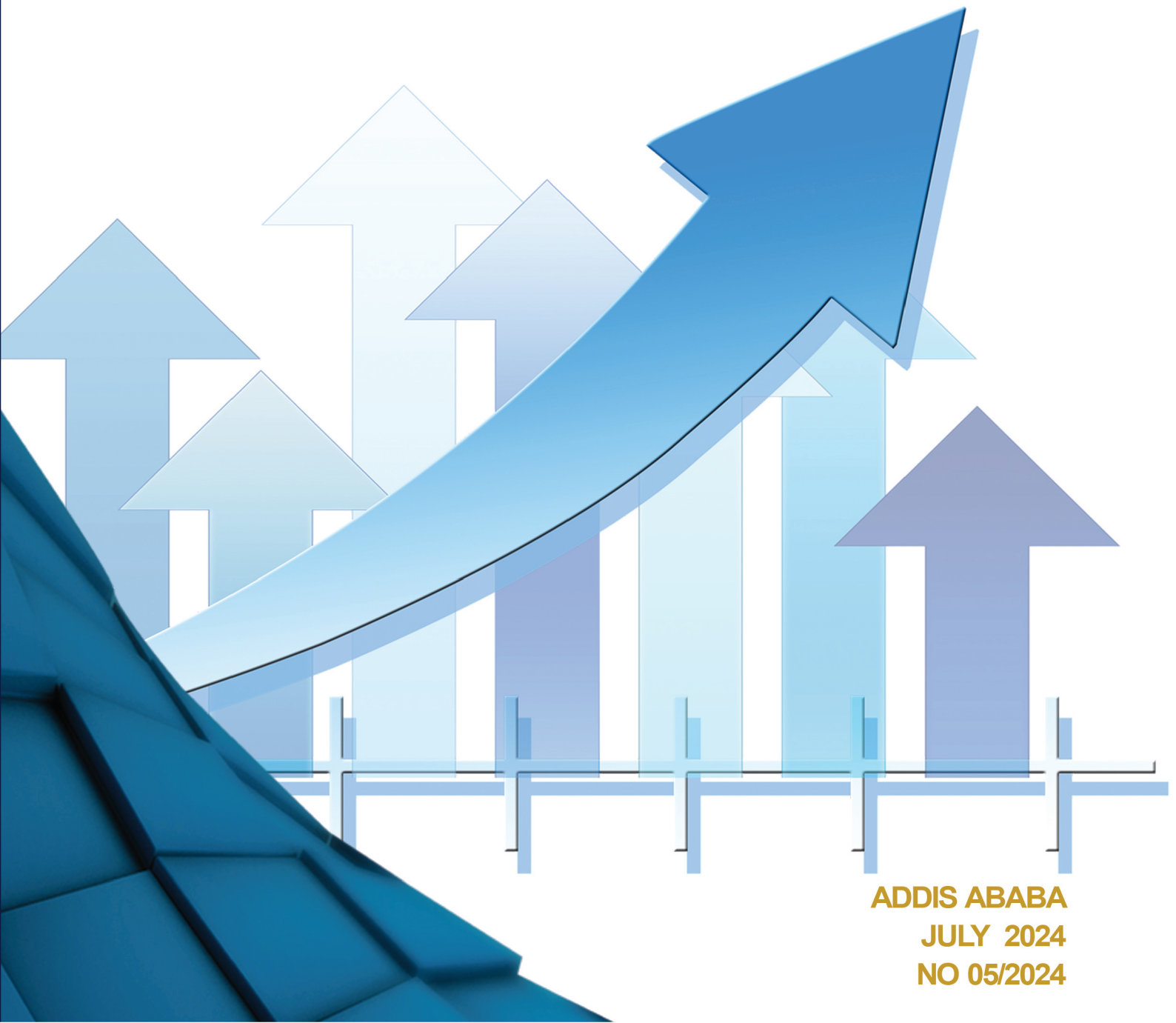
MACRO-FISCAL

PERFORMANCE IN ETHIOPIA AND RECENT FISCAL POLICY DEVELOPMENTS

MINISTRY OF FINANCE



ADDIS ABABA
JULY 2024
NO 05/2024

MACRO-FISCAL PERFORMANCE AND RECENT FISCAL POLICY DEVELOPMENTS IN ETHIOPIA

FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

Ministry of Finance

ADDIS ABABA JULY 2024
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MESSAGE FROM THE MINISTER

It gives me great pleasure to present our Ministry's Annual Flagship report on "Macro-Fiscal Performance and Recent Fiscal Policy Developments in Ethiopia". This report provides a comprehensive overview of the country's macroeconomic and fiscal developments over the past three years. It also presents highlights of recent fiscal policy developments and a detailed discussion on disaster-related fiscal risks.

In the past three years, our country has faced multiple and overlapping challenges. While we have witnessed the resilience of our economy and signs of economic recovery and growth, we still have to deal with the cumulative impacts of the conflict in the north, the COVID-19 pandemic, and other external shocks. These multifaceted challenges accentuate the need for a mechanism to effectively deal with the macroeconomic imbalance that we had to deal with in the first place. Throughout this challenging period, the Government of Ethiopia has remained steadfast in its commitment to prudent macroeconomic management and the implementation of critical reforms to address the macroeconomic imbalance our economy is in and drive sustainable development.

Looking ahead, we remain cautiously optimistic about Ethiopia's economic prospects. We will continue to pursue policies and initiatives aimed at fostering inclusive growth, reducing poverty, and enhancing our country's resilience to shocks. As we navigate the path forward, we are committed to enhancing transparency and accountability in the management of our nation's public finances.

I would like to extend my sincere gratitude to all those who directly or indirectly contributed to the preparation of this report. My special thanks go to the staff of the Fiscal Policy Department for spearheading this publication. Ato Jonse Degefa, Head of the Department, and Ato Yonas Fantaye, Head of the Fiscal Planning and Analysis Division, deserve special appreciation for leading and coordinating the publication of this report, and Ato Daniel Tilahun, Head of the Debt Management Division, for reviewing the report and supplying some of the necessary data used in the report. Several other individuals have played a key role in the preparation of this report. In particular, I would like to acknowledge the invaluable input and support provided by Ato Eyasu Solomon, Dr. Kiflu Gedefe, Ato Fantahun Belew, Ato Zewdu Hailegebrial, and all staff of the Fiscal Policy Division. I would also like to thank UNICEF and BRE-TA for their technical and financial assistance, without their support production of this report would have been difficult.

I hope that this report will serve as a valuable resource for policymakers, researchers, development partners, and all stakeholders invested in the continued progress of Ethiopia. Together, we can build a stronger, more prosperous future for our nation and its people.

Ahmed Shide
Minister

FDRE Ministry of Finance

MESSAGE FROM THE STATE MINISTER

It is my pleasure to introduce the Ministry of Finance's Flagship Report on "Macro-Fiscal Performance and Recent Fiscal Policy Developments in Ethiopia" for the period 2020/21-2022/23. This comprehensive report provides insights into Ethiopia's macroeconomic performance, fiscal performance including developments in public debt, recent fiscal policy changes, and analysis of disaster-related fiscal risks. It is important to note that this report covers a period marked by significant challenges and reforms.

In the last few years, our country has faced a series of overlapping internal and external shocks. These include the COVID-19 pandemic, internal conflicts, climate shocks, surges in international commodity prices, global economic slowdown, and funding squeeze from donors and lenders. These challenges not only have a direct negative impact on the economy but also threaten to jeopardize hard-won development gains by impeding reform efforts and, at times, reversing reform achievements. Moreover, they dented the government's ability to pursue fiscal consolidation and monetary restraint by simultaneously curtailing foreign exchange inflows and government revenues while increasing expenditure needs. These fiscal and monetary measures were crucial in addressing the lingering challenges of inflation, shortage of foreign exchange, exchange rate misalignment, and debt distress.

Amidst these challenges, the government remained steadfast in implementing prudent macroeconomic policies and critical economic reforms, mainly as part of the Homegrown Economic Reform Agenda (HGER 1.0). These reform measures were aimed at correcting macroeconomic imbalances, unlocking new growth opportunities, rebalancing the sources of growth, and enhancing productivity and competitiveness by addressing sector-specific market failures and structural bottlenecks. While HGER 1.0 yielded significant progress, the multifaceted shocks that struck the economy shortly after the launch of the reform program have constrained its success and aggravated existing imbalances such as inflation, foreign exchange scarcity, and debt vulnerability.

This report offers an in-depth analysis of Ethiopia's economic growth performance and price developments. During the HGER 1.0 implementation period from 2019/20 to 2021/22, Ethiopia's real GDP grew at an annual average rate of 6.3 percent, with the economy registering a 7.2 percent growth rate in 2022/23. Although slightly below the desired level, this growth rate exceeded the Sub-Saharan Africa average growth rate of 3.3 percent, reflecting our economy's resilience amid global headwinds. Inflation remained a major concern, hovering around 30 percent in 2022/23,

driven by imported inflation, supply disruptions, and accommodative monetary policy necessitated by the different challenges we have faced.

The external sector performance exhibited a mixed picture in the period under review. While merchandise exports registered a remarkable performance in 2021/22 and an annual average growth rate of 7.6 percent between 2020/21 and 2022/23, they fell short of targets and could not sustain the exceptional achievements of 2021/22. Nevertheless, these export figures are encouraging, given the global economic slowdown and other challenges faced during this period. On the import front, dominated by consumer goods, fuel, and capital goods, imports outpaced exports, leading to a widening trade deficit. This exerted significant pressure on foreign exchange reserves and the exchange rate of the Birr. To address these challenges, the government has initiated measures to boost domestic production, promote import substitution, and enhance export competitiveness.

On the fiscal front, the report delves into the dynamics of government revenue and expenditure, fiscal deficits, and public debt management. Specifically, it highlights measures taken by the government to enhance revenue mobilization, rationalize expenditure, and gradually transition towards non-inflationary deficit financing instruments, however challenging this may have been due to the overlapping shocks.

Over the past decade, domestic revenue sources accounted for around 91.7 percent of the total government revenue, with tax revenues being the primary contributor. Although this is commendable in terms of basing government finances on a more reliable source, our tax-to-GDP ratio has been declining and remained relatively lower than most of our comparator countries. We are working to reverse this trend through comprehensive tax policy reforms to broaden the tax base and enhance tax administration efficiency.

Government expenditure has registered an annual average growth rate of 20 percent, with a recent shift towards recurrent expenditure driven by increased spending needs for peacekeeping operations, reconstruction efforts, humanitarian assistance, and the mounting debt service obligations. In general, fiscal pressures arising from the aforementioned challenges have contributed to a widening of the fiscal deficit, reaching 4.2 percent of GDP in 2021/22, exceeding the 3 percent target set under the Homegrown Economic Reform program. However, in 2022/23, the government implemented strict fiscal policy measures, enabling a reduction in the deficit to 2.6 percent of GDP. In general, over the review period, the government has consistently aimed to maintain a manageable fiscal deficit and sustainable public debt levels, while prioritizing development-oriented expenditure and enhancing domestic resource mobilization. Nonetheless, the multifaceted challenges faced have exerted significant fiscal pressures, underscoring the need for continued prudent fiscal management and comprehensive reforms to ensure macroeconomic stability and sustainable public finances.

