of the budget process, once the MEFF is approved, the annual budget request is prepared by the different public bodies and expected to be within the provided ceilings by the Ministry. A budget hearing is conducted to thoroughly discuss the detail plan on the requested budget by the spending units with the Minister of Finance and Economic Cooperation to rationalize and agree on the budget proposal. Once the budget hearing process is over, the Ministry compiles and documents the annual budget proposal and presents it to the Council of Ministers where eventually the supported annual budget by the council will be presented to the House of Peoples Representatives (Parliament) for appropriation of the budget. Details of the budget process and its timing are presented in Table 3 below. The annual budget is published by the Negarit Gazzet and implemented throughout the budget year by the respective public bodies.

The annual budget process is governed by a budget calendar. The budget calendar contains three phases: The Policy Planning Phase, the Budgeting Phase and the Approval Phase.
### Table 3: Federal Government Annual Budget Calendar

<table>
<thead>
<tr>
<th>Planning/Budgeting cycle</th>
<th>Ethiopia Fiscal Year</th>
<th>European Fiscal Year</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Planning cycle</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Macro-Economic and Fiscal Framework (MEFF)</td>
<td>By Tahisas 30</td>
<td>By January 8</td>
</tr>
<tr>
<td>1.1 MEFF preparation</td>
<td>Until Hidar 30</td>
<td>Until December 9</td>
</tr>
<tr>
<td>1.2 MEFF Approval</td>
<td>By Tahisas 30</td>
<td>By January 8</td>
</tr>
<tr>
<td>2. Notification of The Three-Year Subsidy Estimates</td>
<td>By Tir 01</td>
<td>By January 9</td>
</tr>
<tr>
<td>3. Preparation of the Annual Fiscal Plan</td>
<td>By Tir 15</td>
<td>By January 23</td>
</tr>
<tr>
<td><strong>The budgeting cycle</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>A. Pre-preparation of budget by public bodies</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Pre-preparation of budget</td>
<td>Before Yekatit 01</td>
<td>Before February 8</td>
</tr>
<tr>
<td>2. Notification of annual subsidy</td>
<td>By Yekatit 01</td>
<td>By February 8</td>
</tr>
<tr>
<td>3. Issuing the budget call</td>
<td>By Yekatit 01</td>
<td>By February 8</td>
</tr>
<tr>
<td>4. Budget requests</td>
<td>By Megabit 15</td>
<td>March 24</td>
</tr>
<tr>
<td>5. Preparation of the draft recommended budget</td>
<td>Megabit 15-Ginbot 15</td>
<td>March 24-May 23</td>
</tr>
<tr>
<td>6. Review of recommended budget by the Council of Ministers</td>
<td>Ginbot 16-Ginbot 25</td>
<td>May 24-June 2</td>
</tr>
<tr>
<td><strong>B. Budget Approval</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Legislative approval and appropriation of the budget</td>
<td>Sene 01- Sene 30</td>
<td>June 8-July 7</td>
</tr>
<tr>
<td><strong>C. Implementation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Notification of approved Budget</td>
<td>Hamle 01-Hamle 07</td>
<td>July 8-Julay 14</td>
</tr>
<tr>
<td>9. Accepting the approved budget and action plan preparation</td>
<td>Hamle 08- Hamle 30</td>
<td>July 15-August 6</td>
</tr>
<tr>
<td>10. Implementing the approved budget</td>
<td>Hamle 01- Sene 30</td>
<td>July 8-July 7, the next year</td>
</tr>
</tbody>
</table>

*Source: MoFEC, Program Budget Manual*
The thrust for the Government annual budget is to attain fast, sustainable and inclusive growth, as stipulated in the Growth and Transformation Plan. Optimal allocation of the available financial resources consistent with the GTP objectives is critical to the annual budget formulation and approval. The Government has invested in pro-poor development schemes that ensure inclusiveness without losing sight of the long-term objectives of the development endeavours. To that end, the country has been investing heavily in social and economic infrastructure, basic public services, and rural development. These investments were capable of generating economic growth and slashing poverty by significant margins. In Ethiopia more than 50 percent of the annual budget is allocated to the capital (development) expenditures. This is one of the strengths of the expenditure policies of Ethiopia.

Taking into account the priorities and the medium-term development objectives of the government contained in the GTP, more than 60 percent of the overall budget in Ethiopia is devoted to pro-poor sectors, such as education, health, water and sanitation, agriculture and rural development, and road infrastructure, which have a critical role in enhancing the livelihoods of the poor, and promote social services and growth.

The agriculture sector is central to the livelihoods of the majority of the population and a major source for economic growth as well as poverty reduction. Given this significant contribution, it is one of the priority sectors in the annual budget allocation. Agriculture on the average has therefore received about 10% of the annual budget over the last decade.

Increasing access to education and health services is important for enhancing human capital. With little or no government support, only those with decent income can have access to schooling and health-care services. The Government, therefore, has a critical role in expanding opportunities for the poor and in enabling them to live more productive and decent life through spending on these sectors. In this connection, over the last decade the share of education and health expenditure from the aggregated budgetary resources averaged 24% and 7%, respectively.

Public spending on physical infrastructure can also significantly support the growth momentum of the economy. A good infrastructure improves access to markets, reduces transaction costs, and stimulates economic activity. Government expenditure budget provides emphasises for the importance of road transport in supporting social and economic growth and its role as catalyst to meet poverty reduction targets. In this connection over the last decade the Government annual budget has allocated on the average 20% of the aggregated expenditure to road construction.
Box: 3.2 Classification of Public Expenditure

Classification of Public expenditure refers to the systematic arrangement of different items on which the government incurs expenditure. Different public expenditure classifications can be given from different point of view. The following classification is based on these different views.

**Functional Classification:** The functional classification identifies the purpose of government expenditures. The primary objective of this classification is to provide a strategic overview of the allocation of government resources among different functions and sub functions. The functional classification indicates the main areas of the government’s involvement in the regulation and direct provision of services in different functions. This classification groups the expenditures according to the government’s functions rather than its organizational units or its input/economic classification. Examples of functional classification include defense and security, economic services including agriculture, infrastructure and industrial development as well as social services such as education, health and social welfare. Some functions may be implemented by one, two, or more spending agencies for political, administrative, and technical reasons.

**Economic Classification:** This type of classification identifies the source, legal base, and nature of inputs to be purchased for providing services or outputs, as well as the nature of budgetary transfers within a given spending agency and government as a whole. It creates a basis for classifying all expenditures for the purposes of budget preparation and review (along with other costing techniques where applicable), accounting, reporting, auditing, and finally for economic analysis of government transactions. A traditional economic classification groups inputs of a similar nature (such as salaries, allowances, travel expenses, utility payments), thereby providing a detailed classification of expenditure.

**Recurrent and Capital Expenditure**

**Recurrent or consumption expenditures** incurred on day to day activities of the government. It is paid for salaries and operating expenses in providing peace and security, other general, economic and social services. This type of expenditure is of recurring type which is incurred year after year.

**Capital expenditures** are incurred on building durable assets, like highways, multipurpose dams, irrigation projects, buying machinery and equipment. They are non-recurring type of expenditures in the form of capital investments. Such expenditures are expected to improve the productive capacity of the economy.

*Source: World Bank and Korea Institute of Public Finance from Line-item to Program Budgeting Global Lessons and the Korean Case*
Fiscal policy is one of the most effective policy instruments for direct government intervention to tackle inequality and poverty. The International Monetary Fund (IMF) in its 2017 Annual Report noted that despite strong growth over the past two decades, income inequality remains high in many low-income developing countries (LIDCs). This can impair both the future pace and sustainability of growth and macroeconomic stability. The report highlighted that features such as high levels of informality, limited geographic or intersectoral labour mobility, large intersectoral productivity differences, lack of access to finance, and low levels of infrastructure can make growth-inequality trade-offs particularly challenges these economies (IMF: 2017a).

The 2015 IMF Article IV Consultation report revealed that Ethiopia has an impressive track record of low inequality despite very rapid growth (albeit recently inequality may be on the rise in urban areas). The report acknowledged that Ethiopia allocates a high share (about 70 percent) of its expenditure to poverty-related programs, and that its Productive Safety Net Program (which integrates income support with public employment) delivers transfers in a well-targeted and cost effective way. Accordingly, Government policies supporting agriculture have played a major role in sustaining equitable growth, given that poverty is primarily in rural areas. So the Fund encourages the countries to pursue a fiscal policy among others that can tackle inequalities in their countries.

The Government is determined to design the fiscal policy for promoting inclusive growth. This is possible through using fiscal policy for redistribution. While fiscal policy can reduce inequality from either the spending or the revenue side, Government expenditure policy has proven that the impact from public spending side is significantly greater in reducing inequality. Studies conducted on expenditure subsidies claim that expenditures, especially targeted transfers contributed more to income redistribution than did taxes (Gemma Estrada, Sang-Hyop Lee, and Donghyun Park :2014).

The government expenditure policy is vital, when it comes to influencing spending to be utilized and distributed across populations so that it will have deep implications for inclusive growth. In particular, prioritizing government resources to fund programs that benefit the poor, such as education and health can help foster inclusiveness. Certain types of spending tend to be more equity-promoting than others. This requires a cautious move in better targeting to ensure that benefits from public spending intended to promote equity are captured largely by the poor. In this connection, the food security expenditures, the rural and urban safety net programs played important role in income redistribution.

The role of fiscal policy in income redistribution through expenditure is mainly implemented through subsidy and direct transfer. Government subsidies usually target low-income groups to access essential goods and services at more affordable and stable prices. In view of this
the Government fiscal policy incorporates direct transfers and provides subsidized basic food items and services to low income societies. The rural and urban safety net programs are examples of the Government direct transfer programs aimed at increasing income of targeted households living below the poverty line in selected urban and rural areas. The programs are implemented through the provision of cash transfers, financial and technical support to access livelihood opportunities of the rural and urban poor. Furthermore, the poor are granted free medical services from Government health facilities.

Despite these sound intentions, rather than promoting equity, some subsidies have been found to benefit the well-off. In this connection fuel price subsidy is considered as benefiting the rich rather than the poor. Studies have shown that energy subsidies primarily benefit upper-income groups. There is a tendency for fuel consumption to rise substantially with income, so general subsidies will largely benefit non-poor households. Although aimed at protecting consumers, subsidies aggravate fiscal imbalances, crowd-out priority public spending, and depress private investment, including in the energy sector. Subsidies also distort resource allocation by encouraging excessive energy consumption, artificially promoting capital-intensive industries, reducing incentives for investment in renewable energy, and accelerating the depletion of natural resources. UNDP report points out that most subsidy benefits are captured by higher-income households, reinforcing inequality. Even future generations are affected through the damaging effects of increased energy consumption on global warming (UNDP: 2016).

It has been recognized that removing costly general subsidies while at the same time putting in place well-targeted schemes is useful in budget allocation in order to attain inclusive growth. In this connection, studies in the area point out that targeted subsidies or cash transfer to the poor is a promising option for magnifying the equity impact of public spending in developing countries (Gemma Estrada, Sang-Hyop Lee, and Donghyun Park: 2014).

In light of this, the Ethiopian Government has opted to subsidize food rather than fuel. It has resolved to spend scarce resources on feeding its population. To this end the Government has removed an average US$800 million annual subsidy on petroleum products since September 2008. Since then the Government allocates to subsidize basic food items targeting the low-income group.

In the fiscal year 2016/17, the Government allocated a budget to purchase food from abroad for distribution to areas affected by the El-Nino induced drought. Interestingly, the finance...
allocated to purchase the imported food was generated from the fuel price stabilization fund. This was the outcome of the removal of the fuel subsidy. Accordingly, it is possible to assert that in Ethiopia rather than subsidizing fuel, it has become a source of budgetary finance to cross subsidize basic food items to the poor and drought affected citizens.

The Government has also introduced a Youth Revolving Fund (YRF) to promote entrepreneurship and employment creation for the urban and rural youth. It has allocated budgetary loanable funds from the Federal budget and transferred to the Regional Governments so that the youths with entrepreneurial proposals can access loans from this fund and create job opportunities to the unemployed youth.

The expenditure policy also emphasizes on creating fiscal space through expenditure efficiency measures. Efficiency in resource use is as important as generating additional resources. The public expenditure policy deals with efficiency in allocation among sectors and expenditure management within a sector. Although the expenditure budget allocation is guided by priorities, defining spending priorities within a number of public bodies can be compromised due to low technical capacity and data availability. This might initially result in excess allocation of funding in less priority areas. Thus, there is a need to focus on improving efficiency in disbursement and shifting resources towards areas of high priority throughout the budget cycle. This provides a great opportunity to prevent disruptive expenditure adjustments for priority programs by creating the necessary fiscal space through implementing expenditure efficiency measures.

In this respect, the Government annual budget implementation process focus on tightened fiscal stance through (i) implementing efficiency measures to create resource saving from allocated budget on less priority and unproductive activities, (ii) minimize supplementary expenditures to the greatest extent possible by avoiding requests outside the productive priority sectors, and (iii) ensuring that where funds allocated to the key priority investments remain outstanding unless the intended service or goods are acquired.

In line with this, the Government has issued directives at the beginning of fiscal year 2017/18 in identifying potential budget saving areas, and requiring budgetary institutions to focus on efficiency in order to create fiscal space for priority sectors.

The government expenditure policy also contributes to macroeconomic stability. Excessive spending may lead to inflationary situation. Obviously, productive government
spending has less effect on inflation. Thus, the Ethiopian government expenditure policy follows the allocation of the lion share of the public resources to the capital (productive) sectors which does not contribute much to inflation, but rather contributes to productive capacity creation. Moreover, the level of the fiscal deficit is decided on the consideration of the objective of the monetary policy and usually will be kept as low as possible.

During 2008/09-2010/11 period when the economy exhibited high inflation at 36.3%, Government expenditure financing policy was well managed to support the monetary policy measures taken at the time. This contributed to lowering the inflation, in addition to administrative measures taken to arrest the inflationary situation. Government has curtailed the domestic financing to the possible minimum, continued its effort in allocating more resources to productive (capital) expenditure, purchase and distribute imported basic food items (wheat, edible oil and sugar) at low prices to poor urban households from the budgetary sources. Such measures brought positive results and inflation has been stabilized and remained in a single digit in subsequent years.
4. **BUDGET DEFICIT AND PUBLIC DEBT POLICIES**

4.1 **BUDGET DEFICIT**

The overriding objectives of the Government’s fiscal policy are building prudent public financial management, financing the required expenditure with available resource and refrain from possibility of unsustainable fiscal deficit. Growth in the domestic public debt is contained to a sustainable level in order to ensure macroeconomic stability and to avoid crowding-out the private sector. As a rule of thumb, although there are no written fiscal rules regarding the limit of the fiscal deficit, the GTP II limits the fiscal deficit of the government not to exceed 3% of GDP. The fiscal deficit, however, practically determined as part of the process of setting macroeconomic targets during the preparation of the MEFF and usually set to be consistent with the monetary objectives. Regional governments in Ethiopia, by law are required to run balanced budgets and cannot run budget deficit.