The country's external debt stock has started to decline as a result of the government's conscious decision to suspend non-concessional borrowing and reduce borrowing by state-owned enterprises (SOEs). Consequently, Ethiopia's external debt-to-GDP ratio has improved significantly, dropping from 30.6 percent in 2017/18 to 17.3 percent in 2022/23. The government's decision to prioritize

concessional borrowing has also led to improved average terms, with higher average grant elements (62.5 percent), longer maturity periods (39.1 years), and lower average interest rates (0.3 percent) on loans taken by the central government in 2022/23.

In general, while Ethiopia's public debt burden has moderated in recent years, with improved debt sustainability indicators, the high debt service obligations continue to exert significant fiscal pressures. To tackle this effectively and ensure long-term debt sustainability, we must redouble our efforts in enhancing exports, efficiency in government expenditure, and domestic resource mobilization.

Going forward, Ethiopia's fiscal policy will remain focused on ensuring prudent public finance management and correcting the macroeconomic imbalances while raising the necessary finances to support the country's development agenda. Furthermore, the report sheds light on recent fiscal policy developments and highlights the different policy changes introduced during the reporting period. These policy changes are aimed at improving our public debt management and enhancing our domestic resource mobilization efforts. Finally, the report provides analysis and estimates on fiscal risks posed by natural disasters using our Ministry's recently developed Disaster-Related Fiscal Risk Quantification Model. This underscores our commitment to making our public finances better prepared for shocks and ensuring transparency and accountability in our public finance management.

This report is released at a pivotal juncture as we conclude HGER 1.0 and embark on the full implementation of HGER 2.0 alongside the Mid-Term Development Plan and Investment Program (2023/24 - 2026/27). As is also stated in these documents, I would like to use this opportunity to reiterate our Ministry's firm commitment to working towards correcting the macroeconomic imbalances that our economy is facing, fostering inclusive growth, alleviating poverty, and enhancing our economy's resilience to shocks.

I extend my sincere gratitude to all individuals and stakeholders who contributed to the preparation of this report, particularly the staff of the Fiscal Policy Department for their dedicated efforts. It is my sincere belief that this report will be of greater use to policymakers, researchers, development partners, and the general public.

Eyob Tekalign Tolina (PhD)
State Minister
FDRE Ministry of Finance

ACRONYMS

AGOA	Africa Growth Opportunity Act
BRE-TA	Building Resilience in Ethiopia-Technical Assistance
CBE	Commercial Bank of Ethiopia
CDB	China Development Bank
CIF	Cost Insurance Freight
COFOG	Classification of Functions of Government
DA	Direct Advances
DRF	Disaster Risk Finance
DSSI	Debt Service Suspension Initiative
EAL	Ethiopian Airline
EEP	Ethiopian Electric Power
EFY	Ethiopian Fiscal Year
ERA	Ethiopian Roads Authority
ETB	Ethiopian Birr
EU	European Union
FDI	Foreign Direct Investment
FDRE	Federal Democratic Republic of Ethiopia
FISIM	Financial intermediary services indirectly Measured
FRS	Fiscal Risk Statement
FY	Fiscal year
GDP	Gross domestic product
GTP	Growth and Transformation Plan
GoE	Government of Ethiopia
GVA	Gross Value Added
GXFR	Gross External Financing Requirement
HGER	Homegrown Economic Reform
HRD	Humanitarian Requirements Document
ICBC	Industrial and Commercial Bank of China
IDA	International Development Association
IDF	Industrial Development Fund
IMF	International Monetary Fund
KII	Key informant interview
LAC	Latin America and Caribbean
LAMC	Labilities and Asset Management Corporation
MCF	Marginal cost of public funds
MEFF	Macroeconomic and Fiscal Framework
MOA	Ministry of Agriculture
MOF	Ministry of Finance
MoPD	Ministry of Planning and Development
NBE	National Bank of Ethiopia

OCC	Official Creditor Committee
OECD	Organization for Economic Co-operation and Development
OPEC	Organization for Petroleum Exporting Countries
OPM	Oxford Policy Management
PBS	Protecting Basic Services
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PPP	Public Private Partnership
PSNP	Productive Safety Nets Programmed
PV	Present Value
SOE	State Owned Enterprise
SSA	Sub-Saharan African
UK	United Kingdom
UN	United Nations
UNICEF	United Nations Children's Fund
VAT	Value-Added Tax
WCO	World Customs Organization

1 INTRODUCTION

Ethiopia has registered rapid economic growth for over two and a half decades. During this period, the country achieved remarkable progress in social development, poverty reduction, and the development of critical infrastructure in the power and transport sectors. However, due to how this growth was financed and inefficiencies in the execution of the country's foreign debt-financed flagship projects, it becomes evident that it wasn't possible to sustain these achievements. Instead, the country has been left with deep macroeconomic imbalances characterized by serious debt distress, severe foreign exchange shortage, exchange rate misalignment, high inflation, etc. Following the political transition and reforms, the government fully recognized these problems and launched the Homegrown Economic Reform Agenda (HGER 1.0) in September 2019. As per this reform program, the government took a series of reform measures across the macro-financial, sectoral, and structural fronts to correct the macroeconomic imbalances, unlock new growth opportunities, rebalance the sources of growth, and address sector-specific market failures and structural bottlenecks.

This annual flagship report of our Ministry, covering the period 2020/21-2022/23, is prepared as the country concludes its HGER 1.0 and began full implementation of HGER 2.0 and the Mid-Term Development Plan and Investment Program (2023/24 - 2026/27). The report also covers periods in which the Ethiopian economy passes through some serious internal and external challenges. Specifically, over the last three years, the major challenges that faced Ethiopia include the COVID-19 pandemic, the Russia-Ukraine conflict, increases in international prices of basic commodities, the global economic slowdown, and fund squeeze by donors and lenders. On top of this, the country faced internal challenges, which included internal conflicts and drought in some parts of the country.

This report, divided into two main parts, presents the macro-fiscal performance of the Ethiopian economy. The first part of the report offers a comprehensive assessment of Ethiopia's macroeconomic and fiscal landscape over the past three years. Specifically, it provides insights into the country's economic growth performance, the impact of various shocks, and policy measures taken by the government to address the observed shocks and promote sustainable development. It further discusses the external sector performance and monetary sector developments. On the fiscal performance side, the report presents discussions on the composition of government revenue and expenditure, and the management of the fiscal deficit and its financing. It further delves into developments in Ethiopia's public debt.

The Second Part of the report provides a comprehensive analysis of the recent developments in Ethiopia's fiscal policy and fiscal risk analysis. It presents the fiscal impacts of natural disasters using MoF's Disaster-Related Fiscal Risk Quantification Model. Furthermore, the report includes a summary of a study on the opportunity costs of disaster-induced budget reallocations, using the COVID-19 pandemic as a case study.

Part I:
Macro-Fiscal Performance

2 MACROECONOMIC DEVELOPMENTS

2.1 Real Sector Developments

2.1.1 Economic Growth Performance

Over the past four years, the Ethiopian government has taken significant economic reform measures to promote economic growth and development in the country. Key among these is the comprehensive Homegrown Economic Reform (HGER 1.0) program, designed to correct macroeconomic imbalances, remedy sectoral bottlenecks and structural impediments, rebalance the sources of Economic growth, and unlock new growth opportunities. Implementation of this reform agenda has greatly contributed to the economy's resilience building and helped to withstand the impacts of the overlapping challenges it has faced. The economy has by and large overcome the challenges it faced in the past years and, with the impacts of the major challenges receding, the economy is making a steady recovery.

When reviewing Ethiopia's economic performance over the past three years, it is important to take into account the multifaceted internal and external challenges it faced. In particular, the economy has faced numerous internal and external shocks between 2019/20 and 2021/22. To mention some of the main challenges, the country has faced serious funding squeezes from lenders and donors and surges in international prices of various basic commodities, including fuel, fertilizer, and some food items. These challenges are partly related to the COVID-19 pandemic and the Russia-Ukraine conflict and had serious repercussions on the country's foreign currency reserve holdings and exchange rate pressures, domestic inflation, and pressures on its debt servicing. Unlike other countries, the Ethiopian economy has also faced some serious internal challenges related to drought and internal conflicts that have occurred in different parts of the country.

On top of their direct negative impact on the economy, these challenges threaten to reverse the development gains the country has made over the past years by hindering, delaying, and reversing reform measures. For example, by reducing the government's revenue and increasing its expenditure, these challenges made it difficult to take fiscal consolidation and monetary restraint measures that are necessary to correct the observed macroeconomic imbalances.

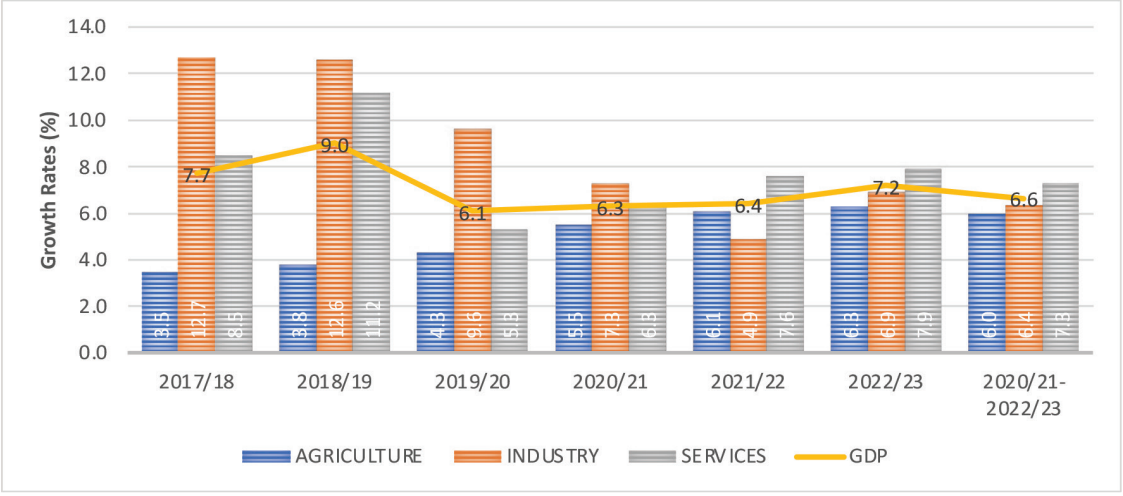
Despite these shocks, the Ethiopian economy has continued to grow, albeit at a slower pace than expected. Ethiopia's economic growth has been below the desired level and this has partly been due to the tight fiscal space and hence the restriction on the government's development activities. During the HGER 1.0 program implementation period, from 2019/20 to 2021/22, Ethiopia's real GDP grew at an annual average growth rate of 6.3 percent. In the 2022/23 fiscal year, the economy registered an annual growth rate of 7.2 percent. Although this growth rate is slightly below the 7.5 percent target set for the fiscal year, it is significantly higher than the Sub-Saharan Africa average growth rate of 3.3 percent (IMF, 2023). In a sense, Ethiopia's economic growth can be considered impressive given the reduced economic growth rates registered by countries across the world following the pandemic, global economic slowdown, the war between Russia and Ukraine, and disruptions in the world trade routes. The growth rate for the 2022/23 fiscal year exceeded the 6.3

percent average growth rate registered over the past three years. In general, we can say that the Ethiopian economy has been resilient and is recovering from the impacts of the multiple shocks it faced.