4.2 **EXTERNAL DEBT POLICY AND MANAGEMENT**

To augment available for domestic financing options, the Government opted to finance its fiscal deficit from external sources on concessional terms. In particular, the Government of Ethiopia finances its budget by accessing external loans on concessional terms. As a rule of thumb, non-concessional loans cannot be used to finance the budgetary activities.

On the other hand, external non-concessional loans are used to finance projects that are run by State Owned Enterprises. In recent years, the government accessed loans from international market on non-concessional terms to finance feasible and profitable projects managed by State Owned Enterprises (SOEs). The country’s total public debt contains central government, government guaranteed and public enterprises.

Recognizing the impact of debt burden on future generation and responsibility of each citizen, any single loan is subject to the approval and oversight of Ethiopian Peoples’ Representative Council (Parliament). Each loan is realized through efficient and effective project preparation and vigilant implementation, monitoring and evaluation mechanisms. In the process of building transparency and accountability in debt management, each loan is issued in the country’s Negarit Gazeta. Furthermore, the country’s debt management is governed by the Federal Government Financial Law and Regulations.

The Government borrows to finance projects that help to boost export, build assets, reduce poverty and enhance social and infrastructure development. External loan policy of the government primarily focuses on concessional loans with longer grace and maturity periods and very low interest rates. The overall debt management is guided by a medium-term strategy. The strategy defines how debt should evolve over the medium term to account for
financing the Growth and Transformation Plan (GTP) while maintaining macroeconomic stability. In addition, the country’s debt management is guided by streamlined loan utilization and administration directive. The Government has also established a public debt management advisory committee.

Ethiopia in collaboration with its development partners has conducted Debt Sustainability Analysis. The DSA has the twin objectives of providing an opportunity for Ethiopian Government to sustainably reduce the debt burden whilst facilitating access to foreign resources for the country’s pressing development needs.
5. **FISCAL INCENTIVES**

The Ethiopian Government offers a comprehensive set of fiscal incentives to attract both foreign and domestic investors and encourage investments into priority areas as well as promoting exports. Such fiscal incentives are granted through various regimes including incentives granted in the investment proclamation, and provisions under the different tax laws.

5.1 **TAX INCENTIVES**

The tax incentives in Ethiopia are particularly provided through either exemption of tax or reduced tax rates. The provisions of tax incentives are implemented through exemptions of customs duty, corporate income tax and VAT on investment activities.

5.1.1 **INCOME TAX EXEMPTION**

Investments engaged in manufacturing, agribusiness, generation, transmission and supply of electrical energy; and ICT are entitled to income tax exemptions for a period ranging between 1 and 15 years, depending on the specific activity and the location of the investment. In addition to this, new investments that will be established in Gambella, Benshangul/Gumuz; Afar (except in areas within 15 kilometres right and left of the Awash River); Somali; Guji and Borena Zones (in Oromia); or South Omo Zone, Segen (Derashe, Amaro, Konso and Burji) Zone, Bench-Maji Zone, Sheka Zone, Dawro Zone, Keffa Zone, Konta and Basketo Special Woredas (in Southern Nations, Nationalities and Peoples Region) are entitled to an income tax deduction of 30% for three consecutive years after the expiry of the income tax exemption period specified above.

Tax incentives are also used to encourage the expansion of the existing investment. If an existing investment is expanded or upgraded to increase its production or service capacity by at least 50% or introduces a new production or service line at least by 100% of an existing capacity, it is entitled to the income tax exemption period specified above. In addition, investors who export at least 60% of their products or services, or supply these to an exporter, will be exempted from the payment of income tax for an additional 2 years.

5.1.2 **CUSTOMS DUTIES AND TAXES**

Both domestic and foreign investors engaged in eligible new investments or expansion of projects in manufacturing, agriculture, agro-industries, power generation, transmission and supply of electrical energy, information and communication technology development

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6 The Government provides income tax exemption up to 15 years for private industrial park developers outside Addis Ababa
(ICT), tourism, construction contracting, education and training, star designated hotel, specialized restaurant, architectural and engineering consultancy works, technical testing and analysis, capital goods leasing and importation of LPG and bitumen are exempted from customs duties and taxes on importation of capital goods for investment purposes.

The following are the different tax incentive privileges granted to investors on the aforementioned investments.

- 100% exemption of customs duties and other taxes levied on imports of all capital goods, such as plant, machinery and equipment and construction materials;
- 100% exemption of customs duties on spare parts worth up to 15% of the total value of the imported investment capital goods, provided that the capital goods are also exempted from the payment of customs duties;
- An investor granted with a customs duty exemption will be allowed to import capital goods duty free indefinitely if his/her investment is in manufacturing and agriculture and for five years if his/her investment is in other eligible areas;
- An investor entitled to a duty-free privilege who purchases capital goods or construction materials from local manufacturing industries shall be refunded the customs duty paid for raw materials or components used as inputs for the production of such goods;
- Investment capital goods imported with duty free privilege may be transferred to another investor enjoying similar privileges;
- 100% repatriation of profits

5.1.3 LOSS CARRY FORWARD

Business enterprises that incur losses during the income tax exemption period can carry forward such losses, following the expiration of the income tax exemption period, for half of the tax holiday period. However, any loss incurred during income tax exemption period is not allowed to carry forward for more than five income tax periods.

5.1.4 EXPORT INCENTIVES

With the exception of semi-processed hides and skins, no export tax is levied on Ethiopian export products. Moreover, there are duty drawback schemes for exportable items on the taxes paid on imported and domestic inputs. The duty drawback scheme offers investors an exemption from the payment of customs duties and other taxes levied on imported and locally purchased raw materials used in the production of export goods. Duties and other taxes paid are drawn back 100% for the export of finished goods. Exporters are also entitled to use Voucher scheme, Bonded Factory scheme, and Manufacturing Warehouse scheme as
an alternative to enjoy the exemptions on their inputs.

5.2 IMPACT OF FISCAL INCENTIVES

As it has been discussed in the foregoing section, the Government has implemented various fiscal incentives to promote foreign and domestic investment and exports. The principal purpose of the incentives is to attract investments to the country, both in quality and quantitative terms. Incentives granted to the export sector are also aimed at increasing the country’s export earnings through producing exportable commodities in bulk and quality and diversity.

Fiscal incentives are expected to attract investment through participation of both foreign and domestic investors in order to spur the country’s output, jobs and other indirect social benefits to be accrued to the citizens. Indeed, fiscal incentives are not the only factors attracting investment. Besides the fiscal incentives, other enabling factors for attracting investments includes, the prospects and stability of the economy, secured political environment, prevalence of peace and security, abundant and affordable skilled labour, proximity to international markets, improved infrastructure are all among the most important factors to attract investment. In order to attract both local and foreign investors the Government has taken a combination of policy and administrative measures beyond the fiscal incentives. Other measures, including upgrading infrastructure, the predominance of abundant and low-cost labour, and huge domestic market; accessibility to international markets, improving logistics and public service delivery and the prevalence of peace and security are equally important in improving the investment climate.

The macroeconomic data of the country indicates that investment has been expanding over the past two decades. The investment share to nominal GDP reached about 40% in 2015/16 from its lowest level of 20%, a decade ago. Moreover, global and regional reports have shown that the FDI flows to Ethiopia registered significant increase over the past few years, reaching over 4 billion USD in 2016/17.

Incentive policies have varying costs and benefits for governments. The costs are due to revenue losses from investments that would have been made even without the incentives and indirect costs such as economic distortions and administrative and leakage costs. While Ethiopia has provided multiple of fiscal incentives it has become difficult to gauge their pros and cons in promoting the FDI and domestic investors as well as the contribution to the overall economy. Over the past years the Government has been granted several fiscal incentives although evaluation study on their impact has not been conducted. The government revenue foregone due to the granted fiscal incentive is unknown; leave alone

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7 A voucher is a printed document having monetary value, which is used in lieu of duties and taxes payable on imported raw materials.
measuring the benefits drawn from it. In other words, it is not known how the fiscal incentive structure is performing; whether it is meeting its objective is not clear, unless a study is conducted. It is with this spirit; recently MoFEC decided to conduct a study on the fiscal incentive scheme with the objective of addressing the issues raised above. This study is on-going in collaboration with the World Bank and International Monetary Fund.
PART TWO

Recent Developments
6. DEVELOPMENTS IN MACROECONOMIC AGGREGATES

6.1 Economic Growth Performance

Several international and domestic assessments made on the Ethiopian economy assert the remarkable progress of the country over the past decade and more. The latest IMF economic assessment also testified that Ethiopia has become one of the fastest growing economy and has achieved higher growth rates than most African countries and overtook Kenya as East Africa’s largest economy in 2017 (IMF 2017a, World Bank Group; 2017).

Interestingly, Ethiopia’s impressive economic growth performance witnessed in the past two years happened in the midst of two critical global and internal situations. These are the very slow global economic growth which affects commodity prices and demand and the “El Niño”-related drought which negatively affected the country’s agricultural sector.

The Global and Regional financial institutions noted that after nearly two decades of strong growth, average economic activity in sub-Saharan Africa has decelerated sharply, against the backdrop of lower commodity prices, a less-supportive global environment. Moreover it has been disclosed that in 2016, growth slowed in about two-thirds of the countries in Africa and is estimated to have reached just 1.5 percent average growths, which is the worst performance in more than two decades (IMF 2017b).

The World Bank Group through their systemic country diagnostic report assert that Ethiopia has achieved substantial progress in economic, social and human development over the past decade (World Bank Group: 2016a). The assessment noted that economic growth was rapid and inclusive averaging 10.2 percent per year since 2004.

This puts the country as one of the fifth fastest growing economies in the world. The Bank further noted that the growth is inclusive because Ethiopia has the lowest level of income-inequality in Africa. According to the World Bank study, in comparison to other African countries, Ethiopia has the lowest inequality as measured by the Gini coefficient. Ethiopia’s Gini coefficient has consistently remained below 30 percent. The Gini for rural Ethiopia is particularly low at 27 percent, and given the majority of the population is located in rural areas this contributes to a low national Gini. Urban Ethiopia has consistently higher inequality than rural areas, across measures and across time, but in comparison to other countries it is still quite low at 35 percent (The World Bank: 2014).

Similarly the recent published 2015/16 Poverty Analysis Study Interim Report of the National Planning Commission disclosed that the national poverty incidence has declined
significantly over recent years, in which the national headcount poverty rate fell from 29.6 percent in 2010/11 to 23.5 percent in 2015/16 (NPC:2017). The decline in poverty incidence was experienced in both rural and urban areas.

The IMF Staff 2017 Article IV press release on September 26, 2017 noted that Ethiopian economy showed strong resilience in 2016/17 amid continued weak global prices for Ethiopia’s key exports and re-emergence of drought conditions in some parts of the country. The report reaffirmed that real gross domestic product (GDP) is estimated to have increased by 9 percent in 2016/17 (IMF 2017c).

According to the National Planning Commission preliminary report Ethiopia’s GDP increased from USD 8.2 billion in 2000/01 to USD 80.6 billion in 2016/17 at current market prices. The high and fast economic growth enabled the country to achieve a remarkable high performance, reaching double that of the Sub-Saharan African (SSA) countries average real GDP growth (Fig 6.1.1).

In fiscal year 2016/17 the economy continued to register an annual real growth of 10.9 percent. For such remarkable growth the agriculture, industry and service sectors contribute 2.5, 4.4 and 4 percent respectively.

In 2015/16 real GDP grew by 8 percent compared to 10.4 percent growth in 2014/15 due to rainfall shortage which affected the agricultural production. As a result sectoral contribution for growth in fiscal year 2015/16 turned out 0.9, 3.1 and 4 percent for agriculture, industry and services respectively. In a retrospective view Ethiopia has been prone to historic
vulnerability to climate change. The country has faced a number of drought episodes. Their impact on the overall economy was significant due to the sectors fragility resulted from absence of appropriate policies and strategies. As the role of agriculture in the economy was dominant the spill over effect on the overall economy was immediate. Thus in those drought years weak performances on the agriculture result in negative growth of the overall economy (Fig 6.1.2).

In this connection, the World Bank in its recent Ethiopia’s economic assessment observed that despite the worst rainfall shortage ever faced the economy over the last fifty years; the ability to keep growth positive in 2015/16 was a remarkable achievement for the country. The report recapitulates that in similar occasions in the past, for instance in 1997/98 and 2002/03 the country has experienced negative GDP growth. In 1997/98 growth dropped to -3.5 percent from 3 percent in the preceding year. Similarly, in 2002/03 it dropped to -2.2 percent from 1.5 percent previous year (World Bank: 2016b). In 2015/16, however, Ethiopia’s economy was among the fastest growing in the world demonstrating the increased resilience of the economy following adverse shocks.

Figure 6.1.2: Past and Recent Drought Episodes Impact on Real GDP Growth (percent)

IMF also acknowledged that timely government interventions and food aid, coupled with improved agricultural practices, technology, and rural infrastructure, appear to have limited the economic impact of the drought relative to earlier drought episodes, including by helping to increase production in less-affected areas (IMF:2016).

Figure 6.1.3: Growth Rates of GDP by Major Industrial Classification at Constant Basic Prices (percent)
Amid the severe rainfall shortage, the agricultural sector grew by 2.3 percent and the overall economy growth was 8.0 percent. This shows that the Agricultural led economic strategy the Government pursued generated the intended results. Specifically, efforts undertaken to implement strategies to improve productivity of smallholder farmers, conserving natural resources and promoting irrigations and the progress in shifting from subsistence agriculture to production of high value agricultural products enabled the country to build resilience in drought vulnerability.

Growth rates in industry and service sectors are laying the foundation for structural changes in the economy. The share of agricultural sector, which employs more than 80 percent of the labour force, declined from 56.4 percent in 2001/02 to 36.3 percent in 2016/17 (Fig 6.1.4). On the other hand, the share of the services sector increased from 36.3 percent to 39.3 percent over the same period while the share of the industrial sector increased from 9.5 percent to 25.6 percent in the same period. The construction industry, particularly roads, railways, dams and residential buildings are the main driver of growth in the industrial sector, contributing more than half of the sector’s growth. In this connection the manufacturing sub-sector having serious emphasis by the Government has not performed as is expected. Service sector growth is mainly dominated by expansion in communication and transport services, hotel and restaurant businesses, as well as wholesale and retail trading. Structural change in the form of labour shifts from low productivity agriculture to higher productivity modern sectors including construction, services and industry is expected to exploit the emerging demographic dividend arising from a rising working age population (World Bank 2016a).
The continued economic growth result in an increase in per capita income of citizens. In absolute figures the level of per capita income increased to USD 863 in 2016/17 from USD 262 in 2006/07, registering more than a triple fold growth (Fig 6.1.5). This has witnessed, an average per capita income (in dollar terms) growth of 7.9 percent over the last decade, which is equivalent to the annual per capita growth rate needed for Ethiopia to reach middle-income status by 2025 (World Bank 2016a).

**Figure 6.1.5: Ethiopia: Per capita Income (in USD)**

Source: National Planning Commission
Compared to the SSA average real per capita growth Ethiopia’s performance was significantly high throughout the decade (Fig 6.1.6). Even in the recent worst years of African economic performance that result in a negative 1 percent decline of per capita income of SSA countries, Ethiopia has registered 6.3 percent growth (2015/16).

**Figure 6.1.6: Ethiopia and SSA Real Per Capita Income GDP Growth (percent)**

Source: IMF: Regional Economic Outlook: SSA Restarting the Growth Engine: April 2007

### 6.2 National Saving and Gross Investment

Domestic saving is a prerequisite to sustain a robust investment in the economy. The role of domestic saving in sustaining investment and economic growth has been witnessed in successful countries. Domestic saving along with foreign capital inflow has become important sources of finance for investment. Gross national saving in Ethiopia compared to SSA countries average is remarkably high as depicted in figure 6.2.1. According to the IMF data over the years between 2008/09 and 2016/17 average national saving in percent of GDP was 28 compared to 18 percent of SSA countries average in the same period. The magnitude is not only high but it is on the rising trend unlike other SSA countries (IMF: 2017a).

**Figure 6.2.1: Ethiopia and SSA Gross National Saving (in percent of GDP)**

Source: IMF: Regional Economic Outlook: SSA Restarting the Growth Engine: April 2007
Domestic saving augmented by foreign resources enables the country to achieve as high as 40 percent of GDP investment rate in recent years. Such huge investment is significantly high as compared with SSA countries average (Fig 6.2.2).

Ethiopia’s gross domestic investment as share of GDP has markedly improved over years in contrast with the sluggish trend observed in most of SSA countries. The high share of investment compared with the SSA average is due to, among others, the creation of an enabling environment, especially for the participation of the private sector along with the public sector aggressive investments in infrastructure and social services. In particular the public investment rose from 5 percent of GDP in early 1990s to 19 percent of GDP in 2011 – the third highest globally (World Bank 2016a). The IMF statistics also designates high gross investment of the country compared to the SSA counties position (Fig 6.2.2). The high investment supported by large scale government investment programs and external sources is necessary to encourage the participation of the private sector to sustain growth and trigger transformation in the country.

**Figure 6.2.2: Ethiopia and SSA Total Investment (Percent of GDP)**

![Graph showing Ethiopia and SSA Total Investment (Percent of GDP)](image)

*Source: IMF: Regional Economic Outlook: SSA Restarting the Growth Engine: April 2007*

Although the country’s performance both in mobilizing domestic saving and investing in the economy looks encouraging, the gap between the saving and investment remains high.
6.3 Price Developments

During the first two years of the second Growth and Transformation Plan (GTP II) implementation period, the annual general inflation rate has remained in a single digit despite the El Niño’s induced drought effect that hit some parts of the country. In 2015/16, the average annual price growth rate has been 9.7 percent and declined to 7.2 percent in June 2016/17. Accordingly, the month-to-month inflation (which shows the current inflation situation) has sharply declined and remained in single digit level marking at 8.8 percent in June 2016/17. This was an encouraging result compared to the level of 38.0 percent in June 2010/11. While food contains a major component of the price index, Government intervention in releasing part of its cereal stock reserves and bulk import of wheat contribute to stabilize the overall price level in the midst of El Niño’s drought effects.

Table 6.3.1. Annual General Inflation

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<tbody>
<tr>
<td>12 Month Moving average (June) in Percent</td>
<td>18.1</td>
<td>34.1</td>
<td>13.5</td>
<td>8.1</td>
<td>7.7</td>
<td>9.7</td>
<td>7.2</td>
</tr>
<tr>
<td>Month to Month Inflation average (June) in Percent</td>
<td>38.0</td>
<td>20.8</td>
<td>7.4</td>
<td>8.5</td>
<td>10.4</td>
<td>7.5</td>
<td>8.8</td>
</tr>
</tbody>
</table>

Source: Central Statistics Agency and Staffs Compilation

The country level Consumer Price Index (CPI) which is based on December 2011 retail price of goods and services as a base period gives 53 and 47 percent country level weights for food and non-food components respectively. Based on this, the price survey data during
the last seven consecutive fiscal years (2010/11-2016/17) showed that the annual general inflation rate which is measured by 12-months moving average has declined by 2.7 percent annually on the average. This is largely contributed by the trend of the non-food component of price, which showed 16 percent annual average decline during the fiscal years 2010/11–2016/17. However, the inflation rate of food items has shown an annual average growth rate of 15.2 percent during the same period. The declining trend showed in the general rate of inflation particularly from 2014/15 on wards was so significant in improving the wellbeing of people and the government effort to promote private investment. This was partly due to Government determination to continue with the effective implementation of its macroeconomic policies focused on controlling money growth and prudent fiscal policy. In addition to this the Government took regulatory and administrative measures to arrest inflation.

Figure 6.3.1: Country wide Annual Inflation Rate, 12-Months Moving Average (2010/11-20016/17)

Moreover, over the past three years food price development in Ethiopia has shown similar pattern with global food price trend, suggesting the presence of noticeable relationship.

Figure 6.3.2: Food price index for the Global and Ethiopia

Source: FAO, CSA (Ethiopia)
6.4 External Sector Developments

Imports and exports are important economic instruments in linking the domestic economy to the rest of the world. In the current interlinked global economy, markets are full of goods from every corner of the world. The markets provide more choices to consumers. In the process countries engaged in both the export and import business. No country is self-sufficient and produces all commodities required by the domestic economy. Nevertheless, countries try to optimize to generate economic growth through net exports. Because more exports means:

- More output from domestic producers;
- Greater number of people employed to produce;
- More receipt of export proceeds which is an inflow of funds into the country, and stimulates consumer spending and contributes to economic growth.

Conversely, imports are considered to be a drag on the economy, as they represent an outflow of funds from a country. To this end excess import in relation to exports is considered as distorting the balance of trade and creating unhealthy economy. However, a high level of imports indicates robust domestic demand and a growing economy. It is also more productive if the imports are mainly of productive assets like machinery, equipment, and raw materials since they improve productivity over the long run. Ethiopia’s trade balance for instance, tends to widen as there is huge import requirement for investment. This of course helped the economy to grow continuously. Nevertheless, exports need to grow commensurately, for the economy to be resilient and sustainable. Ethiopia’s export, however, did not show strong performance as imports and this put pressure on the current account balance.

6.4.1 Export Performance and Structure

Owing to rigorous policy and administrative measures taken to promote the country’s export performance, export earnings increased to USD 3.3 billion in 2013/14 from less than a billion USD a decade ago. However, export earnings showed a declining trend since 2012/13. Between 2007/08 and 2011/12 the country’s export performance registered an average annual growth of 22.5 percent. However, its performance exhibited a negative growth (-1.7 percent average annual growth) in the last 5 years (2012/13-2016/17).
Ethiopia’s export performance has not only declined over time, its position compared to the SSA countries has been very low. As figure 6.4.2 depicts over the last decade Ethiopia’s export of goods and services averaged nearly 12 percent of GDP, while the average for SSA countries was 28 percent.

Among the export commodities the performance of gold significantly accounted both for the positive and negative developments over the last decade. Its enhanced performance contributed for the noticeable overall export growth (38 percent) in 2010/11. As could be recalled in 2011 gold price hit the highest price in the global market. While its price decelerated and reached at very low in 2016. Accordingly it has become the major source of ups and downs in the overall export performance of the country.
6.4.1.1 Recent Developments in World Commodity Markets

Obviously the performance of Ethiopia’s export is influenced by two major factors, world prices of the commodities and quantity (volume) of export items. For Ethiopian export market which is characterized by agricultural commodities, the impact of global commodity prices is significant.

Table 6.4.1: Selected Commodities Global Prices Growth (Percentage Change over the previous Year)

<table>
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</thead>
<tbody>
<tr>
<td>All Commodities</td>
<td>33.4</td>
<td>-30.8</td>
<td>24.6</td>
<td>27.8</td>
<td>-3.5</td>
<td>-4.2</td>
<td>-8</td>
<td>-34.3</td>
<td>-8.7</td>
<td>14.4</td>
</tr>
<tr>
<td>All Food</td>
<td>32.9</td>
<td>-8.8</td>
<td>10.9</td>
<td>23.1</td>
<td>-6.5</td>
<td>-9.6</td>
<td>-1.1</td>
<td>-13.8</td>
<td>2.5</td>
<td>1</td>
</tr>
<tr>
<td>Coffee</td>
<td>15.4</td>
<td>-6.9</td>
<td>27.3</td>
<td>42.9</td>
<td>-25.7</td>
<td>23.6</td>
<td>29.9</td>
<td>-19.7</td>
<td>2.1</td>
<td>3.3</td>
</tr>
<tr>
<td>Beef</td>
<td>2.6</td>
<td>-1.2</td>
<td>27.5</td>
<td>20</td>
<td>2.6</td>
<td>-2.3</td>
<td>22.1</td>
<td>-10.5</td>
<td>-11.1</td>
<td>7.6</td>
</tr>
<tr>
<td>Vegetable Oilseeds &amp; Oils</td>
<td>34</td>
<td>-22.6</td>
<td>12.2</td>
<td>23.8</td>
<td>0.5</td>
<td>-10.3</td>
<td>-8.2</td>
<td>-20.4</td>
<td>7.3</td>
<td>1.1</td>
</tr>
<tr>
<td>Hides and Skins</td>
<td>-11.3</td>
<td>-30</td>
<td>60.5</td>
<td>14</td>
<td>1.4</td>
<td>13.9</td>
<td>16.5</td>
<td>-20.6</td>
<td>-18.8</td>
<td>3.6</td>
</tr>
<tr>
<td>Gold</td>
<td>25.1</td>
<td>11.6</td>
<td>26.1</td>
<td>27.8</td>
<td>6.4</td>
<td>-15.4</td>
<td>-10.3</td>
<td>-8.4</td>
<td>7.6</td>
<td>-0.8</td>
</tr>
<tr>
<td>Crude Petroleum</td>
<td>36.4</td>
<td>-36.3</td>
<td>28</td>
<td>31.4</td>
<td>1</td>
<td>-0.9</td>
<td>-7.5</td>
<td>-47.2</td>
<td>-15.7</td>
<td>19.5</td>
</tr>
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</table>

Source: UNCTAD: Trade and Development Report 2017

In this connection, commodity prices in the global market have continued to plunge since 2011. According to the United Nations Conference on Trade and Development (UNCTAD) the main factors behind the relatively low levels for most commodity prices throughout 2015 were persistent over supply and associated levels of inventories. Since 2011 and continuing to 2015, supply increase has been larger than demand growth for most commodities, due to weak demand in the context of slow global growth (UNCTAD: 2017). As it has been observed in Table 6.4.1 price growth of most of the commodities in the global market has declined in recent years. Ethiopia’s principal exports such as coffee, gold, oilseeds,
vegetables and meat were among the victims in the market. In this connection the highest price decline observed in 2015 in the global market result in a negative 8 percent of Ethiopia’s export earnings as demonstrated in Table 6.4.1 and Fig 6.4.1 above.

**Figure 6.4.4: Growth in Coffee Export Earnings & Its Global Market Prices (Annual Percentage Change)**

![Coffee prices and Coffee export earnings chart](image)


Export performance developments over the past years follow the global commodity prices. Export earnings from the two basic commodities, coffee and gold can demonstrate the situation as observed in figures 6.4.4 and 6.4.5.

**Figure 6.4.5: Growth in Gold Export Earnings & Its Global Market Prices (Annual Percentage Change)**

![Gold Prices and Gold Export Earnings chart](image)


Yet the structure of exports hardly changed over the last two decades and the country’s export earnings still depend on few agricultural commodities (Table 6.4.2). Though, diversification is still lacking, a shift within the major commodity categories has been evident. Ethiopia’s traditional export item coffee represented about 60 percent of the total export item in the 1990s. Its share decelerated to an average of 45 percent in 2000/01 and further to 22 percent in 2013/14. The share of the top five exports (coffee, leather & leather...
products, oil seeds, pulses and chat) declined on average from about 87 percent during 1990/91-2000/01 to 65 percent during 2001/12-2016/17. This indicates the emergence of new export items such as gold, flowers, and textiles in recent years. However, although the share of coffee declined over time from its high of the earlier years, its position has stabilised about a quarter of the overall export earnings and even rising in late years. This has a message that the structural shift has not sustained and the performance of the modern sector (manufacturing products) role in the export market is not yet realized.

Table 6.4.2: Share of major export items in total export (percent)

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</thead>
<tbody>
<tr>
<td>Coffee</td>
<td>45</td>
<td>35.4</td>
<td>26.5</td>
<td>26.5</td>
<td>25</td>
<td>22</td>
<td>26.3</td>
<td>25.6</td>
<td>30.4</td>
</tr>
<tr>
<td>Leather &amp; Leather Products</td>
<td>18.8</td>
<td>7.5</td>
<td>6.4</td>
<td>3.5</td>
<td>4.1</td>
<td>4</td>
<td>4.4</td>
<td>4.1</td>
<td>4</td>
</tr>
<tr>
<td>Oil Seeds &amp; Pulses</td>
<td>10.2</td>
<td>24.8</td>
<td>19.6</td>
<td>20.1</td>
<td>26.8</td>
<td>31.1</td>
<td>28.9</td>
<td>29.2</td>
<td>21.7</td>
</tr>
<tr>
<td>Chat</td>
<td>15.1</td>
<td>8.9</td>
<td>10.4</td>
<td>7.6</td>
<td>9.1</td>
<td>9.1</td>
<td>9.1</td>
<td>9.2</td>
<td>9.6</td>
</tr>
<tr>
<td>Gold</td>
<td>7</td>
<td>6.5</td>
<td>1.4</td>
<td>19.1</td>
<td>19.4</td>
<td>14</td>
<td>10.7</td>
<td>10.2</td>
<td>7.4</td>
</tr>
<tr>
<td>Flower</td>
<td>0</td>
<td>2.2</td>
<td>8.4</td>
<td>6.2</td>
<td>6.3</td>
<td>6.1</td>
<td>6.8</td>
<td>7.9</td>
<td>7.7</td>
</tr>
<tr>
<td>Live Animals &amp; Meat</td>
<td>0</td>
<td>3.7</td>
<td>4.5</td>
<td>6.5</td>
<td>5.6</td>
<td>5.7</td>
<td>5</td>
<td>5.2</td>
<td>6</td>
</tr>
<tr>
<td>Others</td>
<td>4</td>
<td>11</td>
<td>22.7</td>
<td>10.5</td>
<td>3.8</td>
<td>7.3</td>
<td>8.7</td>
<td>8.7</td>
<td>12.3</td>
</tr>
</tbody>
</table>

Source: National Bank of Ethiopia

While the overall export performance depends on few agricultural commodities, export growth both price and volume remains highly volatile. Figure 6.4.6 reveals the situation by examining developments in coffee export earnings against its global price and volume growth.