Ethiopia's GDP at current market prices increased from 4.3 trillion birr in the 2020/21 fiscal year to ETB 8.7 trillion in the 2022/23 fiscal year, registering a 41.7 percent increase. According to data from the National Accounts Statistics, Ethiopia's GDP per capita increased from 1,092 US dollars in 2020/21 to 1,549 US dollars in 2022/23, showing a 27.2 percent growth rate (MoPD, 2023).

The real economic growth in 2022/23 was broad-based and was driven by a 6.3 percent increase in agriculture, a 6.9 percent rise in industry, and a 7.9 percent expansion in the service sector. The agricultural growth has been mainly due to increased crop and livestock production. The industry sector rebounded from a slowdown in 2021/22, with improvements in manufacturing and construction, as well as a surge in electricity and water. The growth of the industrial sector has been limited due to foreign exchange scarcity, reduced government spending, the country's suspension from AGOA, and the ongoing unrest in various parts of the country. The agricultural sector's growth has mainly been due to increased crop production. In this regard, the government has designed and implemented a program for self-sufficiency in wheat production, and excellent results have been achieved. The service sector also saw improved growth, particularly in transportation, communication, hotels, and restaurants. The COVID-19 pandemic had a significant impact on both the industry and service sectors, causing their growth rates to decline in 2019/20. While the service sector has since recovered, growing at 6.3 percent, 7.6 percent, and 7.9 percent in the following years, the industry sector's growth rate continued to decrease before gradually improving in 2022/23 (see Figure 2.1).

Figure 2.1: GDP and Sectoral Annual Growth Rate (%) at Constant Basic Prices



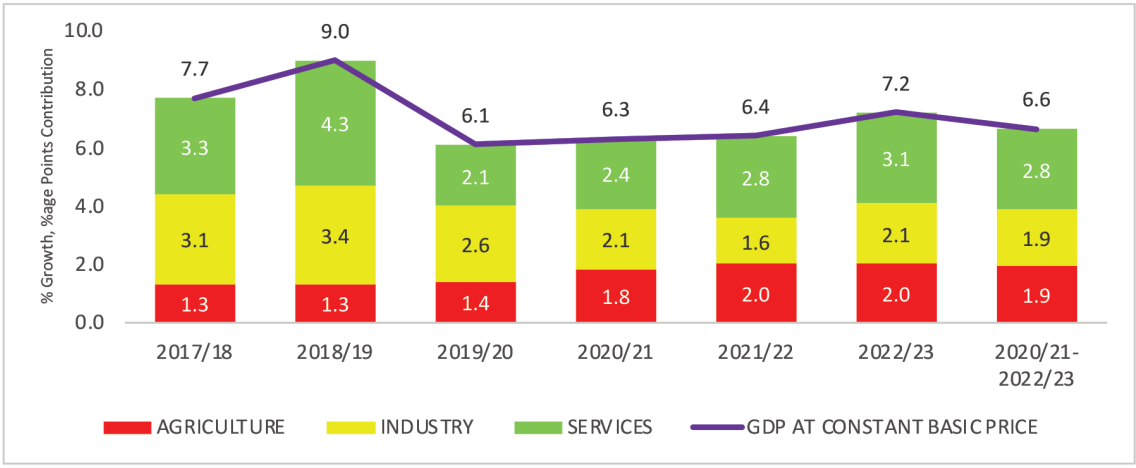
Source: Own computation using Data from the Ministry of Planning and Development.

Regarding the sectoral contribution to the real GDP growth, over the past three years, the contributions of the agricultural and industry sectors to the 6.6 percent average real GDP growth rate have been a similar 1.9 percentage points (or 28.8 percent each). The contribution of the

service sector, on the other hand, reached 2.8 percentage points (or 42.4 percent). Since 2019/20, the agriculture sector's contribution to real GDP growth has been increasing until 2021/22 as the industry and service sectors' contributions to real GDP growth began to decline following the COVID-19 outbreak. Nonetheless, the sector's 2 percentage points contribution to the 7.2 percent real GDP growth in 2022/2023 remained unchanged from that of 2021/22.

The service sector's contribution to real GDP growth declined significantly in 2019/20, falling below the industry sector's contribution. However, it has since shown gradual improvement, increasing from 2.4 percentage points in 2020/21 to 3.1 percentage points in 2022/23, indicating recovery from the pandemic's adverse effects. In contrast, the industrial sector's contribution declined continuously from 3.4 percentage points in 2018/19 to 1.6 in 2021/22. This slowdown can be attributed to instability in northern Ethiopia, COVID-19 pandemic impacts, foreign exchange shortages, and a construction sector slowdown. However, in 2022/23, the industrial sector rebounded significantly, contributing 3.1 percentage points (43.1% of the total) to the 7.2% annual real GDP growth rate (see Figure 2.2).

Figure 2.2: Contributions to GDP Growth by Major Economic Activity (%), Constant Basic Prices



Source: Own computation using Data from the Ministry of Planning and Development.

In terms of the structure of the economy, the share of agriculture in the overall GDP tends to decline continuously, albeit at a very slow pace. For example, it declined from 36.3 percent of GDP in 2016/17 to 32.5, 32.4 and 32.2 percent of GDP in 2020/21, 2021/22, and 2022/23, respectively. On the other hand, the share of the industrial sector in GDP showed gradual improvement over the years. Specifically, it increased from 26.0 percent in 2016/17 to 29.3 percent in the 2020/21 fiscal year. In 2021/22 and 2022/23, however, the share of the industrial sector in GDP slightly declined to 28.9 and 28.8 percent, respectively. Over the past six years, the share of the service sector in GDP has remained stable; except for a small decline in 2019/20, it showed a slight yearly increment. The service sector has the largest share of GDP accounting for, on average, 40.0% of the GDP between fiscal years 2020/21 and 2022/23 (see Table 2.1).

Ethiopia's economy shows signs of structural transformation, with resources shifting from the lower-productivity agricultural sector to higher-productivity service and industrial sectors. However, a

couple of comments are in order. First, the share of agriculture in GDP remains significantly high at over 30%, suggesting that meaningful structural transformation is still in its early stages. Second, it is crucial to examine whether agriculture's share of the labor force is declining; if not, this could indicate either underdevelopment in other sectors or improvements in agricultural productivity. Third, the Ethiopian economy follows the atypical agriculture-to-services-to-industry structural transformation, deviating from the typical agriculture-to-industry-to-services transformation. This deviation raises concerns and requires policymakers' attention, given the industrial sector's vital role in economic diversification, job creation, and overall economic development. Furthermore, a service sector-led transformation may not lead to sustainable economic growth if dominated by low-productivity, low-wage, and low-skill service activities.

Table 2.1: Percentage Distribution of GDP by Major Industrial Classification (%) at Constant Basic Prices

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	AVERAGE
AGRICULTURE	36.3	34.9	33.3	32.7	32.5	32.4	32.1	32.3
INDUSTRY	26.0	27.2	28.1	29.0	29.3	28.9	28.8	29.0
SERVICES	38.8	39.0	39.8	39.5	39.6	40.0	40.3	40.0
TOTAL	**101.1**	**101.1**	**101.1**	**101.2**	**101.3**	**101.3**	**101.2**	**101.3**
Less: FISIM	1.1	1.1	1.1	1.2	1.3	1.3	1.2	1.3
GVA at Constant Basic Prices	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

Source: Own computation using Data from the Ministry of Planning and Development.

2.1.2 Price Developments

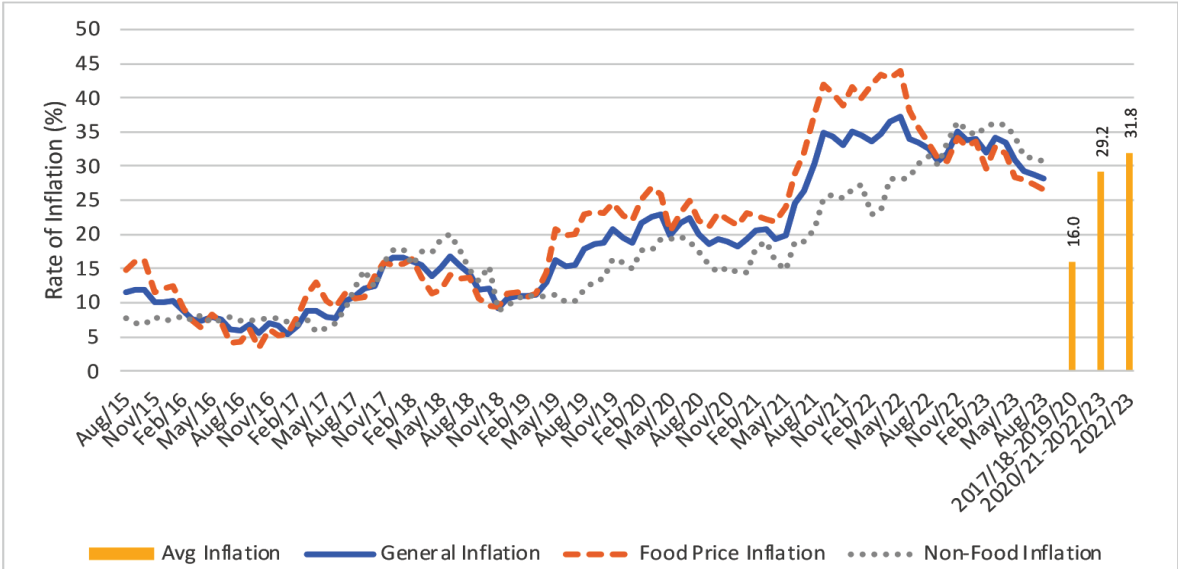
In recent fiscal years, inflation remains to be a major challenge for the Ethiopian economy. Although it showed some improvement in the 2022/23 fiscal year, it continues to hover around 30 percent. As can be seen in Figure 2.3, the increase in prices has been caused by the increases in the prices of food and non-food items. However, unlike previous years, the price of non-food items had a relatively larger contribution in 2022/23. This was due to a significant (8.4 percentage points) decline in food price inflation and a similar (8.8 percentage points) increase in non-food price inflation.

The general inflation rate increased from 18.7 percent at the beginning of the 2020/21 fiscal year and reached its highest level of 35.1 percent in November 2022/23. After showing improvement in the following months of the fiscal year, it declined to 28.2 percent in August 2022/23. The annual average inflation rate for the 2020/21 fiscal year was 20.1 percent, and in the 2021/22 fiscal year, it showed a 13.6 percentage points increase. In 2022/23, it showed a slight improvement and reached 32.6 percent. This can be the result of the impacts of some of the challenges receding and the inflation control measures taken by the government.

Although the current rate of inflation is unacceptable by any standard, it is important to keep in mind that this inflation rate is the cumulative effect of the overlapping challenges that have

tested the economy in the past years. In particular, the significant increase in the global price of commodities, including fuel, fertilizers, and food items. On top of the imported inflation, the drought and conflicts disrupting production and distribution, the government's limited access to foreign currency from donors and lenders, and the pressure on the foreign exchange rate, etc. resulted in a loose fiscal and monetary policy, which might have contributed to the surge in prices. The government is taking the necessary fiscal and monetary policies and embarking on different initiatives to increase food production and productivity to reverse the increasing trend in inflation, make sure it does not take root, and put it under control sustainably. Improving the peace and security situation in various parts of the country will also play an important role in taming inflation. The National Bank of Ethiopia (NBE) is also taking the necessary measures, making inflation control its main area of focus. Some of the measures that the bank is taking include limiting credit growth to 14 percent for the 2023/24 fiscal year, limiting the government's direct advance from the bank to one-third of the previous year, and increasing the interest rate commercial banks borrow from NBE from 16 percent to 18 percent.

Figure 2.3: Trends in Inflation: General, Food and Non-Food Inflation (%)



Source: Own computation using Data from Central Statistical Service.

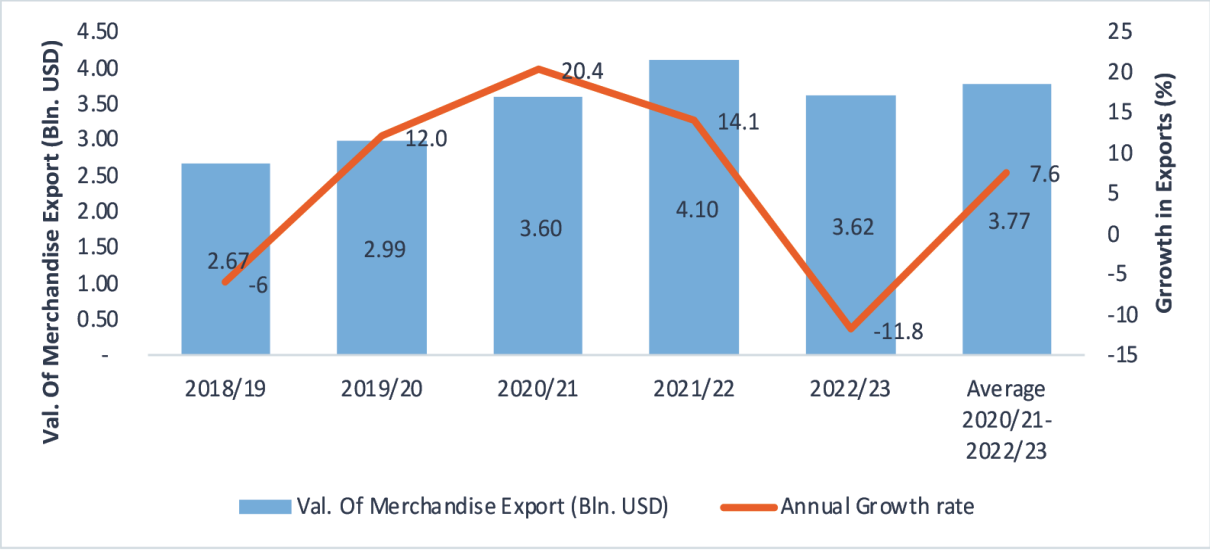
2.2 External Sector Performance

2.2.1 Merchandise Export Performance

Ethiopia's merchandise export performance has exhibited a promising trajectory over the last three years, despite falling short of targets and remaining insufficient to meet the country's foreign currency needs for economic development. Certain product categories, such as gold and minerals in 2020/21 and coffee in 2021/22 benefited from improved global market prices, offset declines in exports of other commodities, and helped to sustain growth in overall export earnings. This contrasts with the period between 2014/15 and 2018/19, when the nation's export performance experienced a downward trend, with an annual average decline of 4.1 percent.

After this period of decline, merchandise export earnings rebounded, recording annual growth rates of 12.1 percent in 2019/20, 20.4 percent in 2020/21, and 14.1 percent in 2021/22. Consequently, the HGER 1.0 period (2019/20–2012/22) witnessed an impressive annual average growth rate of 15.5 percent in export earnings. Notably, the fiscal year 2021/22 marked a historic milestone, with export earnings reaching USD 4.1 billion for the first time in the country's history. However, this remarkable performance could not be sustained in 2022/23, as export earnings declined to USD 3.6 billion, representing an 11.8 percent decrease compared to the previous year. Despite this setback, the country's export performance achieved an annual average growth of 7.6 percent during the period 2020/21-2022/23 (see *Source: Own computation using Data from the National Bank of Ethiopia.*).

Figure 2.4: Value and Percentage Growth of Export Earnings



Source: Own computation using Data from the National Bank of Ethiopia.

The weak export performance observed in 2022/23 has been due to poor export performances of all major export commodities, where exports of gold, textiles, and coffee showed a 63.9, 15.3, and 6.3 percent decline, respectively. This poor performance in the exports of these commodities influences the performance of the aggregate merchandise exports as this depends on the performances of a few commodities contributing a higher share to the total exports (see Figure 2.5). Particularly, the major decline in gold exports contributed significantly to the low export earnings recorded in the fiscal year, where the sector's share in the total merchandise export earnings declined from 13.3 percent in the previous year to 5.4 percent in 2022/23. Although the international market price for coffee increased by 17.5 percent, Ethiopia's export earnings from the commodity decreased due to a 20.3 percent decrease in the volume of exports. Despite the decline in coffee exports, its share in total merchandise exports increased from 34.9 percent to 37.0 percent as export earnings from the other commodities declined more sharply (see Table 2.2). Particularly, export earnings from oilseeds and leather and leather products have shown a consistent downward trend in both value and shares. This declining trend in the export earnings of these commodities warrants investigations into contributing factors and potential solutions. Regarding exports of leather and leather products, it is important to study the impacts of the export taxes on raw hides and skins in 2008, the taxes

on semi-finished leather products in 2012, and the subsequent lifting of the export tax on semi-finished leather products (pickled and wet blue leather) in early 2020. A comprehensive analysis of these policy changes could provide valuable insights into the sector's performance and inform future strategies to increase the sector's export earnings.

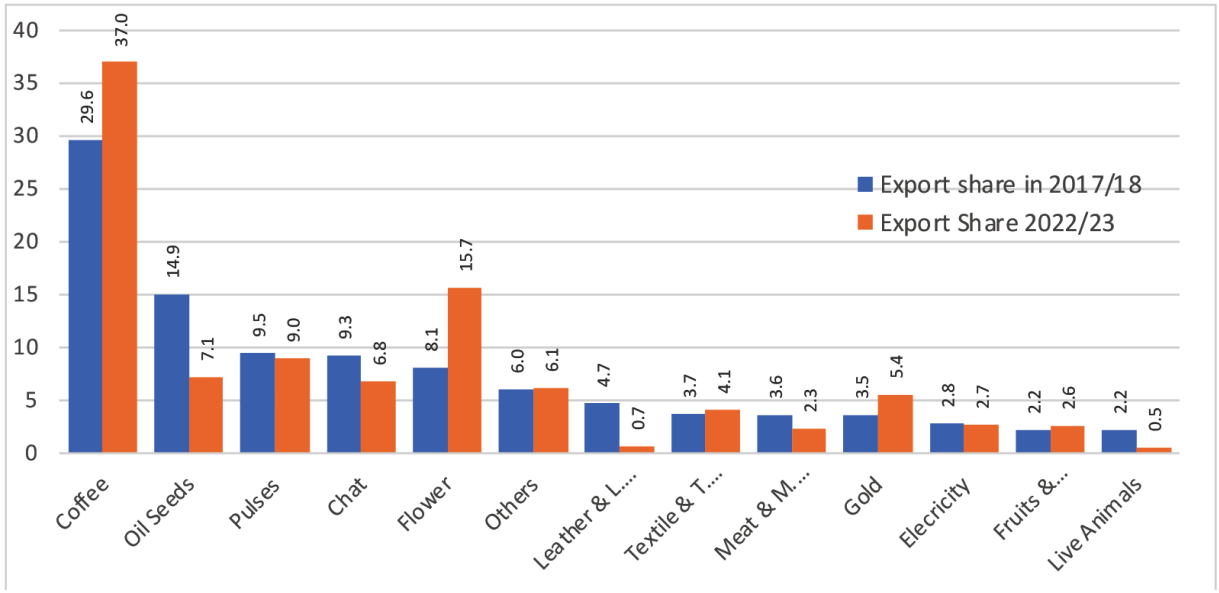
In general, the main reasons for the poor merchandise export performance recorded in the 2022/23 fiscal year can be attributed to fluctuations in international commodity prices, the spread of illegal and contraband trade, Ethiopia's suspension from AGOA, internal peace and security problems, and other bottlenecks in the trading system. Commodities like coffee, oilseeds, flowers, meat and meat products, fruits and vegetables, and live animals experienced declines in export volumes despite some increases in export prices. The declines in export earnings from leather and leather products, textile and textile products, gold, etc are partly explained by declines in prices of the commodities. In addition, it is safe to assume that the foreign exchange shortage and the unattractiveness of the exchange rate for exporters have played a negative role. Overall, this highlights the ongoing challenges in building a robust and diversified export sector that can provide a reliable source of foreign exchange to the economy.

Table 2.2: Export Performance by Major Export Items (In millions of USD)

Particulars	2020/21		2021/22		2022/23		Difference from the previous year	
	Value	% Share	Value	% Share	Value	% Share	Value	%
Coffee	909.4	25.3	1430.5	34.9	1340.2	37.0	-90.3	-6.3
Oilseeds	335.5	9.3	265.9	6.5	258.0	7.1	-7.9	-3.0
Leather and Leather Products	36.5	1.0	33.2	0.8	24.7	0.7	-8.4	-25.5
Pulses	233.8	6.5	218.9	5.3	324.5	9.0	105.6	48.2
Meat & Meat Products	75.3	2.1	109.6	2.7	81.7	2.3	-27.9	-25.5
Fruits & Vegetables	69.3	1.9	87.8	2.1	92.5	2.6	4.7	5.3
Textile & Textile Products	147.1	4.1	175.6	4.3	148.7	4.1	-26.9	-15.3
Live Animals	44.9	1.2	29.2	0.7	17.5	0.5	-11.7	-40.1
Chat	402.5	11.2	391.6	9.5	247.5	6.8	-144.0	-36.8
Flower	470.6	13.1	541.6	13.2	567.8	15.7	26.1	4.8
Gold	651.6	18.1	546.4	13.3	197.0	5.4	-349.4	-63.9
Electricity	90.5	2.5	93.5	2.3	96.4	2.7	3.0	3.2
Others	129.5	3.6	180.0	4.4	222.0	6.1	42.0	23.4
Total export	**3596.6**	**100**	**4103.7**	**100**	**3618.5**	**100**	**-485.2**	**-11.8**

Source: Own computation using Data from the National Bank of Ethiopia.