Figure 6.4.6: Growth in Coffee Export Earnings, its global price and volume (Annual percent Change)

Source: National Bank of Ethiopia and Table

Recent market developments revealed that the country’s export market destination follows the current global economic developments and its economic and diplomatic relations. Export markets shifted to emerging economies of Asia and the Middle East in recent years. IMF staff report acknowledges that one third of 2015 export revenue comes from markets where Ethiopia was not present 15 years ago. The Report further recalls that FDI has flowed to horticulture and light manufacturing, and non-traditional exports account for more than 10 percent of total exports. For example, flower exports expanded from US$440,000 and 5 destinations in 2004 to US$225 million and 59 destinations now (IMF: 2016).
The World Bank study on the Ethiopian export sector identified that the country’s export performance is vulnerable to the global price swings because unprocessed and undifferentiated agricultural products dominate its exports. The study recalls that while benefitting from upward price trends since 2003, the recent drop in prices of key commodities led to the worst export performance in a decade. To overcome this challenge, the Bank advises that renewed efforts must aim to improve competitiveness, including through value addition and export diversification (World Bank: 2014).

The foregoing discussions boiled down that to curtail the volatility of export, the only option is to move aggressively towards value addition and diversification of export commodities and market. To this end, Government massive investment in promoting industrial park development is an encouraging intervention in enhancing the country’s export earnings.

6.4.2 Import Performance

Despite low export performance the share of imports of Goods and Services averaged 30 percent of GDP between 2008/09-2016/17 which is comparable to average of SSA countries.

Figure 6.4.7: Ethiopia and SSA imports of Goods and Services in percent of GDP

The structure of imported items is dominantly capital goods, raw materials, semi-finished goods, fertilizer and fuel which accounted on the average about 70 percent for the last 8 years; compared to 30 percent of consumer goods (Table 6.4.3). Fuel imports increased from 17.7 percent in 2001/02 to 19.4 percent of total imports in 2011/12, although its share has been relatively low in recent years owing to the lower international oil price.
Table 6.4.3: Structure of Imports by End-use (percent)

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<tbody>
<tr>
<td>Raw Materials</td>
<td>1.6</td>
<td>1.7</td>
<td>2.5</td>
<td>1.8</td>
<td>1.3</td>
<td>1.2</td>
<td>1.0</td>
<td>0.9</td>
<td>0.8</td>
<td>1.2</td>
</tr>
<tr>
<td>Semi-Processed</td>
<td>16.0</td>
<td>17.9</td>
<td>14.5</td>
<td>17.7</td>
<td>16.2</td>
<td>16.3</td>
<td>15.7</td>
<td>17.3</td>
<td>16.6</td>
<td>16.6</td>
</tr>
<tr>
<td>Fertilizer</td>
<td>1.0</td>
<td>3.0</td>
<td>3.0</td>
<td>5.5</td>
<td>2.7</td>
<td>2.9</td>
<td>3.1</td>
<td>2.6</td>
<td>2.3</td>
<td>3.2</td>
</tr>
<tr>
<td>Fuel</td>
<td>17.7</td>
<td>18.7</td>
<td>17.6</td>
<td>19.4</td>
<td>14.0</td>
<td>18.8</td>
<td>12.4</td>
<td>8.0</td>
<td>11.5</td>
<td>14.0</td>
</tr>
<tr>
<td>Capital Goods</td>
<td>30.1</td>
<td>31.6</td>
<td>34.1</td>
<td>26.4</td>
<td>33.0</td>
<td>35.4</td>
<td>41.8</td>
<td>40.8</td>
<td>38.2</td>
<td>35.5</td>
</tr>
<tr>
<td>Consumer Goods</td>
<td>31.7</td>
<td>27.9</td>
<td>29.9</td>
<td>31.3</td>
<td>31.9</td>
<td>26.9</td>
<td>27.4</td>
<td>31.5</td>
<td>31.0</td>
<td>30.0</td>
</tr>
<tr>
<td>Others</td>
<td>2.9</td>
<td>2.1</td>
<td>1.4</td>
<td>3.4</td>
<td>3.5</td>
<td>1.5</td>
<td>1.7</td>
<td>1.5</td>
<td>1.9</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Source: National Bank of Ethiopia

6.4.3 Trade Balance

While the export performance declined over the years, the trade deficit widened as import continued to rise. Moreover compared to the SSA countries performance Ethiopia’s trade balance on goods is more pronounced as observed in figure 6.4.8.

Figure 6.4.8: Ethiopia’s Trade Balance (percent of GDP)

Source: IMF: Regional Economic Outlook: SSA Restarting the Growth Engine: April 2007

Obviously poor performance of export value which is not commensurate with an increased import value results in availing insignificant level of hard currency. As a result the share of exports earnings in financing imports exhibits a declining trend over years. The only highest ratio registered was 34.3 percent in 2010/11, whereas it declined to nearly 17 percent in 2015/16.
Another indicator in disappointing performance of export earnings is the country’s low level of foreign exchange reserve. As shown in figure 6.4.10 the amount of foreign exchange available to cover months of import in Ethiopia has been estimated for about 2 months compared to 4.7 months for the SSA countries average in 2016/17. Therefore, going forward boosting export performance has no option in order to sustain the economic growth and address the external imbalances.

Figure 6.4.10: Ethiopia’s Foreign Exchange Reserve In months of Imports

Source: IMF: Regional Economic Outlook: SSA Restarting the Growth Engine: April 2007
6.5 Urban Employment and Unemployment

The capacity of the economy in absorbing the labour force needs to be monitored regularly and appropriate employment policy should consequently be adopted. Thus, the level of employment and unemployment of the country is widely used as an overall indicator in evaluating the performance of the economy.

In the analysis of the labour force, a country’s urban population above a certain age threshold (often ten years and above in our case) is divided into three mutually exclusive categories: the employed, the unemployed, and the economically inactive population. Adding up the employed and the unemployed gives the country’s urban labour force. It is then quite straightforward to calculate both employment and unemployment rates. The 2016 national labour force survey reveals that the total urban population of the country was estimated to be 19,086,000 of which 9,494,000 (49.7 percent) were male and 9,592,000 (50.3 percent) were female (Central Statistical Agency: 2016).

At country level, the size of employed urban population aged ten years and above was 7,429,522 persons in April 2016 of which 4,142,866 (55.8 percent) are male and 3,286,656 (44.2 percent) are female. The periodical analysis exhibits that the proportion of employed population increases overtime. The size of employed persons in 2016 shows a significant increase by 346,428 persons (4.9 percent).

Figure 6.5.1: Employment to Population Ratio by Sex during the last three surveying periods

Labour market trends in urban Ethiopia have been improving overtime. Figure 6.5.1 shows that, the employment to population ratio of urban population was 52.6 percent in 2016. This means 53 percent of the total urban population of the country aged ten years and above
are employed. The differential by sex also depict that the ratio of males (64.2 percent) is significantly higher than females (42.8 percent).

The highest proportion (about 72 percent) of the employed persons of the urban population of the country was absorbed by the service sectors followed by the industry (20.3 percent). Agriculture and allied activities shares was only 7.3 percent in 2016. Periodical analysis of major sectors of the economy shows that percentage shares of employment in urban areas has slightly increased in the service sectors, while the employment share for agriculture sector portrays a decline over the last three years.

Figure 6.5.2: Percentage distribution of employed population by major sectors of the economy

![Graph showing percentage distribution of employed population by major sectors]

Source: Computed from CSA data

According to 2016 survey, in urban areas 1,657,880 persons were engaged in the informal sector out of the total 7,429,522 employed urban population. This make up 22.3 percent of the total employment at national urban level. The proportion of urban employed population who were working in the informal sector in 2016 slightly declined a (1.06 percent) compared to that of 2015 and 18.1 percent against 2014. Females who were working in this sector are significantly higher than males during the three survey periods.

The highest proportions of employed persons who work in the informal sector are found in Somali and Afar regions; representing 36.4 percent and 34.1 percent, respectively. The lowest proportion, in this respect was registered by Addis Ababa City Administration (10.5 percent).

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8 The informal sector is defined irrespective of the kind of work place where the productive activities are carried out, the extent of fixed capital used, the duration of the enterprise and its operation as main or secondary activity of the owner.
The 2016 survey result reveals that unemployed urban population in the country was 1,509,227 out of which males are 428,250 and females are 1,080,997. This means the rate of unemployment in the current status approach for urban areas of the country is 16.9 percent. That is nearly 17 persons are unemployed out of 100 economically active persons aged ten years and above. The differentials of unemployment by sex show that female unemployment rate (24.7 percent) is more than double as compared to male (9.7 percent). The comparison of this recent unemployment rate exhibits a decline of 1.5 percentage point during the last three survey periods. Regarding the age pattern of unemployment, the rates of unemployment is prevalent among youth population.

Figure 6.5.3: Trend of Urban Unemployment rate by sex during the three survey periods

![Graph showing trend of urban unemployment rate by sex during the three survey periods.](source: Computed from CSA data)

Figure 6.5.4 depicts unemployment rate is higher in urban areas of Dire Dawa Administrative Council (23.9 percent) followed by Addis Ababa city Administration (21 percent), Tigray region (20.6 percent) and Afar Region (19 percent). In addition, in urban areas of Somali region unemployment rate is found to be 18.2 percent closely followed by Amhara region about 18 percent. While the rest of urban areas of regions unemployment rate ranged from 8.2 percent in Gambella Region to 15.2 percent in Oromia region.

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9 Central Statistics Agency Statistical Reports on Urban Employment Unemployment Survey consider urban level, employed population aged ten years and above.
With the expansion of education, huge number of active population is joining the labour market; while the jobs created in the industrial and service sectors are not keeping pace with the labour market growth. Due to this the level of unemployment, particularly, youth unemployment in the urban Ethiopia is becoming very significant. For these labour force to be absorbed many jobs has to be created via investment expansion. Private investment is expanding over the past years and many jobs have been created though the pace at which private investment is expanding has not been enough to create the necessary number of jobs. The Government of Ethiopia is doing its level best to attract more private investment to address unemployment; especially youth unemployment. To supplement the on-going effort, for instance, in 2016/17 the Government leveraged its fiscal revenue to establish a Youth Revolving Fund of Birr 10 billion with the aim of availing some finance for the youth entrepreneurs in all regions. Moreover, with the help of development partners, Job Compact project has been initiated.

6.6 Private Sector Development

As a developmental state, Ethiopia’s public sector has fundamental responsibility in directing the economic growth of the country. However, the government clearly recognizes the role of the private sector in building the country’s economy. Private sector participation in the country’s economic development through mobilizing capital, providing employment opportunities, promoting efficient resource management and enhancing productivity has irreplaceable role. In view of this, the Government in its current Growth and Transformation Plan has accorded significant emphasis for the flourishing of private investment both from domestic and external sources through designing appropriate policies and strategies, and creating supporting institutions.
Government’s effort in attracting FDI in recent years has become effective and Ethiopia has emerged as one of the top ten African Countries in investment attractiveness. In 2017 Ethiopia has improved its position and ranked 4th best performers among African countries as compared to its 7th position of the preceding year. A number of factors including, the high and sustainable economic growth observed over the past years, large domestic market, the fiscal incentives granted to investors, the country’s untapped human and natural resources and the country’s strategic position to foreign market have helped Ethiopia to allure potential foreign investors.

Table 6.6.1: Top Ten African Countries in Investment Attractiveness

<table>
<thead>
<tr>
<th>Country</th>
<th>2017</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Egypt</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>South Africa</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Morocco</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Ethiopia</td>
<td>4</td>
<td>7</td>
</tr>
<tr>
<td>Ghana</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>Kenya</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>Tanzania</td>
<td>7</td>
<td>9</td>
</tr>
<tr>
<td>Rwanda</td>
<td>8</td>
<td>12</td>
</tr>
<tr>
<td>Tunisia</td>
<td>9</td>
<td>11</td>
</tr>
<tr>
<td>Cote d’Ivoire</td>
<td>10</td>
<td>8</td>
</tr>
</tbody>
</table>

Source: RMB Where to Invest in Africa

Virtually creditworthiness of the country has positive contribution for FDI flow. Credit Rating Institutions views Ethiopia as stable outlook. In its assessment (December 2016) -- Moody’s Investors Service, (“Moody’s”) has affirmed a B1 rating and stable outlook for Ethiopia’s FDI flows.

The stable outlook balances Moody’s assessment of Ethiopia’s prospects for continuing economic growth in the medium term supported by investments in the country’s infrastructure against ongoing institutional constraints and event risk. Furthermore, the affirmation and stable outlook reflect Moody’s expectation that higher political risks are unlikely to translate into significant deterioration in key credit metrics over the next 12-18 months.
In the same token in October 2016, S&P Global Ratings also affirmed its ‘B/B’ long- and short-term foreign and local currency sovereign credit ratings on Ethiopia. Thus S & P Global rating disclosed that for Ethiopia the outlook is stable.

6.6.1 Licensed investment projects: Structure and composition

In 2016/17, the Ethiopian Investment Commission (EIC) and Regional Offices licensed a total of 605 investment projects. Licensed investment projects decreased by 29 percent compared with the 2015/16 level (Fig 6.7.1).

Figure 6.6.1: Number of investment permits issued

The distribution of investment permits by ownership is still dominated by domestic private investors. However, in 2015/16 the share of domestic investors declined to 50 percent compared to its share of 89 percent in the preceding year. Conversely the total investment projects issued to foreign private investors turned out to 48 percent against its share of 9 percent in 2015/16, (Fig 6.6.2). The public investment registered at EIC share remains insignificant in all years.

Figure 6.6.2: Investment by ownership (share in percent)
With regard to sectoral distribution of investment projects, the service sector accounted for the largest proportion (49.1 percent) of projects followed by industry (45.6 percent) of which the manufacturing sector accounts 28.9 percent in 2016/17 (Fig 6.6.3).

**Figure 6.6.3: Sectoral distribution of investment in 2016/17 (percent)**

![Sectoral distribution of investment in 2016/17 (percent)](chart)

*Source: computed from EIC data*

The regional distribution of the permitted investment projects showed that Addis Ababa continue to be the most attractive region for investment than other regions in 2016/17 (Fig 6.6.4). Out of the total licensed investment projects, Addis Ababa accounted for 45.1 percent, followed by Oromia (20.8 percent) and Tigray (11.2 percent) in the period under consideration. The performance of other regions in terms of attracting investment projects was not satisfactory. More has to be done by other regions to shift the distribution from Addis Ababa to other regions; as desired by the investment law.

**Figure 6.6.4: Regional distribution of investment projects (percent of total)**

![Regional distribution of investment projects (percent of total)](chart)

*Source: Computed from EIC data*
During the period under review, out of the employments that are expected to be generated by the projects that are under the stage of pre-implementation when they are fully operational, 89 percent are expected to be permanent and 11 percent will be temporary jobs (Fig 6.6.5).

**Figure 6.6.5: Employment creation of licensed projects, 2016/17**

Among the licensed projects during the period under review, the lion share of the projects are under the stage of pre-implementation (89.7 percent) and the rest projects are under the stage of operation and implementation.

<table>
<thead>
<tr>
<th>Description</th>
<th>Pre-implementation projects</th>
<th>Implementation stage</th>
<th>Operational stage</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of projects</td>
<td>89.8</td>
<td>5.5</td>
<td>4.8</td>
<td>100.0</td>
</tr>
<tr>
<td>Capital</td>
<td>95.4</td>
<td>1.7</td>
<td>2.9</td>
<td>100.0</td>
</tr>
<tr>
<td>Employment</td>
<td>98.2</td>
<td>1.4</td>
<td>0.3</td>
<td>100.0</td>
</tr>
<tr>
<td>Permanent</td>
<td>98.3</td>
<td>1.4</td>
<td>0.3</td>
<td>100.0</td>
</tr>
<tr>
<td>Temporary</td>
<td>97.7</td>
<td>1.8</td>
<td>0.6</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Overall, it appears that although investment licenses have been given to investors, the conversion rate is very low; suggesting that close monitoring and follow up is required to identify constraints that inhibit progress of projects.
The conversion rate was higher in Hareri and followed by Oromia region in 2016/17 (Table 6.6.3). The Addis Ababa City Administration was also better in terms of realized licensed projects over the same period. Of course, Addis Ababa was also a home for a large share of pre-implementation projects.

Table 6.6.3: Status of licensed investment projects by region (percent), 2016/17

<table>
<thead>
<tr>
<th>Region</th>
<th>Pre-implementation projects</th>
<th>Implementation stage</th>
<th>Operational stage</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Addis Ababa</td>
<td>91.9</td>
<td>2.9</td>
<td>5.1</td>
<td>100.0</td>
</tr>
<tr>
<td>Afar</td>
<td>100.0</td>
<td>0.0</td>
<td>0.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Amhara</td>
<td>96.7</td>
<td>3.3</td>
<td>0.0</td>
<td>100.0</td>
</tr>
<tr>
<td>B.Gumze</td>
<td>100.0</td>
<td>0.0</td>
<td>0.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Dire Dawa</td>
<td>100.0</td>
<td>0.0</td>
<td>0.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Gambella</td>
<td>100.0</td>
<td>0.0</td>
<td>0.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Harari</td>
<td>50.0</td>
<td>50.0</td>
<td>0.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Multiregional</td>
<td>100.0</td>
<td>0.0</td>
<td>0.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Oromia</td>
<td>78.6</td>
<td>11.9</td>
<td>9.5</td>
<td>100.0</td>
</tr>
<tr>
<td>SNNPR</td>
<td>80.6</td>
<td>9.7</td>
<td>9.7</td>
<td>100.0</td>
</tr>
<tr>
<td>Somali</td>
<td>100.0</td>
<td>0.0</td>
<td>0.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Tigray</td>
<td>94.1</td>
<td>5.9</td>
<td>0.0</td>
<td>100.0</td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td><strong>89.8</strong></td>
<td><strong>5.5</strong></td>
<td><strong>4.8</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Source: Computed from EIC data
7. FISCAL DEVELOPMENTS

The main trust of fiscal policy in Ethiopia is strengthening domestic revenue generation, effective and efficient allocation and utilization of the resources as well as maintaining fiscal deficit consistent with macroeconomic objectives. The key goals of fiscal policy under the GTP II, includes maintaining macroeconomic stability, ensuring financial prudence through domestic resource mobilization, allocation of public finance for optimal impact on public welfare and high economic growth, and promoting export-led manufacturing development. Budgetary outlays under GTP II are also planned to reflect the government’s commitment to end poverty.

7.1. Government Revenue

Ethiopia takes primary responsibility for its own development, thus places high importance on domestic resources. It recognizes that domestic resources are more reliable in financing ambitious development plans. The government has a trust that enhanced economic activity and robust growth are critical in mobilizing public resources from tax and non-tax sources.

In line with this during the years 2007/08-2016/17 on average about 77 percent of the government budgetary revenue was mobilized from domestic revenue sources. Its reliance on domestic sources has become intensified in recent years. During the year 2016/17 for instance the general government collected a total amount of Birr 269.1 billion from domestic revenue and grant sources. From this, Birr 256.6 billion (95 percent) was generated from domestic sources. Over the last decade the overall Government revenue mobilized from domestic and external grant witnessed an average growth of 24 percent; while domestic source collection registered an average annual growth of 28 percent. On the other hand budgetary revenue from grant over the last decade showed an average growth of 3.7 percent.

Figure 7.1.1 Annual Growth of Government Major Revenue Sources (percent)
Budgetary resources emanated from the external sources were not only low in quantity, but they were also volatile. Although the revenue from non-tax sources illustrates an improved average annual growth, its contribution was not stable. Accordingly, the only unwavering and consistent source of Government revenue over the last decade was tax revenue with an average growth of 28 percent. However, its growth declined over the recent years and depicts an annual growth of about 10 percent in 2016/17 compared to an average growth of 34 percent between the years 2009/10-2014/15.

In 2016/17, domestic revenue constituted about 95.4 percent of the total revenue and has shown significant increment compared with 75 percent, ten years back. In 2007/08 external grant nearly contributes about 25 percent of the national revenue. However, its share declined to 5 percent in 2016/17 as depicted in Fig 7.1.2. This clearly demonstrates that Government finance has become more reliant on domestic sources, which is a positive sign of enhancing trustworthy sources.

**Figure 7.1.2: Share of domestic revenue and external grant in 2007/08 and 2016/17**

<table>
<thead>
<tr>
<th></th>
<th>2007/08</th>
<th>2016/17</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic Revenue</td>
<td>75%</td>
<td>95%</td>
</tr>
<tr>
<td>external Grant</td>
<td>25%</td>
<td>5%</td>
</tr>
</tbody>
</table>

*Source: Ministry of Finance and Economic Cooperation*

Within the domestic sources of revenue the share of tax and non-tax revenue in the last decade has shown slight shifts. In this connection, in 2007/08 the share of non-tax revenue was about 20 percent which slightly declined to 17.9 percent in 2016/17 implying less reliance on non-tax sources.
This large share of tax from the total revenue implies that the country’s revenue base has grounded on more reliable source as a result tax become an important source of domestic revenue. This was because of the efforts made to promote tax collection and underpinned through intensive reforms undertaken to strengthen capacity of tax collection authorities. Amidst of this the share of non-tax revenue from the total revenue has been rising since 2014/15 due to the need to look for supplementary budget to mitigate the El Niño induced drought effects as well as salary adjustments for public employees.

Among the tax sources, income taxes contribution improved faster than consumption taxes. This is due to the progressive tax system which generates tax revenue from high income groups. The major sources of income tax include public enterprises, private corporates and high income earning individuals. There is also a clear shift of tax revenue dependence from international trade to income and domestic consumption taxes over the last ten years.
In 2007/08 nearly half of the government tax revenue was generated from the international trade. This was due to its simplicity in the tax administration as it is collected at ports and entry and exit points of the country along with increased import values. With the steady growth of the economy coupled with enhanced tax collection capacity the share of direct and indirect taxes increased to 69 percent, while the share of international trade declined to 31 percent in 2016/17 compared to its 50 percent share a decade ago (Fig 7.1.5).

Therefore, for the last decade the contribution of direct tax, domestic indirect tax and import duty & taxes average about 34.8 percent, 27.5 percent and 38 percent respectively on the average over the last decade (Fig 7.1.6).
In general, over the last decade the economy mobilized the necessary finance from domestic sources largely from taxes. Tax revenue over the last 10 years grew on the average by about 29 percent albeit its growth rate has not kept pace with the growth of the economy and tends to decline in the pace of growth in last two years.

The tax-to-GDP ratio is an economic measurement that gauges the amount of taxes collected by the government against the amount of income that the country generates from the overall economic activities. In Ethiopia over the last decade the economy has registered consistent and steady growth which puts the country at the forefront in the global economic arenas. Despite this growth performance, the country’s tax to GDP ratio remains below 11 percent. In 2016/17 as a share of GDP the total domestic revenue collection nearly accounts about 14.8 percent while the share of tax revenue was 11.4 percent which is not far from the decade average and less than the two preceding year’s performance.
Box 7.1.: African Countries tax-to- GDP Ratio

The average tax-to-GDP ratio in the 16 African countries (the “Africa (16) average”) was 19.1 percent in 2015. Tax-to-GDP ratios, which are defined as total tax revenue, including social security contributions, as a percentage of gross domestic products (GDP), ranged from 10.8 percent in the Democratic Republic of the Congo to 30.3 percent in Tunisia. Thirteen countries had a lower tax-to-GDP ratio than the Latin American and the Caribbean (LAC) average of 22.8 percent in 2015, with the exceptions being Morocco, South Africa and Tunisia. The average in OECD countries in 2015 was 34.3 percent. Africa’s GDP growth remained robust in 2015 despite significant drops in global commodity prices and the weakening of global demand due to the slow recovery of developed countries from the financial crisis. Between 2014 and 2015, the Africa (16) average tax-to-GDP ratio also increased by 0.4 percentage points, slightly less than the LAC average (0.6 percentage points) and more than the OECD average (less than 0.1 percentage points). All countries but Kenya, Tunisia and Morocco had increases in their tax-to-GDP ratio over this period. Cabo Verde recorded the highest increase between 2014 and 2015 of 1.8 percentage points followed by Uganda and South Africa (both 1.1 percentage points).


Tax revenue in terms of GDP not only remained far from the GTP II Projection (17 percent of GDP), but also has followed a declining trend since fiscal year 2014/15. This implies that although the amount of tax collected has shown significant growth, the rate of growth was not proportionate with the rate of economic growth.

Moreover, total domestic revenue in terms of GDP compared to SSA countries remained low, though the difference has narrowed in recent years (Fig 7.1.7).
Apparently, all SSA countries economy is characterized by low domestic revenue to GDP. This is due to the presence of large size of the informal sector (cash-based economy) in their economy. The situation in Ethiopia is more pronounced as its position is even lower than the SSA countries as depicted in the above figure, despite the various reform measures implemented over years.

Although unreserved efforts have been undertaken to improve the tax administration, a number of assessments acknowledge that the tax collection capacity has not improved to bring visible changes in mobilizing tax resources consistent with the economic growth. A recent study conducted on domestic resource mobilization signified major causes of low tax to GDP ratio in the country. The study detects that the major challenge in revenue mobilisation revolves around the enforcement of the tax laws and the administration to discharge this responsibility. Consistent and persistent application of the tax laws are lacking. Follow up on the issuance of receipt (use of sales register machines) is sporadic. Significant amount of sales with no receipt all over the country are evident. In addition, audit coverage is low (less than 10%) in a number of tax jurisdictions considering poor tax compliance.

The study further noted that tax administration in the country is bested by shortage of right people in quality and quantity. Skill and knowledge gaps in different functions such as audit, intelligence and investigation are widespread all over the country. The problem of shortage of man power is also exacerbated by high turnover (MoFEC: 2017).
In order to address such weakness, the Government is further working to strengthen the domestic tax revenue mobilization capacity through addressing the inefficiency in the tax administration. Some of the efforts in this line include:

• A dedicated Tax Policy Directorate has been established within the Ministry of Finance and Economic Cooperation. The Directorate has assumed the responsibility to enhance evidence based and coordinated efforts on tax policy, tax legislation, forecasting, analysis of revenue potential and tax administration.

• The Federal Income Tax law was revised in view of promoting the fairness of the tax system and broaden the tax base. Efforts are also underway to overhaul the excise tax and VAT policy and administration.

• A tax administration proclamation was also introduced applying to all types of taxes. It has the objectives of facilitating the implementation of the tax law both on the enforcement of the law and entertaining taxpayers’ complaints on tax decisions.

• Strengthen the capacity of the Revenue and Customs authority to improve tax collection efficiency by implementing the on-going tax and customs reforms has become a continuous process. In this connection an initiative on Tax Transformation for Sustainable Development has been introduced. The initiative has the objectives of reforming major priority areas in tax administration. It also addresses issues related to improve human resource development and management of revenue offices; expand modern information system for rapid and reliable tax administration; and improve customer relations and awareness creation among taxpayers.

• At regional level tax authorities determined to enhance their revenue by expanding the tax base through capturing informal and new businesses into the tax net.

7.2 Government Expenditure

Government expenditure has been an important driver of Ethiopia’s economy. The expenditure pattern was mainly focusing on allocating more resource for building economic and social infrastructure to provide basic services. To this end, the lion share of the annual budget was devoted to capital expenditures which are critical in bringing future benefits through building physical assets and infrastructures, as well as promoting human resources development and research and development.
Over the past decade the share of capital expenditure from total expenditure outweighs the recurrent expenditure, although the share of recurrent expenditure surpassed the capital expenditure in fiscal year 2016/17 for the first time in the decade (the share of capital expenditure stood 46 percent, while the recurrent accounted for 54 percent).

Apparently the declining share of capital expenditure is due to the over years accumulated capital expenditures on economic and social infrastructures which require recurrent outlays in later years. Furthermore, supplementary budget for drought affected areas and salary adjustments for public servants implemented during the recent fiscal years are additional factors for increased recurrent outlays. Continues increments on regional expenditures are also an obvious source of rising recurrent expenditure, as largely finance basic service deliveries at grass root level.

**Figure 7.2.1: Share of Recurrent and Capital Expenditure 2007/08-2016/17**

Government expenditures are classified as functional and economic. Functional Government expenditure in turn is classified as economic, social and administrative & general service spending. Figure 7.2.2 reveals that about 75 percent of total expenditure on average has been spent on economic and social sectors for the last ten consecutive years. In a more specific manner, the share of economic sector expenditure was higher until recent years (up to 2014/15 than social sectors owing to higher budgetary allocation to the road, agriculture and rural development as well as water resources). However, in the last two fiscal years (two consecutive years of GTP II) the share of social expenditure exceeded the economic sectors share. This is due to rising recurrent expenditures in education and health as well as rehabilitation outlays undertaken by the government to mitigate El Niño induced drought effects.
As part of the efforts to cover government expenditures with domestic sources and curtail budget deficit, expenditure to GDP ratio has been declining. Empirically, the share of government expenditure in GDP has declined from its annual average share of 25 percent between 1991/92-2000/01 to 21.5 percent in 2004/05-2008/09. Furthermore, the share has steadily declined since 2002/03 and averaged 18 percent of GDP between 2008/09-2016/17. Compared to the SSA countries average also Ethiopia’s position is low as depicted in figure 7.2.3.