Figure 2.5: Export Share by commodity: 2017/18 vs. 2022/23



Source: Own computation using Data from the National Bank of Ethiopia.

2.2.2 Merchandise Import Performance

Ethiopia's value of merchandise import is dominated by consumer goods and fuel, which take up more than half of the country's imports. This is followed by imports of capital goods and semi-finished (intermediate) goods. Over the last three years, the share of raw materials remained below one percent. Over the past 10 years, capital goods and semi-finished goods together accounted for an average of about 50.1 percent of the country's total import bill, these are essential items for the country's industrialization process and for achieving its development objectives. However, in the fiscal years under review, the share of these two import commodities declined to 45.9 percent (in 2020/21), 37.4 percent (in 2021/22), and 41.1 percent (in 2022/23). During this period, the country's import bill spent on consumer goods has been the highest at USD 5.9 billion (34.4 percent share), followed by fuel at USD 3.96 billion (23.1 percent share), capital goods at USD 3.3 billion (22.1 percent share), and semi-finished goods at USD 3.3 billion (19 percent share).

In terms of import value, we note that Ethiopia's total import bill showed a 5.4 percent decrease compared to last year and reached a total value of USD 17 billion. This decrease in imports recorded during the 2022/23 fiscal year was entirely due to a 22.5 percent and 13.1 percent decrease in imports of consumer goods and semi-finished goods, respectively. It can be assumed that this decrease is associated with the government's temporary ban on non-essential imports, the lack of foreign currency (import compression), and the substitution of imported goods with domestic production (in wheat and other commodities). On the other hand, expenditure on capital goods and fuel increased by 25 percent and 15 percent, respectively. This can be attributed to the rise in the international price for these commodities and the fact that they are unavoidable imports.

The decrease in the value of imports led to some improvements in the trade balance. However, the trade deficit of USD 13.5 billion recorded in the 2022/23 fiscal year showed an increase from USD 2.8 billion in the 2020/21 fiscal year. The resulting widening gap between the supply and demand for foreign currency is putting a lot of pressure on the exchange rate of the birr. In this regard, it has made it difficult to increase foreign currency reserves and narrow the difference between the official and parallel foreign exchange rates using government policy.

To address the sustained trade imbalance, while it is important to diversify the export base, improve the value-addition, and reduce reliance on agricultural commodities, it is also crucial to find ways to limit foreign exchange spent on imports of fuel and consumer goods. This requires creating a favorable policy environment for promoting the use of fuel-saving technologies and boosting domestic production to substitute for imported consumer goods. In this regard, the government is embarking on a "buy Ethiopian" initiative and this is hoped to increase the domestic production capacity – to substitute imports and create the necessary capacity that can support exports. The government's policy support for electric vehicles and removal of fuel subsidies is also expected to play an important role in limiting the increase in demand for imports of fuel. If the country is unable to boost its foreign exchange reserves through these kinds of measures, it will be difficult to achieve overall macroeconomic stability and promote economic growth and development.

Table 2.3: Values of Import Items by End Use (In millions of USD)

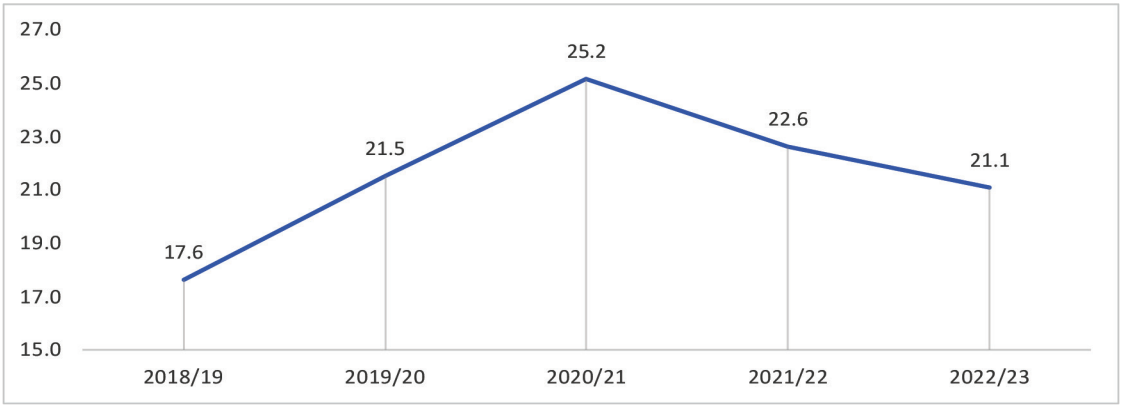
Particulars	2020/21		2021/22		2022/23		Difference from the previous year	
	Value	% Share	Value	% Share	Value	% Share	In USD	In %
Raw materials	138.9	1.0	114.5	0.6	107.9	0.6	-6.6	-5.8
Semi-finished goods	2681.0	18.8	3748.2	20.7	3258.2	19.0	-490.0	-13.1
Fuel	1940.8	13.6	3460.4	19.1	3966.5	23.1	506.1	14.6
Capital goods	3879.7	27.2	3038.1	16.8	3798.0	22.1	759.9	25.0
Consumer goods	5472.4	38.3	7618.3	42.0	5904.6	34.4	-1713.6	-22.5
Others	175.0	1.2	148.5	0.8	113.3	0.7	-35.2	-23.7
Total Import	**14287.9**	**100**	**18128.0**	**100**	**17148.5**	**100**	**-979.4**	**-5.4**

Source: Own computation using Data from the National Bank of Ethiopia

The government's main goal has been to promote exports and ensure the availability of foreign currency to fulfill the rising demand for imports, notably of machinery (investment goods) and intermediate goods. This is important as the majority of the investments in the country rely on imported capital goods, raw materials, and semi-finished (intermediate) goods, which require a sizable foreign currency.

Ethiopia has a severe lack of foreign currency as a result of the subpar performance in its merchandise export sector, which has not been growing in parallel with the rising import value. As a result, the revenue generated by exports never fully covered the import value. For the past three years, export earnings could on average finance only 23.0 percent of the country's import bill. In 2018/19, exports covered only 17.6 percent of the import bills. This increased during 2019/20 and 2020/21 to 21.5 and 25.2 percent, respectively. This, however, was not sustained and decreased to 22.6 percent and 21.1 percent in 2021/22 and 2022/23, respectively.

Figure 2.6: Export Capacity in Financing Imports



Source: Own computation using Data from the National Bank of Ethiopia

2.3 Monetary Developments

As indicated above, controlling inflation remained to be a major challenge for the Ethiopian economy – inflation has been in double digits since 2017/18. The NBE is redoubling its effort to control inflation and bring it to single digits by making use of policy tools at its hand. In this regard, NBE is taking necessary measures to limit the growth rate of money supply and manage its potential impact on inflation.

One way the NBE conducts its monetary policy is by using the reserve money as an (intermediate) instrument to set the growth of broad money (M2) in line with the growth rate of nominal GDP. The relationship between broad money and reserve money has important implications for understanding the money creation process and the effectiveness of monetary policy. A faster growth in broad money relative to growth in reserve money may signal that the money multiplier is increasing, and this could lead to higher inflation in the future unless it is addressed by applying the necessary monetary policy actions.

Over the last three years, the growth rate of money supply as measured by broad money has been on the decline. It declined from 29.9 percent in 2020/21 to 27.2 percent in 2021/22 and 26.6 percent in 2022/23 (see Table 2.4). Moreover, comparing this with the nominal GDP growth rate observed over the past three years, we can say that in recent years the growth rate in broad money is unlikely to have contributed a lot to the observed high inflation rate. Furthermore, in the last two years, the growth in broad money has been slower than that of reserve money, which grew at 7.2 percent, 37.2 percent, and 32.0 percent in 2020/21, 2021/22 and 2022/23, respectively (see Table 2.5). As a result, the money multiplier, which is given by the ratio of broad money to reserve money, has declined from 5.1 in 2020/21 to 4.7 and 4.5 in 2021/22 and 2022/23, respectively. However, the annual average money multiplier observed in the recent three years (4.8) has been higher than what was observed in the previous three years (4.3). Since this increase in the money multiplier can lead to higher inflation in the future, it is important to take the necessary policy measures. Moreover, the growth rate of broad money (M2), averaged 27.9 percent over the period 2020/21-2022/23, is higher than the 21 percent annual average growth rate target set in the ten-year development plan and requires careful attention.

Table 2.4: Factors Influencing Broad Money (In Billion Birr)

Particulars	Year Ended June 30					
	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Domestic Credit	**784.6**	**963.7**	**1,176.9**	**1,481.8**	**1,930.6**	**2,444.4**
Claims on Central Gov't (net)	102.0	109.8	137.1	214.3	421.2	585.4
Claims on Non-Central Gov't	682.6	853.9	1,039.8	1,267.6	1,509.4	1,859.0
Other Items (net)	**83.4**	**91.5**	**131.0**	**132.8**	**103.9**	**113.5**
Broad Money (M2)	**740.6**	**886.8**	**1,037.6**	**1,348.3**	**1,715.3**	**2,170.8**
	Annual Growth Rate					
External Assets (net)		**-63.2**	**-157.4**	**-90.2**	**13617.5**	**43.7**
Domestic Credit		**22.8**	**22.1**	**25.9**	**30.3**	**26.6**
Claims on Central Gov't (net)		7.6	24.8	56.3	96.6	39.0
Claims on Non-Central Gov't		25.1	21.8	21.9	19.1	23.2
Other Items (net)		**9.6**	**43.2**	**1.4**	**-21.8**	**9.2**
Broad Money (M2)		**19.7**	**17.0**	**29.9**	**27.2**	**26.6**

Source: Own computation using Data from the National Bank of Ethiopia.

It can be seen that the growth in broad money is primarily driven by the expansion of domestic credit, which grew by 22.1 percent, 25.9 percent, and 30.3 percent in 2020/21, 2021/22, and 2022/23, respectively. In this regard, according to the HGER 1.0 program, the government has set out a plan to significantly limit the use of direct advances from NBE to finance its deficit and gradually phase out the system. The plan is to completely cover the budget deficit with non-inflationary financing instruments. To this end, the government introduced market-based treasury bills and treasury notes. As part of this, while the stock of direct advances was converted to a 25-year bond, the stock of treasury bills was converted into a three-year treasury note. Although implementation of this policy has started out well at the beginning of the reform program, sustaining it has been difficult due to the overlapping challenges the country has faced over the last three years.

Table 2.5: Reserve Money and its Components (In Billion Birr)

Particulars	Year Ended June 30					
	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Reserve Money	**174.2**	**200.7**	**246.5**	**264.3**	**362.5**	**478.5**
Currency in Circulation	112.9	121.8	140.5	163.7	208.2	254.3
Banks deposits at NBE	61.3	78.9	106.0	100.6	154.3	224.2
	Annual Growth Rate (percent)					
Reserve Money		**15.3**	**22.8**	**7.2**	**37.2**	**32.0**
Currency in Circulation		7.9	15.4	16.5	27.2	22.1
Banks deposits at NBE		28.9	34.3	-5.1	53.4	45.3
	Money Multiplier (Ratio)					
Narrow Money to Reserve Money	1.6	1.5	1.5	1.7	1.6	1.5
Broad Money to Reserve Money	4.3	4.4	4.2	5.1	4.7	4.5

Source: Own computation using Data from the National Bank of Ethiopia.