Figure 7.2.3: Government Expenditure to GDP ratio for Ethiopia & Sub-Saharan Countries

Source: IMF: Sub Saharan Africa; Regional Economic Outlook; April 2017
7.2.1 RECURRENT EXPENDITURE

Recurrent expenditures finance the day to day activities of the Government. It largely consists of salaries of public servants and their operating expenses including maintenance, stationary, fuel, etc. They are critically important to sustain public service provisions by different organs of the Government. Functionally the recurrent expenditure also divided into general, economic and social services as well as others. General services largely consist of the three organs of government such as parliament, justice, police and defence. Government institutions including finance, planning, statistics and mapping are also part of these segments of expenditure. Major expenditure components of economic services include agriculture and natural resources, water, mining, energy, industry, trade, transport, communication, road, and housing. As the name designates social services contain education, health, and social protection. Among the recurrent expenditure components the share of social service expenditures averages 42 percent, followed by general services (37 percent) and economic services (14 percent) over the last decade. Other expenditures largely dominated by external debt servicing averaged 7 percent of the aggregated recurrent expenditure in the same period.

Figure 7.2.4: Share of sectoral recurrent expenditure from total recurrent expenditure (percent)

The trends of recurrent expenditure during the last ten consecutive years have shown significant shift to the social sector. In 2016/17, expenditure on social services had the largest share from the total recurrent expenditure (49 percent), compared to 38 percent a
decade ago. The share of administrative and general service on the other hand declined to 30 percent from a high of 40 percent in the same period. Such developments demonstrate Government’s commitment to expand social services including education and health services as an important tool in achieving its development target.

7.2.2 CAPITAL EXPENDITURE

Capital expenditure is spending on investment or development activities of the Government. Spending, on capital expenditures have benefits for extending years into the future. Capital expenditure finances building of physical assets for government use (for example, office buildings), economic and social infrastructures benefiting citizens and create enabling environment for private sector development such as, roads, water, energy, schools, hospitals, clinics and research (Davina Jacobs, Jean-Luc Hélis, and Dominique Bouley: 2009).

Accordingly capital expenditure is usually seen as expenditure creating future benefits, as there could be some lags between when it is incurred and when it brings impact on the economy. Capital expenditure functional classification is similar to the recurrent and consists of the general, economic and social developments. The budgetary institutions under each category are also the same to the recurrent expenditure.

As it has been discussed earlier in Ethiopia over the last decade, the share of capital expenditure exceeded that of the recurrent except fiscal year 2016/17 outturn. The overall Government expenditure in fiscal year 2016/17 amounted to Birr 329.3 billion in 2016/17, surpassing by Birr 48.4 billion (17.2 percent) and grew by 5.6 percent from the preceding fiscal year performance. However, the actual execution rate of capital expenditure was about 86.2 percent of its budget. A number of factors can be cited for low actual performance of the capital expenditure. Revenue generated during fiscal year 2016/17 was below expectation. Thus to maintain reasonable level of deficit the Government has to curtail capital expenditures. From total capital expenditure, about 75.9 percent was financed from treasury sources.

Besides, the Government capital expenditure is supposed to enhances economic growth by encouraging private sector investment attributable through facilitating role of government in the provision of public infrastructure. In this case, capital expenditure on economic infrastructure averaged 68 percent over the last decade. The share of social capital expenditure averaged 25 percent over the same period (Fig 7.2.5).

It is obvious that Ethiopia has a huge challenge to eliminate poverty and improve the livelihood of its citizens. This entails designing appropriate polices, investing in social sectors and building infrastructure as well as creating conducive environment for the private sector. In this regard, providing emphasis for the rural development and food security where
the majority involves is highly decisive. Provision of basic services and infrastructure such as education, health, water, and road are equally important in boosting the living standard of the population. Consequently, government expenditure in financing such vital basic services and infrastructure building over the last decade substantially increased, albeit starting from low aggregated expenditure shares in percent of GDP.

**Figure 7.2.5: Share of Sectoral Capital Expenditure from total Capital Expenditure (percent)**

![Graph showing share of sectoral capital expenditure from total capital expenditure.](source)

Pro-poor budget allocation focuses on policies, strategies, and programs that will contribute significantly to addressing the challenges of realizing broad based pro-poor growth, employment creation and human development. In this aspect, pro-poor spending during the year 2007/08-2016/17 EFY averaged 66 percent of the total expenditure, and showed that education and road constitute the highest shares.

**Figure 7.2.6: Share Pro-poor Sector Expenditure from Total Expenditure (percent)**

![Graph showing share pro-poor sector expenditure from total expenditure.](source)
7.3 Fiscal Decentralization

Ethiopia adopted fiscal decentralisation about two decades ago which defines the Federal and sub-national governments’ responsibilities with respect to revenue, expenditure, intergovernmental transfer, and borrowing. The fiscal decentralization therefore installed assignment of taxation power and generating fiscal resources to finance public expenditure requirements. It also assigns responsibilities and functions between the federal government and the sub-national governments in terms of expenditure and resource allocation. It designs inter-governmental transfers (budget grant) in filling the gap in revenue mobilization and expenditure management of regional governments.

The country’s fiscal decentralization has been increasingly implemented over the last two decades. During the last decade the revenue share of Regional Governments increased to 25 percent in 2016/17 from 20 percent of 2005/06. One significant factor in improved share of Regional Government could be the enhanced performance of tax revenue collection from domestic indirect taxes and direct tax as compared to the international trade tax which is the exclusive domain of the Federal Government. Obviously this is an encouraging sign of broadening the tax base and bringing the informal sector and the hard-to-tax group into the tax net.

Figure 7.3.1: The Share of Federal and Regional Governments Tax Revenue (percent)

Fiscal decentralisation is an important fiscal policy in boosting basic service delivery and hence facilitates and underpins the development effort by bringing fiscal power to local government with decentralised governance. Fiscal decentralisation by providing fiscal power to lower level governments encourage local governments to spend more wisely and to feel more accountable for money they are responsible for raising. In this context Regional Governments in Ethiopia are responsible in providing major basic services
including education, health, rural road, agriculture and natural resources related services.

![Figure 7.3.2: The Share of Federal and Regional Governments Expenditure (percent)](image)

As the provision of basic services is further pushed to Regional Governments and Woredas, the share of Regional Governments expenditure increased to 58.3 percent in 2016/17 from 39.7 percent in 2005/06. Obviously, the rising share of regional expenditure is due to increased block grant transfers from the Federal Government coupled with improved tax revenue mobilization by them. This undoubtedly contributes to reinforce public service delivery at the grass root level and thereby promoting inclusive growth.

The revenue assignment of Regional Governments is not enough to finance their expenditures, as the most of pertinent tax bases are allocated to the Federal Government. Conversely considerable level of expenditure power is given to the Regional Governments. This is a deliberate action to allow the Federal government to hold control over the public financing system and to narrow both the vertical and horizontal imbalances. This allows the Federal Government to redistribute tax revenues to Regional Governments through an agreed intergovernmental fiscal transfer system.

Therefore, the mismatch between expenditure responsibilities and revenue assignment has been financed through transfer from the federal government. Two types of grant transfer system exist: Specific and General Purpose grant. Specific purpose grants are earmarked grants to specific programs/projects. While general purpose grants are block grants which are distributed to the regions using the formula decided by the House of Federation;

The principal source of finance for regional governments is the block grant transfer. Accordingly the Federal Government progressively allocated block grant transfer over the last decade. Since 2010/11 the Government has also introduced a specific purpose grant
in view of meeting the MDGs. The specific purpose grant was supposed to finance capital (development) projects at Regional and Woreda level. In this regard, aggregated block grant transfer to Regional Government reached Birr 101 billion in 2016/17 from a level of Birr 7.1 billion in 2005/06 (Fig 7.3.3). Block grant transfer in recent years exhibited extraordinary growth and registered an annual growth of 28 percent over the last decade. From the aggregated Federal Government budget allocation its share increased to 44 percent in 2016/17 from 32 percent in 2005/06. Over the same period block grant transfer to Regional Governments showed an annual average growth of 28 percent.

Figure 7.3.3: Developments in Inter-government Budget Transfer

Source: MoFEC, Central Accounts Directorate

7.4 Financing

While Government expenditure needs are unlimited, financing resources are not, thereby making the risk of budget deficit evident. But unless the extent of budget deficit and its financing is managed prudently, it has negative consequences, in macroeconomic stability. Therefore the bottom line in Government budget management is the level and its means of budget deficit financing. In Ethiopia the level and financing of the budget deficit is designed in view of promoting the desired macroeconomic goals such as controlling inflation, boosting private investment and growth and maintaining external credit worthiness.
Table 7.4.1 General Government Budget Financing from 2007/08-2016/17 (in percent of GDP)

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<td>(7.0)</td>
<td>(5.3)</td>
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<td>0.9</td>
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<td>2.0</td>
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<td>0.04</td>
<td>0.03</td>
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<td>0.6</td>
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</table>

Source: Ministry of Finance and Economic Cooperation

The Government over the past years capped the overall budget deficit at 3 percent of GDP. The cap was preserved as depicted in table below. In fiscal year 2016/17, the overall budget deficit including grant turned out to be 3.4 percent of GDP. This was against a deficit target of 3.9 percent of GDP and the gap was financed from both external (48.1 percent) and domestic (51.9 percent) sources through borrowing instruments. Generally, for the past ten consecutive years the budget deficit was at the reasonable level and the financing was made through noninflationary way.

### 7.5 Overview of External Debt Situation

Ethiopia’s domestic saving is insufficient to finance its increasing investment need. Moreover, foreign exchange earnings from export of goods and services finance a small portion of the country’s imports. This calls for the need to finance the current account gap from capital flows from the rest of the world. In this connection, apart from the flow of capital in the form of FDI and official grant, important external source of financing available is external loan. Although external loan requires the servicing of the debt and...
thereby creates burden on the national budget and foreign exchange, it has become vital to finance the critical need of the nation’s development appetite.

7.5.1 Debt Outstanding

The country’s total public debt including central government, government guaranteed and public enterprises borrowing increased from USD 2.3 billion in 2006/07 to USD 23.5 billion in June 2017 according to the debt statistics. The borrowings have been used to finance mega infrastructure projects which are vital for sustaining the country’s growth trajectory. Therefore, the growth in the debt portfolio of the country is clearly commensurate with the progresses made in the past years’ development. This is particularly evident in the progresses made in the energy, telecom, road, railway, industrial park, and water and irrigation infrastructures, as well as sugar industries.

Figure 7.5.1: Ethiopia: External Debt Outstanding (in million USD)

![Graph showing external debt outstanding from 2006/07 to 2016/17](image)

Source: MoFEC, Public Sector Debt Statistical Bulletin various issues

7.5.2 External Debt Composition

The aggregated external debt comprises of all Federal Government external loans contracted between external creditors and MoFEC, the government-guaranteed and the non-guaranteed external debt, contracted by public enterprises. In terms of debt composition the country’s indebtedness differs from earlier situation. In June 2017 from the entire outstanding debt 55 percent was owed by central government compared to 87.2 percent of 2006/07, which its debt service financing is through the national budget.
On the other hand, the share of government-guaranteed external debt which comprises loans and suppliers credits contracted by public enterprises, mostly the debt of the Ethiopian Electric and Power (EEP), has increased from less than 1 percent in 2006/07 to 29.6 percent in June 2017. The servicing debt in this regard is the responsibility of the respective borrower or public enterprise.

Furthermore, the share of the non-guaranteed external debt which includes loans contracted by the Ethiopian Airlines (EAL) and Ethio-Telecom (former ETC), also increased marginally from 12.2 percent in 2006/07 to 15.4 percent in June 2017. This is also obvious that each public enterprise is responsible to finance the debt service.

### 7.5.3 Sources of External Debt

The major sources of credit were Multilateral (International and Regional Financial Institutions), and Bilateral (governments). Particularly, the International and Regional Financial Institutions such as the World Bank, the African Development Bank, the European Union, Arab Bank for Economic Development for Africa, OPEC Fund for International Development, IMF and others have been the principal creditors of the nation. Bilateral sources consists of the country’s long time development partners mostly the Paris Club members and non-Paris Club members including, UK-DFID, Exim-Bank of China and Exim-Bank of India. Furthermore, Ethiopia has been benefiting from countries recently transformed from aid recipient to donor status Asian and Middle East Countries, which manage to lessen the impact of the global financial and economic crisis.

The share of loan originating from official creditors (multilateral and bilateral creditors) averaged 71.1 percent between 2010/11- 2016/17. Whereas, private creditors’ share averaged 29.3 percent in the same period as depicted in Fig 7.5.3. This implies that most
of the country’s loan was drawn as official development assistance on concessional terms. Nevertheless, the share of commercial credit has increased in recent years due to augmented activities of the state owned public enterprises such as EAL, ETC, EEP, ERC, etc.

Figure 7.5.3: Total Public Sector Debt Outstanding by Major Creditors

![Figure 7.5.3: Total Public Sector Debt Outstanding by Major Creditors]

Source: MoFEC, Public Sector Debt Statistical Bulletin various issues

7.5.4 External Debt Average Terms and Grant Element

External debt by nature entails future repayment of the principal and interest. Hence its burden on financing the debt service depends on the attached interest amount, and repayment and grace period granted by the creditor. Obviously loans with minimum interest rate have less debt financing obligation. Similarly credits with high maturity and grace period allow more time to generate resources needed to finance the interest as well as the principal.

The overall grant element averaged 34.7 percent of total credit for the years 2010/11-2016/17, which is under concessional loans categories. Interest rate on loans was on the average 1.9 percent, with average maturity period of 25.2 years and grace period of 5.9 years for the same period (Table 7.5.1).
Table 7.5.1: Public External Debt, New Commitment, Amount, Average Terms & Grant Element

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<td>7819.41</td>
<td>5369.26</td>
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Source: MoFEC, Public Sector Debt Statistical Bulletin various issues

Although the country’s debt commitment contains grant element, it is not free from involving obligations on debt service. Accordingly, developments in debt service in terms of principal repayments and interest payments follow the recent outstanding debt stock trends. Total debt service increased from USD 99.4 million in 2006/07 to USD 1.2 billion in 2016/17. The responsibility of debt financing is shifted to public enterprises from the central government as indicated in Figure 7.5.4.

Figure 7.5.4: External Debt -Service by Major Borrower Category

Source: MoFEC, Public Sector Debt Statistical Bulletin various issues
7.5.5 External Debt Disbursement

Ethiopia invested its debt resources to infrastructure and social developments. The country’s loan commitment finance economic and social sectors that have direct impacts on medium and long term socio-economic developments as well as asset and infrastructure building.

As the country’s development strategies provides emphasis to infrastructure development, the lion’s share of external loan finances infrastructure sectors. Between 2010/11 and 2016/17, about 28.4 percent of the total government loan disbursements financed transport and communication, followed by 19.3 percent for road transport, 18.1 percent electricity, 10.2 percent industry and tourism, and 7.4 percent agriculture (Table 7.5.2). The overall loan finance allocation indicates that government has properly invested its loan resources to finance its medium and long-term development programs.

Table 7.5.2: Public Sector Loan Disbursement by Economic Sector (in Percentage Share)

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<td>7.4</td>
</tr>
<tr>
<td>Highway Transport</td>
<td>14.3</td>
<td>16.6</td>
<td>13.4</td>
<td>10.1</td>
<td>5.5</td>
<td>46.3</td>
<td>28.3</td>
</tr>
<tr>
<td>Electricity, Gas, Steam</td>
<td>17.0</td>
<td>30.8</td>
<td>15.0</td>
<td>14.4</td>
<td>17.3</td>
<td>14.8</td>
<td>17.5</td>
</tr>
<tr>
<td>Industry and Truism</td>
<td>5.5</td>
<td>9.7</td>
<td>7.1</td>
<td>5.1</td>
<td>17.9</td>
<td>11.3</td>
<td>14.4</td>
</tr>
</tbody>
</table>

Source: MoFEC, Public Sector Debt Statistical Bulletin various issues

Recognizing the impact of debt burden on future generation and responsibility of each citizen, any single loan is subject to Ethiopian Peoples’ Representative Council’s (Parliament) approval and scrutiny. Each loan is realized through efficient and effective project preparation and vigilant implementation, monitoring and evaluation mechanisms. In the process of building transparency and accountability in debt management, each loan is issued in the country’s Negarit Gazeta. By and large, the country’s debt management is governed by the Federal Government Financial Law and Regulations.

As the debt burden piles and the performance of the export became very sluggish, the debt repayment capacity of the country is becoming a concern for the debt situation of the country. Cognizant of this fact, the Government recently decided to slow down the access to commercial loan in order to mitigate the risk until the performance of export is improving. A debt directive was also issued to strengthen the debt management framework of the country.
7.5.6 Domestic Debt

7.5.6.1 Domestic Debt Outstanding

During 2015/16, the country’s domestic debt stock stood at Birr 378.2 billion; while the level has increased to Birr 472.9 billion during 2016/17, showing 25 percent growth. In terms of the percentage share from the total domestic debt stock, SOE’s bonds and loans has taken the largest percentage share, 49.6 percent, in 2016/17. Following SOE’s Bonds and loans, Direct Advance and T-Bill’s constituted 27 and 15.5 percent, respectively, in the year under review.

Out of the total domestic debt outstanding, the share of the central government borrowing from all instruments was 50.4 percent (Birr 238.5 billion), while that of SOEs amounted birr 234.4 (49.6 percent).

Table 7.5.3: Domestic Debt outstanding by types of borrowing instructions (in millions of Birr)

<table>
<thead>
<tr>
<th>Description</th>
<th>2015/16</th>
<th>2016/17</th>
<th>percent Change in 2016/17 Compared to 2015/16</th>
<th>Percentage Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Government</td>
<td>167,231.9</td>
<td>238,473.0</td>
<td>42.6</td>
<td>50.4</td>
</tr>
<tr>
<td>Direct Advance</td>
<td>100,765.0</td>
<td>127,765.0</td>
<td>26.8</td>
<td>27.0</td>
</tr>
<tr>
<td>T-Bills</td>
<td>57,252.6</td>
<td>73,271.6</td>
<td>28.0</td>
<td>15.5</td>
</tr>
<tr>
<td>Bonds</td>
<td>9,214.4</td>
<td>37,436.5</td>
<td>306.3</td>
<td>7.9</td>
</tr>
<tr>
<td>State-owned Enterprises</td>
<td>211,014.0</td>
<td>234,419.9</td>
<td>11.1</td>
<td>49.6</td>
</tr>
<tr>
<td>Bonds and loans</td>
<td>211,014.0</td>
<td>234,419.9</td>
<td>11.1</td>
<td>49.6</td>
</tr>
<tr>
<td><strong>Total Domestic Debt</strong></td>
<td>378,245.9</td>
<td>472,892.9</td>
<td>25.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance and Economic Cooperation

7.5.6.2 Domestic Debt Service

In 2016/17, a total of Birr 20.1 Billion of domestic debt has been serviced. This amount represents a 3 percent increment in the total amount of domestic debt serviced in 2016/17 as compared to 2015/16. In 2015/16 a total of Birr 19.6 Billion worth of domestic debt was serviced. Out of the total domestic debt serviced in 2016/17, Birr13.6 Billion (67.6 percent) represents the amount that has gone for interest servicing and the remaining Birr 6.5 Billion (32.4 percent) went for principal repayment to holders of government bonds. Compared to 2015/16, the amount of principal domestic debt serviced declined by 4.2 percent and the total amount of domestic interest serviced increased by 6.5 percent. Hence, the total amount of the overall domestic debt serviced increased by 2.8 percent in the year under review.
Table 7.5.4: Domestic Debt Service Payment (In millions of Birr)

<table>
<thead>
<tr>
<th>Description</th>
<th>2015/16</th>
<th>2016/17</th>
<th>percent Change in 2016/17 compared to 2015/16</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Government</td>
<td>4,831.9</td>
<td>5,379.8</td>
<td>11.3</td>
</tr>
<tr>
<td>Principal</td>
<td>1,131.0</td>
<td>845.6</td>
<td>-25.2</td>
</tr>
<tr>
<td>Interest</td>
<td>3,700.9</td>
<td>4,534.2</td>
<td>22.5</td>
</tr>
<tr>
<td>State-owned Enterprises</td>
<td>14,738.4</td>
<td>14,738.4</td>
<td>0.0</td>
</tr>
<tr>
<td>Principal</td>
<td>5,679.5</td>
<td>5,679.5</td>
<td>0.0</td>
</tr>
<tr>
<td>Interest</td>
<td>9,058.9</td>
<td>9,058.9</td>
<td>0.0</td>
</tr>
<tr>
<td>Total Domestic Debt Service</td>
<td>19,570.3</td>
<td>20,118.2</td>
<td>2.8</td>
</tr>
<tr>
<td>Principal</td>
<td>6,810.4</td>
<td>6,525.1</td>
<td>-4.2</td>
</tr>
<tr>
<td>Interest</td>
<td>12,759.9</td>
<td>13,593.1</td>
<td>6.5</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance and Economic Cooperation

7.6 Progress in Public Finance Management

Over the last two decades, the Government has made meaningful strides in most visible areas of Public Financial Management. 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 provide timely, transparent and accurate financial information across the public sector remained critical in the reform endeavour. To this end the Expenditure Management and Control Program which is implemented over the last decade has undertaken several reform measures in modernizing the country’s public finance management. Reform areas include among others:

- Implementing legal and regulatory framework to maintain fiscal discipline;
- Embarking on a medium-term framework for the annual budget process;
- Establishing an effective and efficient cash management system;
- Installing modern accounting function to strengthen its accountability to the legislature and the public at large;
- Strengthened the legal framework for procurement;
- Adopting a strategy for introducing a modern internal and external audit services;
- Initiating an IFMIS project to computerize its financial processes and install modern financial information flow.

The recent activities of the Program focuses on consolidating improved PFM systems and reviewed the previously enacted laws, regulations and directives in view of correcting...
failures, bottlenecks and challenges in implementing the reform agendas. Over the last fiscal year (2016/17) the reform program has undertaken the following reform activities among others.

- Streamlined the financial administration through revising the Public Administration Law, Regulations and Directives so as to incorporate current developments, rationalize procedures and principles;
- Revised the Public procurement administration proclamation and submitted to the Council of Ministers,
- Design and implement public debt management directive;
- Introduce various directives and procedures on internal audit, procurement, etc;
- Conduct a number of procurements of goods and services to run the various reforms undertaken over the previous years;
- Undertake a number of trainings on IBEX, IFMIS, budget formulation, public procurement, internal audit, financial transparency and accountability, financial administration laws, regulation and directives.

More over the Government has placed serious emphasis on the efficiency and effectiveness of public expenditure. To this end directives aimed at creating fiscal space through budgetary saving has been issued. Public bodies are requested to identify potential budget saving areas, and to focus on efficiency in their budgetary execution. Efficiency measures to be taken by the public bodies stipulated by the Ministry of Finance and Economic Cooperation Directives among others include the following:

- Rationalize and secure approval from the Ministry of Public Service and Human Resource for over time payment to public servants;
- The directive obliges public bodies to reduce the consumption of common user items like stationeries. They are advised to move towards paperless system by more depending on information technology to reduce cost of stationaries.
- Reduce the procurement and pronating of less important items to run the function of public bodies including promotional materials such as printed paper, note books, pens, calendar, agendas, and yearbooks and so on;
- Reduce workshops, seminars and meetings associated costs by serving only water and coffee and avoid the purchase of t-shirts, bags and cultural dresses during hosting these events;
- Except basic messages targeting the benefits of the public bodies are restricted to avoid self-advertising via mass media and/or sponsoring different events.
- Refrain from giving donation to any organization or individual other than university students with disabilities and summer course trainees.
• Public bodies are requested to obtain approval of foreign travel from The Prime
Minister’s Office for their senior officials including heads of institutions under their
supervision through producing foreign travel programs exhibiting, the objectives
of the program, quantity of participants, duration and cost of the foreign travel.
They are also advised to reduce foreign travel costs through evaluating cost benefit
of foreign travel of middle level management and experts.
• The directive obliges public bodies to reduce the consumption of common user
items like stationeries. They are advised to move towards paperless system by
more depending on information technology to reduce cost of stationaries.
• Public bodies are requested to take expenditure efficiency measures and safe
resources from expenditure items including telephone services, oil and lubricants
and vehicle maintenance, utilities and so on.
• With regard to capital expenditure, public bodies are forbidden to execute projects
which were not included in the budget.
• They are also required to have a strict project management system to ensure the
efficiency, proper execution and cost effectiveness of government projects.

7.7 Public Finance Management Assessment

The Government in collaboration with its development partners designed indicators as a
base for regularly assessing the public financial management (PFM). In this connection
since 2004 Fiduciary Assessment (FA) and Joint Budget Annual Review (JBAR) of the
country’s financial management has been conducted regularly. Both exercises evaluated
the Federal and Regional Governments PFM in terms of transparency, accountability, and
efficiency.

The FA focused on budget formulation, approval and execution (payroll, procurement
and cash flow), accounting, reporting, monitoring and external auditing, as well as the
oversight role of the various legislative bodies and public access to and availability of
financial information. While the JBAR exercise focused issues of macroeconomic policies
and plans, budgeting revenue, debt management, comprehensiveness of budget, aid
management, and medium term forecasting. FA is conducted in every three years; whereas
JBAR is undertaken twice in a year.

Given the country’s emphasis on decentralization of activities and responsibilities PFM
assessments consider Federal vs. regional performances. By and large the FA covers a
number of the Public Expenditure and Financial Accountability (PEFA) program indicators
including donors’ practices.
Notwithstanding, unfinished assignments of the country’s financial management reform agenda the latest overall assessment rating undertaken at Federal level in 2015 looks encouraging as it is depicted below. The assessment compares progresses between 2010 and 2014.

**PEFA Performance Indicators for FDRE, 2010 and 2014**

<table>
<thead>
<tr>
<th>Indicator</th>
<th>2010</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. PFM OUT-TURNS: Credibility of the budget</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PI-1 Aggregate expenditure out-turn compared to original approved budget</td>
<td>B</td>
<td>A</td>
</tr>
<tr>
<td>PI-2 Composition of expenditure out-turn compared to original approved budget</td>
<td>C+</td>
<td>B+</td>
</tr>
<tr>
<td>PI-3 Aggregate revenue out-turn compared to original approved budget</td>
<td>B</td>
<td>B</td>
</tr>
<tr>
<td>PI-4 Stock and monitoring of expenditure payment arrears</td>
<td>A</td>
<td>A</td>
</tr>
<tr>
<td><strong>B. KEY CROSS-CUTTING ISSUES: Comprehensiveness and Transparency</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PI-5 Classification of the budget</td>
<td>B</td>
<td>B</td>
</tr>
<tr>
<td>PI-6 Comprehensiveness of information included in budget documentation</td>
<td>A</td>
<td>B</td>
</tr>
<tr>
<td>PI-7 Extent of unreported government operations</td>
<td>D+</td>
<td>D+</td>
</tr>
<tr>
<td>PI-8 Transparency of Inter-Governmental Fiscal Relations</td>
<td>B+</td>
<td>A</td>
</tr>
<tr>
<td>PI-9 Oversight of aggregate fiscal risk from other public sector entities</td>
<td>C+↑</td>
<td>C</td>
</tr>
<tr>
<td>PI-10 Public Access to key fiscal information</td>
<td>C</td>
<td>C</td>
</tr>
<tr>
<td><strong>C. BUDGET CYCLE</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C (i) Policy-Based Budgeting</td>
<td></td>
<td></td>
</tr>
<tr>
<td>PI-11 Orderliness and participation in the annual budget process</td>
<td>A</td>
<td>A</td>
</tr>
<tr>
<td>PI-12 Multi-year perspective in fiscal planning, expenditure policy and budgeting</td>
<td>C↑</td>
<td>B</td>
</tr>
<tr>
<td></td>
<td>C (ii) Predictability &amp; Control in Budget Execution</td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>--------------------------------------------------</td>
<td>---</td>
</tr>
<tr>
<td>PI-13</td>
<td>Transparency of taxpayer obligations and liabilities</td>
<td>B+</td>
</tr>
<tr>
<td>PI-14</td>
<td>Effectiveness of measures for taxpayer registration and tax assessment</td>
<td>B</td>
</tr>
<tr>
<td>PI-15</td>
<td>Effectiveness in collection of tax payments</td>
<td>NS</td>
</tr>
<tr>
<td>PI-16</td>
<td>Predictability in the availability of funds for commitment of expenditures</td>
<td>B</td>
</tr>
<tr>
<td>PI-17</td>
<td>Recording and management of cash balances, debt and guarantees</td>
<td>B↑</td>
</tr>
<tr>
<td>PI-18</td>
<td>Effectiveness of payroll controls</td>
<td>B+</td>
</tr>
<tr>
<td>PI-19</td>
<td>Competition, value for money and controls in procurement</td>
<td>NA</td>
</tr>
<tr>
<td>PI-20</td>
<td>Effectiveness of internal controls for non-salary expenditures</td>
<td>B+ ((i) over-scored)</td>
</tr>
<tr>
<td>PI-21</td>
<td>Effectiveness of internal audit</td>
<td>C+</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>C (iii) Accounting, Recording and Reporting</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>PI-22</td>
<td>Timeliness and regularity of accounts reconciliation</td>
<td>B+</td>
</tr>
<tr>
<td>PI-23</td>
<td>Availability of information on resources received by service delivery units</td>
<td>NA</td>
</tr>
<tr>
<td>PI-24</td>
<td>Quality and timeliness of in-year budget reports</td>
<td>B+ ((i) over-scored)</td>
</tr>
<tr>
<td>PI-25</td>
<td>Quality and timeliness of annual financial statements</td>
<td>C+</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>C (iv) External Scrutiny and Audit</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>PI-26</td>
<td>Scope, nature and follow-up of external audit</td>
<td>C+↑</td>
</tr>
<tr>
<td>PI-27</td>
<td>Legislative scrutiny of the annual budget law</td>
<td>D+↑</td>
</tr>
<tr>
<td>PI-28</td>
<td>Legislative scrutiny of external audit reports</td>
<td>C+</td>
</tr>
</tbody>
</table>
### D. DONOR PRACTICES