Component-wise, quasi-money supply consisting of savings and time deposits, showed a 29.9 percent annual expansion at the end of 2022/23 and reached ETB 1.46 trillion compared with ETB 1.13 trillion in 2021/22. Similarly, the growth of narrow money, which consists of the most liquid forms of money – currency in circulation and demand deposits - exhibited a 20.1 percent annual growth to reach ETB 706.1 billion at the end of 2022/23 fiscal year from ETB 588 billion in the 2021/22 fiscal year (see Table 2.6). This is due to both higher growth rates of demand deposits and currency outside banks, and it might be an indication of improvements in money demand for transaction and investment purposes. The higher growth rate of narrow money can potentially lead to higher economic growth, however, if this is not accompanied by economic growth, it can lead to asset price bubbles and excessive credit expansion. More importantly, since the rate of growth in narrow money recorded in recent years is faster than its historical average, this may suggest that the NBE has been adopting a relatively accommodative monetary policy, potentially leading to inflationary pressures, asset price bubbles, and a pressure to devalue the exchange rate of the birr.

Table 2.6: Components of Broad Money (In Billion Birr)

Particulars	***Year Ended June 30***					
	2017/18	***2018/19***	***2019/20***	***2020/21***	***2021/22***	***2022/23***
Narrow Money Supply		**9.9**	**16.7**	**21.3**	**34.4**	**20.1**
Currency Outside Banks		6.5	18.5	22.5	29.8	22.1
Demand Deposits (net)		11.4	15.9	20.8	36.5	19.3
Quasi-Money		**25.8**	**17.2**	**34.5**	**23.8**	**29.9**
Savings Deposits		27.4	20.9	38.6	24.5	29.4
Time Deposits		17.8	-2.9	7.5	17.7	34.3
Broad Money Supply		**19.7**	**17.0**	**29.9**	**27.2**	**26.6**
	Annual Growth Rate					
Narrow Money Supply		**9.9**	**16.7**	**21.3**	**34.4**	**20.1**
Currency Outside Banks		6.5	18.5	22.5	29.8	22.1
Demand Deposits (net)		11.4	15.9	20.8	36.5	19.3
Quasi-Money		**25.8**	**17.2**	**34.5**	**23.8**	**29.9**
Savings Deposits		27.4	20.9	38.6	24.5	29.4
Time Deposits		17.8	-2.9	7.5	17.7	34.3
Broad Money Supply		**19.7**	**17.0**	**29.9**	**27.2**	**26.6**

Source: Own computation using Data from the National Bank of Ethiopia

Bank deposits reached 1.96 trillion in the 2022/23 fiscal year, showing an annual increase of 24.1 percent compared to last year (see Table 2.6). This increase in bank deposits can be attributed to increased access to banks, branch expansion, and improvements in savings culture. For this to continue in the future, it is important to underline the need to keep the real interest rate from going negative by controlling the rate of inflation.

3 FISCAL PERFORMANCE

Ethiopia's fiscal policy is primarily focused on: First, supporting broad-based and inclusive growth, poverty reduction, and economic development by supporting investment in infrastructure, human capital development, high-impact social programs, and incentivizing the private sector to invest in strategic areas that can enhance Ethiopia's competitiveness and job creation. Second, utilizing public finances in an effective and efficient manner, avoiding wasteful spending, and prioritizing public investments in areas that have the highest developmental impact. Third, maintaining a manageable fiscal deficit and public debt thereby ensuring macroeconomic stability, creating a conducive business environment for the private sector, and safeguarding the country's financial resilience. Fourth, strengthening domestic resource mobilization thereby ensuring the availability of sustainable public finances and reducing the country's reliance on external financing.

In view of the above, this section reviews Ethiopia's performance in revenue mobilization, government expenditure, fiscal deficit, and deficit financing.

3.1 Government Revenue

The government gives due attention to domestic resource mobilization as this provides a more reliable, sustainable, and predictable source of funding compared to external grants and loans. In this regard, the government's primary focus is on enhancing tax and non-tax revenue collection through improving tax administration, broadening the tax base, and reducing tax evasion and avoidance. Although the government recognizes the crucial roles of external grants and concessional loans in supporting development endeavors, the diminishing role of these sources that we have observed in recent years underscores the crucial need to rely on own sources of financing.

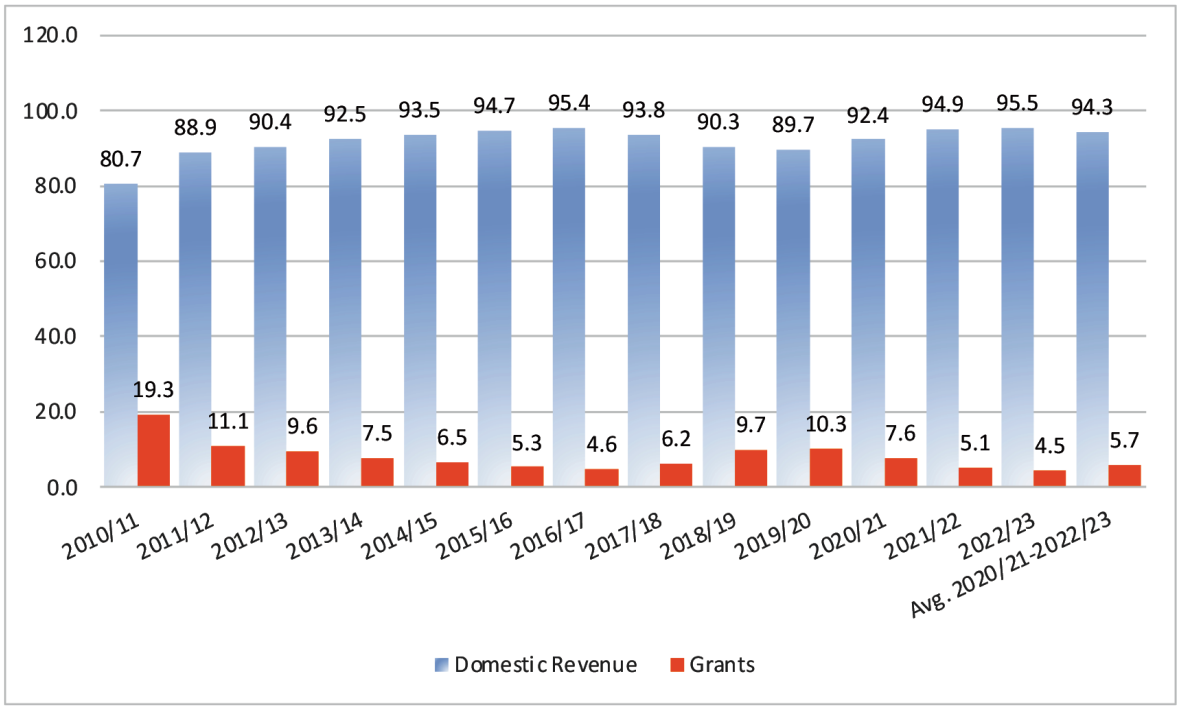
In line with this, between 2010/11 and 2022/23, domestic revenue sources constituted an average of 91.7 percent of total government revenue. This proportion has increased in recent years, reaching an average of 94.3 percent during 2020/21-2022/23, underscoring the government's growing reliance on domestic resources for budgetary financing. The share of domestic revenue in total government revenue rose steadily from 89.7 percent in 2019/20 to 92.4, 94.9, and 95.5 percent in 2020/21, 2021/22, and 2022/23, respectively. While this trend primarily reflects enhanced domestic resource mobilization efforts, it is also partly attributable to decreases in foreign borrowing and grants.

The fiscal year 2022/23 exemplifies this shift: out of the total revenue of ETB 717.1 billion, ETB 685.0 billion (95.5 percent) came from domestic sources, while only ETB 32.1 billion (4.5 percent) was derived from external grants. This distribution clearly demonstrates the government's increasing dependence on domestic financing.

Over the past decade, total government revenue has grown at an average annual rate of 18.3 percent. During this period, external grant flows increased by approximately 13.1 percent annually, while domestic revenue grew at a more robust average annual growth rate of 18.9 percent. These figures

further illustrate the government's successful efforts to bolster domestic revenue generation, reducing reliance on external sources and enhancing fiscal autonomy.

Figure 3.1: Share of Domestic Revenue and External Grant from 2013/14-2022/23 (in percent)

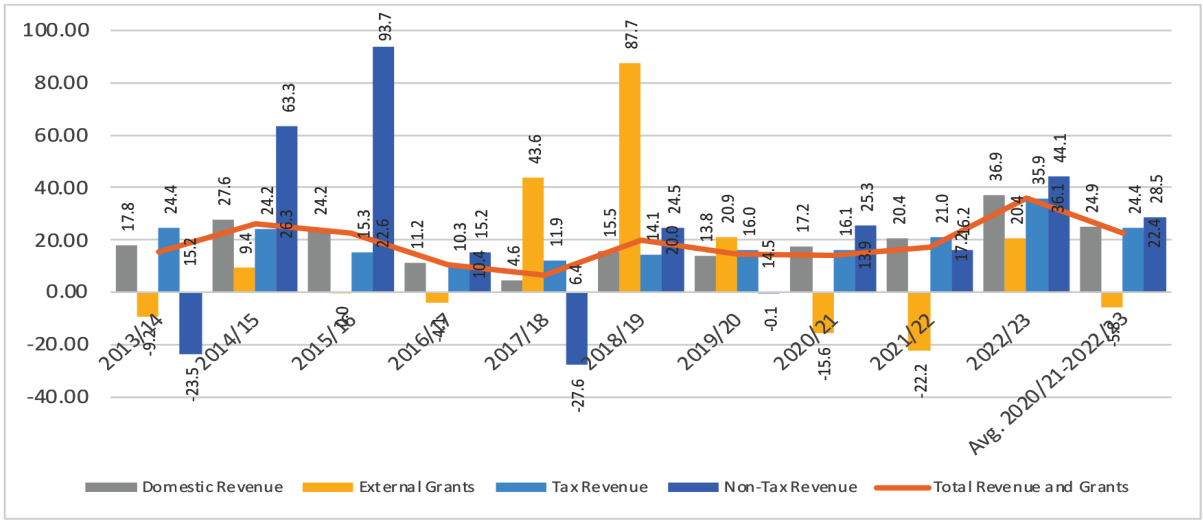


Source: Own computation using Data from the Ministry of Finance.

Budgetary resources mobilized from external grants, while contributing less to total government revenue, have exhibited significant volatility. For example, in the period 2017/18 to 2019/20, this revenue source showed high growth rates. However, it experienced sharp declines of 15.6 percent and 22.2 percent in fiscal years 2020/21 and 2021/22, respectively. This downturn was primarily due to reduced foreign aid receipts following the conflict in the northern part of the country. Following a peace agreement, however, external grants rebounded, growing by 20.4 percent in the fiscal year 2022/23 to reach 32.1 billion Birr.

Non-tax revenues, despite fluctuations, have played a crucial role in meeting government expenditure needs. In the last three years, non-tax revenues had an average growth rate of 28.5 percent, exceeding its 10-year average annual growth rate of 23.1 percent. In contrast, tax revenue has remained the most stable and consistent source of government revenue over the past decade, with an average growth rate of 18.9 percent. Recent years have seen notable improvements in tax revenue, with an average annual growth of 24.2 percent from 2020/21 to 2022/23, surpassing the 10-year average growth rate of 18.9 percent (see Figure 3.2). However, it's important to note that, when adjusted for inflation, which has exceeded 30 percent in recent years, tax revenue is declining in real terms. While this partly reflects the complex challenges facing the Ethiopian economy, it signifies the urgent need for substantial improvements in tax revenue collection.

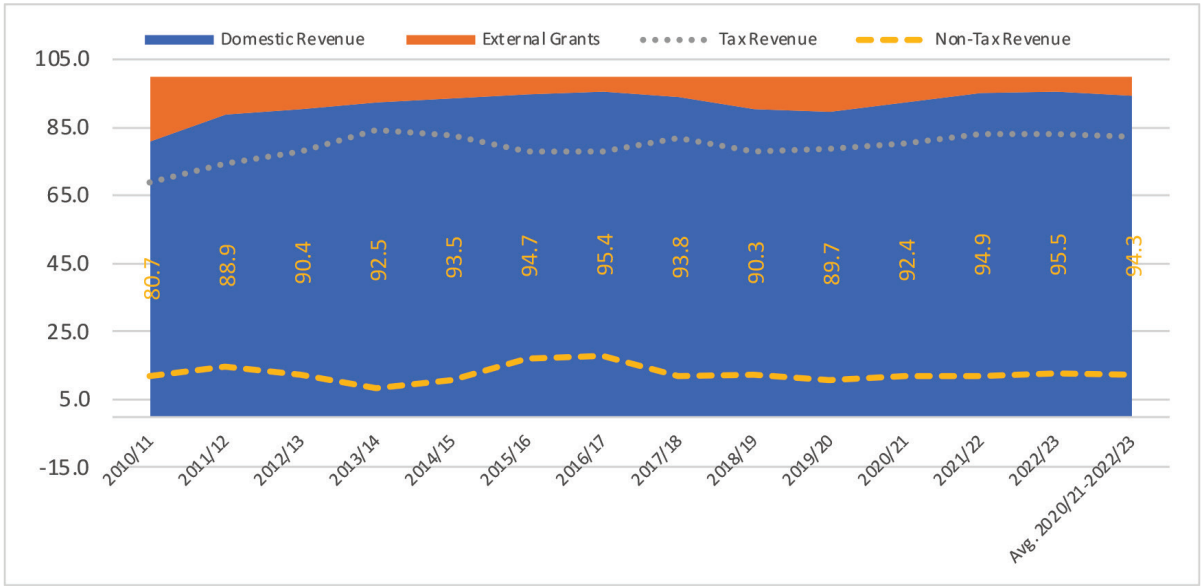
Figure 3.2: Annual Growth Rates of Major Sources of Government Revenue (Percent)



Source: Own computation using Data from the Ministry of Finance.

From 2013/14 to 2022/23, non-tax revenue sources accounted for an average of 13.4 percent of total domestic revenue. While non-tax revenues are collected from different sources, a little above 50 percent of the non-tax revenue is collected from residual surpluses, capital charges, interest income, and state dividends. During this period, tax revenue constituted the major source of domestic revenue, averaging 86.6 percent of the total (as illustrated in Figure 3.3). This underscores tax revenue's critical role as the primary source of domestic revenue and implies that the government's financing rests on relatively stable and predictable revenue streams.

Figure 3.3: Shares of the Different Revenue Sources in Total Revenue (in percent)



Source: Own computation using Data from the Ministry of Finance.

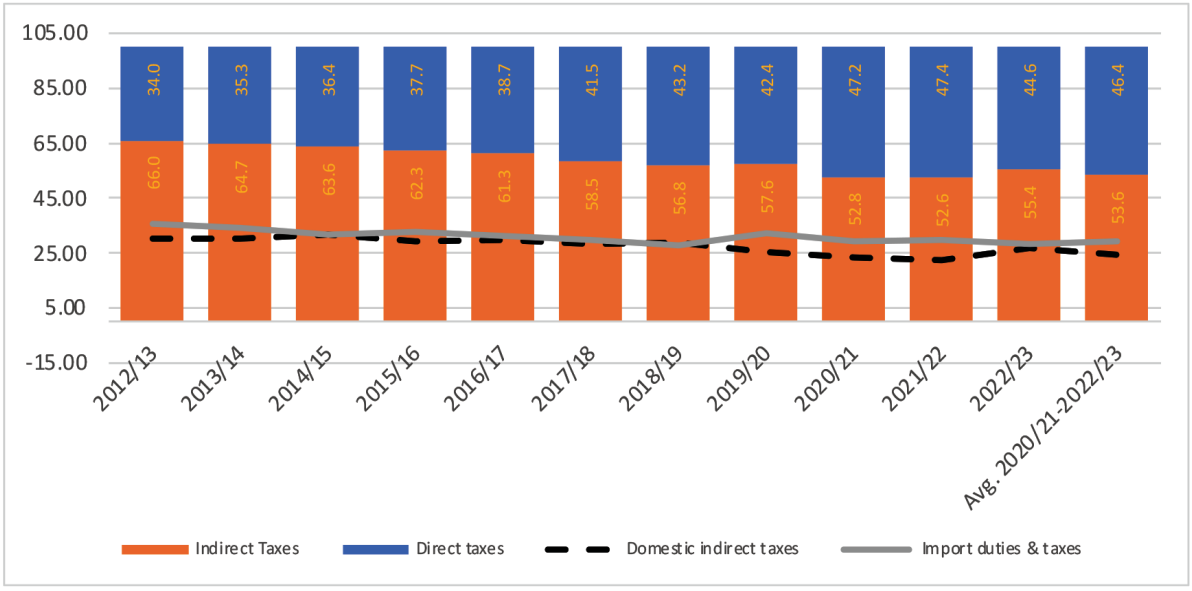
Indirect taxes, comprising domestic indirect taxes and import duties and taxes, have historically been the primary source of tax revenue in Ethiopia. However, their share has been declining over time. The average share of indirect taxes over the period 2012/13-2019/20 (61.3 percent) was 7.7

percentage points higher than the average for 2020/21-2022/23. This is consistent with the situation in other African countries, where the contribution of consumption taxes outweighs income taxes. In 2021, taxes on goods and services in Africa accounted for an average of 51.9 percent of total tax revenues, with VAT alone accounting for 27.8 percent. Taxes on income and profits made up 37.9 percent of tax revenues. According to OECD Revenue Statistics in Africa 2023, taxes on goods and services were the main source of tax revenues for 24 out of the 33 countries included in the report in 2021. For the remaining nine countries, taxes on income and profits were the primary source (OECD et al., 2023).

Over the past decade, Ethiopia has experienced a noticeable shift in its tax revenue sources, moving from international trade taxes to domestic taxes. In particular, the reliance on international trade taxes, such as import duties, has decreased in favor of income taxes and domestic consumption taxes. For example, in the fiscal year 2013/14, international trade taxes accounted for 34.3 percent of the total government tax revenue. This substantial share of international trade tax can be attributed to the relative ease of administering taxes on imports at ports and borders.

Following Ethiopia's economic growth and its improved tax collection capacity, which supports the expansion of direct tax sources, we have observed a gradual decline in the share of international trade taxes from 35.7 percent in 2012/13 to 28.4 percent in 2022/23. This change has been primarily driven by the consistent growth in the share of direct taxes, which increased from 35.3 percent in 2013/14 to 47.2 percent, 47.4 percent, and 44.5 percent in 2020/21, 2021/22, and 2022/23, respectively. On the other hand, the share of domestic indirect taxes decreased from 29 percent in 2018/19 to 22.6 percent in 2021/22 before slightly increasing to 27.1 percent in the 2022/23 fiscal year (see Figure 3.4). The relative importance of domestic taxes has significantly increased, rising from 65.7 percent of total tax revenue in 2013/14 to an average of 69.1 percent in the last 10 years, and further to an average of 70.7 percent from 2020/21 to 2022/23.

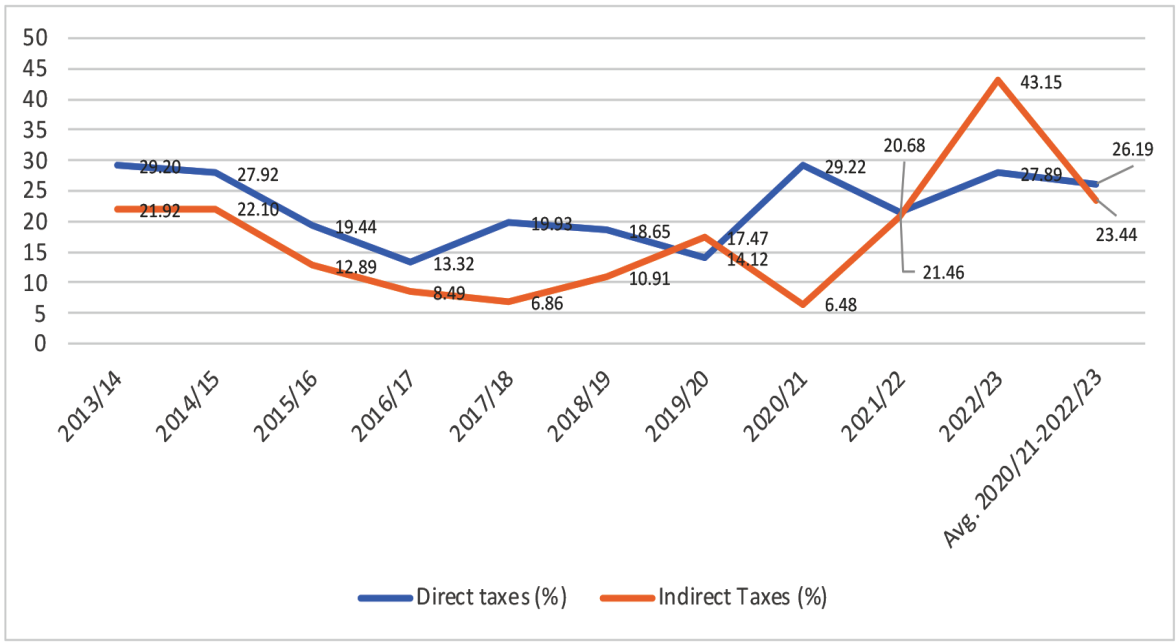
Figure 3.4: Share of Different Tax Types in Total Revenue (in percent)



Source: Own computation using Data from the Ministry of Finance.