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Description</th>
<th>Score</th>
<th>2010</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>D-1</td>
<td>Predictability of Direct Budget Support</td>
<td>NS</td>
<td>A</td>
<td></td>
</tr>
<tr>
<td>D-2</td>
<td>Financial information provided by donors for budgeting and reporting on project and program aid</td>
<td>C</td>
<td>D+</td>
<td></td>
</tr>
<tr>
<td>D-3</td>
<td>Proportion of aid that is managed by use of national procedures</td>
<td>C</td>
<td>D</td>
<td></td>
</tr>
</tbody>
</table>

#### Summary of scores for 2010 and 2014

<table>
<thead>
<tr>
<th>Score</th>
<th>2010</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>3</td>
<td>7</td>
</tr>
<tr>
<td>B+</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>B</td>
<td>6</td>
<td>7</td>
</tr>
<tr>
<td>C+</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>C</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>D+</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>D</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>NS</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>31</td>
<td>31</td>
</tr>
</tbody>
</table>


In total, nine indicators appear to have scored higher (PI-1, 2, 8, 12, 13, 21, 22, 26 and 27), eight have scored lower (PI-6, 9, 16, 20, 24, 28, D-2 and D-3), and ten have remained unchanged (PI-3, 4, 5, 7, 10, 11, 14, 17, 18, 25). Three other indicators (PI-15, 9, D-1) were not applicable or not scored in 2010, and PI-23 was not scored in either year. The 2015 PEFA assessment report noted that overall, there appears to be a forward movement. However, the comparisons are strongly affected by new information taken into account in this assessment, which was not taken into the 2010 assessment. Several of the 2010 indicator and dimension scores appear to have been over-rated, which results in an under-assessment of progress since then.
7.8 Role of Government Spending for Growth and Poverty Reduction

Poverty in Ethiopia has declined substantially in recent decades. It has been recognized that Government budget has contribute for the realization of the country’s poverty reduction strategy. To this end, substantial amount of resources have been allocated particularly for identified pro-poor sectors including agriculture, education, health, water and irrigation and infrastructures development. Public investment in rural areas has benefitted the poor through its impact on the agricultural productivity, and government expenditure on rural poverty and employment programs such as productive safety net program that directly benefitted the rural poor.

A study conducted by UNDP on Income Inequality Trends in sub-Saharan Africa asserts that the Ethiopian development experience over 1995-2011 is an example of how quickly growth can occur in a poor country with low and stable inequality and rapidly falling poverty. The study noted that between 1996 and 2011, Ethiopia recorded rapid GDP growth, a six percent surge in agricultural production, low stable inequality and falling poverty. A key ingredient of Ethiopia’s success was the 1995 adoption of an agricultural development-led industrialisation that defines increasing land yields as a precondition for successful industrialisation, urbanization and development and, given the country’s egalitarian land distribution, favourable distributive effects. The Government promoted a market-led, state-assisted and regionally decentralised agricultural-led model of development that modernised rural institutions, enhanced the diffusion of inputs, promoted crop diversification, adopted progressive tax and expenditure policies, and launched the rural Productive Safety Net Programme. The study asserts that the implementation of the Productive Safety Nets Programme (PSNP) in Ethiopia between 2005 and 2008 prevented vulnerable people from selling their assets as a result of shocks; 55 percent of the beneficiaries affirmed that the programme increased their household incomes and 7.8 million that previously relied on emergency food relief became food-secure (UNDP: 2017).

According to 2015/16 Poverty Analysis Study which was conducted by National Planning Commission, the national poverty incidence has declined significantly over recent years, in which the national headcount poverty rate fell from 29.6 percent in 2010/11 to 23.5 percent in 2015/16 (National Planning Commission: 2017).

A World Bank study identifies two strong reasons why investing in basic services and infrastructure is critical for developing countries: (i) There is a broad consensus in the political science and economics literatures about the importance of investing in education, health, and basic infrastructure to accelerate economic growth and human development; and (ii) Expanding primary service and infrastructure networks can not only improve
government responsiveness to citizens’ needs, but also bolster social cohesion and expand the spatial presence of the state in a country, facilitating citizens’ identification with their nation, and decreasing the risk of political instability and violence (World Bank: 2015).

In view of this the Government has recognized that budget allocation that focus on the provision of basic services and infrastructure such as education, health, agriculture and food security, water, and road played an important role in advancing the living standard of children, women and the disadvantaged population. Consequently, government expenditure in financing such vital basic services and infrastructure building over the last decade substantially increased that ultimately boosted economic growth.

From the aggregated expenditure the share of Government budget allocation to education ranks first. Nearly a quarter of the expenditure goes to Education which is critical to build the country’s human resource and ultimately benefiting boys and girls. In this regard, the recent study conducted by IMF noted that investing in education is more pro-poor than investing in roads. The study argues that despite investment in education appearing to be a more pressing need in many developing countries; spending on roads often exceeds that on schools. While investment in schools tends to generate a long-run increase in output and seems invisible in the short-term compared to road investments, governments in developing countries investment priorities favour roads.

The study reiterates that combined dynamics of front-loaded fiscal costs of investments and slow pace of accrual of growth benefits from investing in schools, albeit larger in the long run, the political myopia always bias them to focus on short-run outcomes (Atolia, M. et al (2017). Unlike the global trend, however, the government of Ethiopia has been committed to undertake long-term investments in schools benevolently.

According to the 2013 IMF article IV review, the government of Ethiopia has been successfully maintaining public investment and pro-poor spending in line with GDP despite the tight resource constraint. The Fund Mission recalled that while the expenditure-to-GDP ratio has declined from the peak of 27.3 percent in 2002/03 to 16.9 percent in 2011/12, pro-poor expenditure has been maintained, averaging 12.4 percent of GDP over the 10 year period (IMF:2013). Similarly, the World Bank Ethiopia’s Poverty Assessment reveals that growth has been driven by public expenditure and has been instrumental for poverty reduction over the fifteen year period from 1996 to 2011. According to the assessment public investment has been a central element of the development strategy of the Government of Ethiopia and progressive public spending has contributed to poverty reduction since 2005 (World Bank:2014). In a nut-shell public expenditure in Ethiopia has significantly contributed for the remarkable progress in wellbeing of citizens.
8. CONCLUDING REMARKS

Over the last decade and more Ethiopia has registered an impressive economic growth. The high economic growth has witnessed in the midst of slow global financial and economic developments resulted in low commodity prices and demand of its trading partners as well as the “El Niño”-related drought impacts domestically. Among the most significant policies and strategies contributed to the country’s economic growth, the fiscal policy of the Government has the prominent role.

The fiscal policies realized through tax, expenditure and financing of public expenditure significantly contributed for the sustainable, fast and inclusive economic development. Besides mobilizing and allocating public resources the fiscal policy has a pivotal role in maintaining macroeconomic stability. The tax policy aimed at mobilizing government revenue, promotes salient features of redistribution functions, and supports domestic production and employment creation through promoting private investment.

The Government expenditure policy plays an active role in transforming the socio-economic development of the country through optimally allocating of the national budget using a Medium Term Macroeconomic and Fiscal Framework (MEFF) and program based annual budget. The Government offers a comprehensive set of fiscal incentives to attract both foreign and domestic investors and encourage investments into priority areas as well as promoting exports.

On the virtue of prudent fiscal policies adopted by the Government, Ethiopia has become one of the fastest growing economies over the last decade. The high and continues economic growth of the country resulted in an increase in per capita income and rising living standard of citizens. The recent published 2015/16 Poverty Analysis Study Interim Report of the National Planning Commission, disclosed that the national headcount poverty rate fell from 29.6 percent in 2010/11 to 23.5 percent in 2015/16. Per capita income of citizens also increased to USD 794 in 2015/16 from USD 262 in 2006/07, registering more than a triple fold growth within a decade.

National domestic saving and investment of the country which are critical inputs for sustainable economic growth performed well and help boosting the economic growth. The rate of national saving and gross capital formation over the past decade registered significant increase in terms of GDP. However, the gap between the national saving and gross investment widen as public investment increased.

Imports and exports are important economic instruments in linking the domestic economy to the rest of the world. The strong export performance observed over the previous years was unsustainable and has showed a declining trend since 2012/13. While the export
performance declined over the last three years, the trade deficit widen as import continued to rise.

Although the public sector in Ethiopia has played fundamental role in directing the economic growth of the country, the private sector participation in the country’s economic development through mobilizing capital, providing employment opportunities, promoting efficient resource management and enhancing productivity has been irreplaceable role.

In the light of this, Government’s effort in attracting FDI in recent years has become effective and Ethiopia has been one of the top ten African Countries in investment attractiveness. In 2017 Ethiopia has improved its position and ranked 4th best performers among African countries as compared to its 7th position of the preceding year.

Ethiopia takes primary responsibility for its own development, thus it places high importance on domestic resources. The Government recognizes that domestic resources are more reliable in financing ambitious development plans. In line with this during the years 2007/08-2016/17 on the average about 77 percent of the government budgetary revenue was mobilized from domestic revenue sources. Within the domestic sources of revenue, the share of tax revenue steadily increased. Despite its absolute growth, however, tax revenue in terms of GDP has not improved and remained below the regional average and far from the expectation of GTP.

Government expenditure has been a significant driver of Ethiopia’s economy. In realizing the country’s development agenda the annual budget allocates more resources towards important sectors in poverty reduction, basic services provision and infrastructure and asset building. Accordingly, the bulk of the financial resource was devoted to capital expenditures which are critical in promoting social and economic infrastructure. However, in 2016/17 the share of recurrent expenditure outweighs the capital expenditure for the first time in the decade.

Ethiopia adopts fiscal decentralization which defines the Federal and sub-national governments’ responsibilities with respect to revenue, expenditure, intergovernmental transfer, and borrowing. The country’s fiscal decentralization has been increasingly implemented in favour of sub-national governments over the last two decades. The revenue share of Regional Governments increased to 25 percent in 2016/17 from 20 percent of 2005/06. As the provision of basic services is further pushed to Regional Governments and Woredas, the share of Regional Governments expenditure also lifted to 58.3 percent in 2016/17 from 39.7 percent in 2005/06.

The revenue assignment of Regional Governments is not enough to finance their expenditures, as the most lucrative tax bases are allocated to the Federal Government. The mismatch
between expenditure responsibilities and revenue assignment has been financed through transfer from the federal government. Accordingly the Federal Government progressively allocated block grant transfer and aggregated block grant transfer to Regional Governments reached Birr 101 billion in 2016/17 from a level of Birr 7.1 billion in 2005/06.

Ethiopia’s domestic saving is insufficient to finance its ever increasing investment need. Moreover, foreign exchange earnings from export of goods and services finance a small portion of the country’s imports. This calls for the need to finance the current account gap from capital flows from the rest of the world. In this connection, external loan has become one important source of the country’s desperate need of foreign currency. The country’s total public debt including central government, government guaranteed and public enterprises borrowing increased from USD 2.3 billion in 2006/07 to USD 23.5 billion in June 2017. Although borrowing funds have been used to finance mega infrastructure projects which are vital for sustaining the country’s growth trajectory, their principal and interest repayment has to be settled by foreign currencies.

Over the last two decades, the Government has made meaningful strides in most visible areas of Public Financial Management. 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. Moreover the Government has resolved in creating fiscal space through budgetary savings from non-priority areas.

Although most of the macroeconomic and sectoral developments accounted for the realized sustainable and inclusive growth over the past decade, some vital economic dynamics such as inflation, domestic resource mobilization and export performance were not supportive. With regard to inflation the Government has managed to reduce and stabilize the double digit figure to a single digit during the last three years. The performances of domestic resource mobilization particularly the tax revenue and export earnings continue to be critical challenges of the Ethiopian economy.

Ethiopia has continued to register strong economic performance. Nevertheless, to realize the country’s aspirations to attain the middle income countries status, the need to transform the economy and sustain the fast and inclusive growth, building a strong financial position through mobilizing domestic resources; attracting FDI, promoting the foreign exchange earnings through diversified and high value added exportable commodities, and building a public sector that delivers better services and good governance in a more efficiently and effective manner are more potent instruments.
In attaining such objectives the concerted efforts of the public and private sector in the following areas are compelling.

**While the financing needs for Ethiopia’s transformation agenda are substantial enhancing the mobilization of domestic financial resources is indispensable.** Currently more than ever domestic tax and nontax revenue sources are likely to remain the dominant source of financing for the country’s socio-economic developments. Increasing domestic revenue has become the most sustainable way to finance public expenditure. This requires improving tax policy and administration at Federal and regional levels. As repeatedly stated, enhancing tax revenue administration and aggressively working in promoting tax payers compliance have to be a continues and top priority tasks of the Government.

**Strong export performance backed by diversified export commodities and market is vital in sustaining the economic growth.** Increasing export proceeds is not only a reliable source of foreign exchange; it demonstrates competitiveness of the economy in the global milieu. As the economy demands imports of capital and intermediate goods, as well as raw materials, availing the necessary foreign exchange to finance the ever-increasing need is obvious. Furthermore, the country’s debt financing requires foreign exchange. It is therefore important to enhance the foreign exchange in order to sustain the country’s borrowing capacity.

**The role of public investment in the country’s overall economic growth was noticeable in the past.** However, to sustain the growth momentum and its effectiveness, more emphasis has to be given for improving the institutions and procedures governing project appraisal, selection, and monitoring of public investments. It is critical to put in place sound public investment management systems to have more efficient levels of public investment, crowd in more private investment, and exhibit higher growth rates. Operation and maintenance expenditures are useful for optimal use of existing social and economic infrastructures. Thus it is essential to allocate sufficient and appropriate recurrent expenditures for existing infrastructures and fully integrate into a medium-term expenditure framework to ensure that they receive adequate budgetary resources.

**Economic growth to be more inclusive and sustainable the need to create employment opportunity to the unemployed particularly the youth is important.** Thus the need to invest in economic and social sectors that can create significant employment opportunities for the youth and ensure that new jobs are progressively created in more knowledge-intensive sectors with greater added value is essential. Such efforts have to be synchronized with the education system and vocational training opportunities to ensure that students to graduate with skills useful for the current work environment in addition to general know-how.
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