Over the past decade, revenue growth from income/direct taxes has generally outpaced that of consumption/indirect taxes, with fiscal years 2019/20 and 2022/23 being the only two exceptions. Specifically, in the fiscal year 2022/23 revenue from indirect taxes grew by 43.1 percent, surpassing the growth of revenue from direct taxes by 15.4 percentage points. The higher growth rate of indirect tax collection in 2022/23 can be attributed to an increase in revenue from domestic indirect taxes of ETB 62 billion (63 percent) and revenue from import duties and taxes of ETB 37 billion (28.4 percent), compared to the previous year's performance. Overall, over the past decade, revenue from income taxes grew at an average annual growth rate of 22.1 percent, while revenue from consumption taxes increased at an average annual growth rate of 17.1 percent (see Figure 3.5).

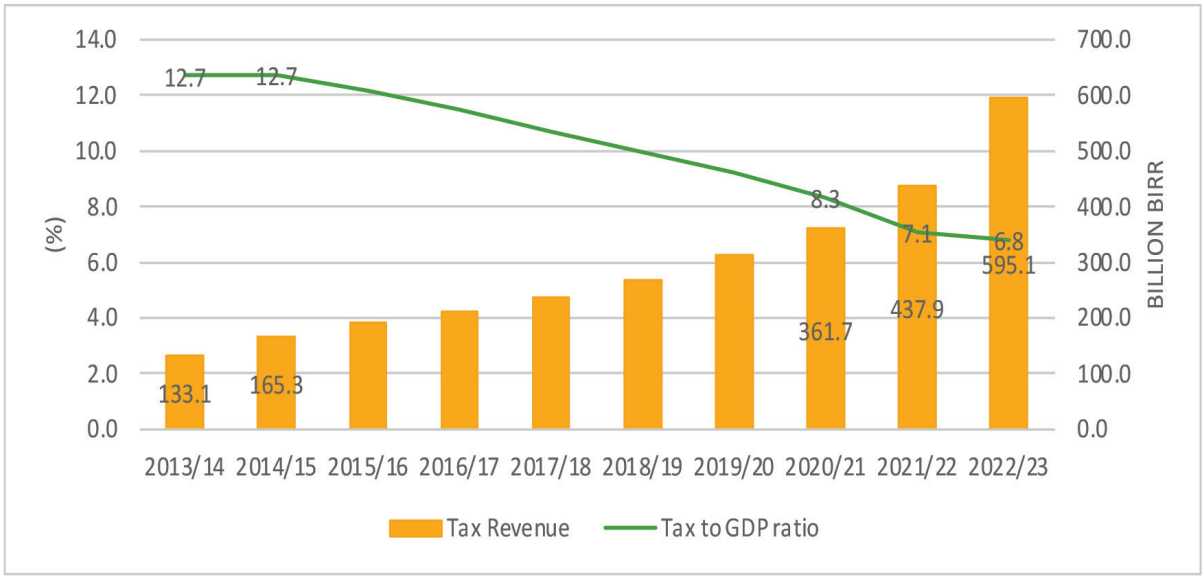
Figure 3.5: Annual growth rate of Revenue from Direct and Indirect Taxes: 2013/2014-2022/223 (in percent)



Source: Own computation using Data from the Ministry of Finance.

The tax-to-GDP ratio is an economic indicator that compares the amount of tax collected by a government to the amount of income generated by the country's overall economic activities. Despite experiencing consistent economic growth of over six percent in the past decade, Ethiopia faces challenges in aligning its tax revenue with this growth. While the nominal tax revenue has been growing, the tax-to-GDP ratio has been declining since 2014/15, dropping from 12.7 percent to 6.8 percent in the 2022/23 fiscal year (see Figure 3.6). This downward trend indicates that Ethiopia's tax system is not keeping up with the pace of its economic expansion and has a low elasticity with respect to GDP. Furthermore, Ethiopia's tax-to-GDP ratio is significantly lower than other Sub-Saharan African countries. As shown in Figure 3.7, Ethiopia's tax-to-GDP ratio is below that of most of these countries, as well as the regional average tax-to-GDP ratio of 15 percent. This emphasizes the urgent need to enhance the country's tax administration and introduce reforms that can broaden the tax base and improve its elasticity to GDP.

Figure 3.6: Tax Revenue, Tax Revenue to GDP ratio from 2013/2014-2022/23 (in percent)

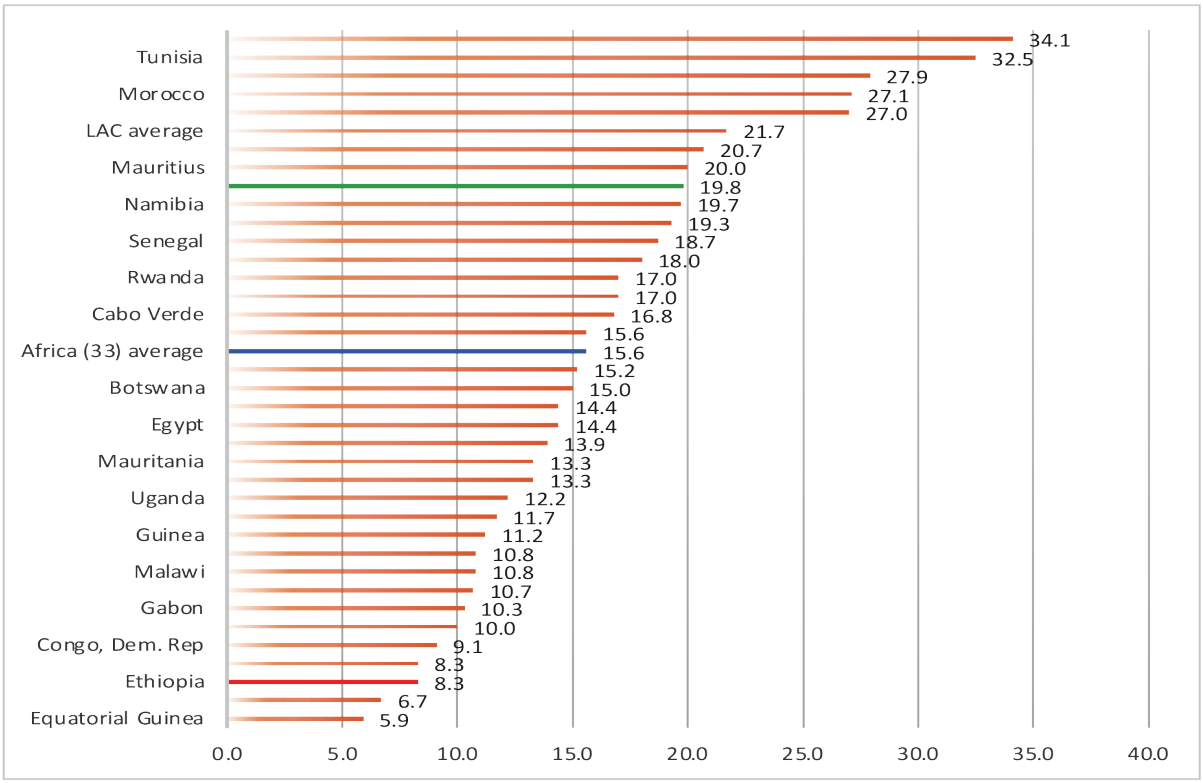


Source: Own computation using Data from the Ministry of Finance.

Box1.1 African Countries tax –to-GDP Ratio

In 2021, the Africa (33) average tax-to-GDP ratio remained below its pre-pandemic level of 15.8% in 2019, having declined by 0.3 percentage points (p.p.) in 2020. This was also the case for the Asia-Pacific region, whose average tax-to-GDP ratio declined by 0.9 p.p. in 2020 before increasing by 0.2 p.p. in 2021. By contrast, the average tax-to-GDP ratio in the LAC region increased by 0.8 p.p. and regained its pre-pandemic level in 2021. In the OECD, tax revenues increased as a percentage of GDP in both years on average. These figures underscore the urgent need for enhancing tax administration and broadening the tax base in African countries to ensure stable and increasing revenue streams that can fund crucial development projects and bolster economic resilience. Tax-to-GDP ratios varied widely across the 33 countries in 2021, from 5.9% in Equatorial Guinea to 32.5% in Tunisia. Tax revenues as a percentage of GDP increased in 20 countries and decreased in 13 between 2020 and 2021. Chad registered the largest decrease, of 4.6 p.p., followed by the Seychelles and Equatorial Guinea (2.6 p.p. and 2.5 p.p. respectively). By contrast, Botswana's tax-to-GDP ratio recorded the largest increase in 2021 (of 2.8 p.p.), followed by South Africa (1.9 p.p.) and the Democratic Republic of the Congo (1.8 p.p.). Reflecting the diverse economic landscapes within Africa, tax-to-GDP ratios exhibited substantial variance, highlighting the necessity for country-specific tax policy designs and implementation strategies. The increase in the Africa (33) average tax-to-GDP ratio between 2010 and 2021 was mainly generated by value added tax (VAT) and personal income tax. In 2021, taxes on goods and services remained the main source of tax revenues in Africa, accounting for an average of 51.9% of total tax revenues, with VAT accounting for 27.8%. Taxes on income and profits accounted for 37.9% of tax revenues. Taxes on goods and services were the main source of tax revenues for 24 of the countries included in this report in 2021. For the other nine countries, taxes on income and profits accounted for the principal share. Between 2020 and 2021, revenues from taxes on goods and services increased by 0.2% of GDP on average; this category was most adversely affected by the COVID-19 pandemic in 2020, decreasing by 0.4% of GDP. Within taxes on goods and services, increases of 0.1 p.p. in 2021 in revenues from VAT represented a modest rebound following a 0.3 p.p. decrease between 2019 and 2020. Revenues from income taxes decreased by 0.1 p.p. on average in 2021 due to a fall in corporate income tax revenues over the period, having remained stable between 2019 and 2020. Social security contributions decreased by 0.1 p.p. in 2021, following an increase of the same magnitude in 2020.s
Source: (OECD et al., 2023) Revenue Statistics in Africa 2023

Figure 3.7: Tax to GDP Ratio (in percent) for Ethiopia and Other African Countries (2021)



Source: OECD 2023: Revenue Statistics in Africa 2023

3.2 Government Expenditure

Like in any other developing country, government expenditure in Ethiopia plays a crucial role in supporting economic growth and development. The pattern of government spending in Ethiopia has been centered on directing more resources into the development of economic and social infrastructure to provide basic services and eradicate poverty. In the fiscal year 2022/23, total government expenditure reached ETB 943.9 billion increasing from ETB 185.5 billion a decade ago in 2013/14. Over the last decade, between the period 2013/14 and 2022/23, government expenditure has registered an annual average growth rate of 20 percent. This high and consistent growth in government expenditure is expected given the growing demand for public services that comes with economic growth and urbanization. Specifically, there has been very high demand for spending on infrastructure (roads and railways, power generation and transmission, telecommunication), as well as in education and health facilities. On top of this, especially in recent years, there has been a growing demand for debt servicing costs.

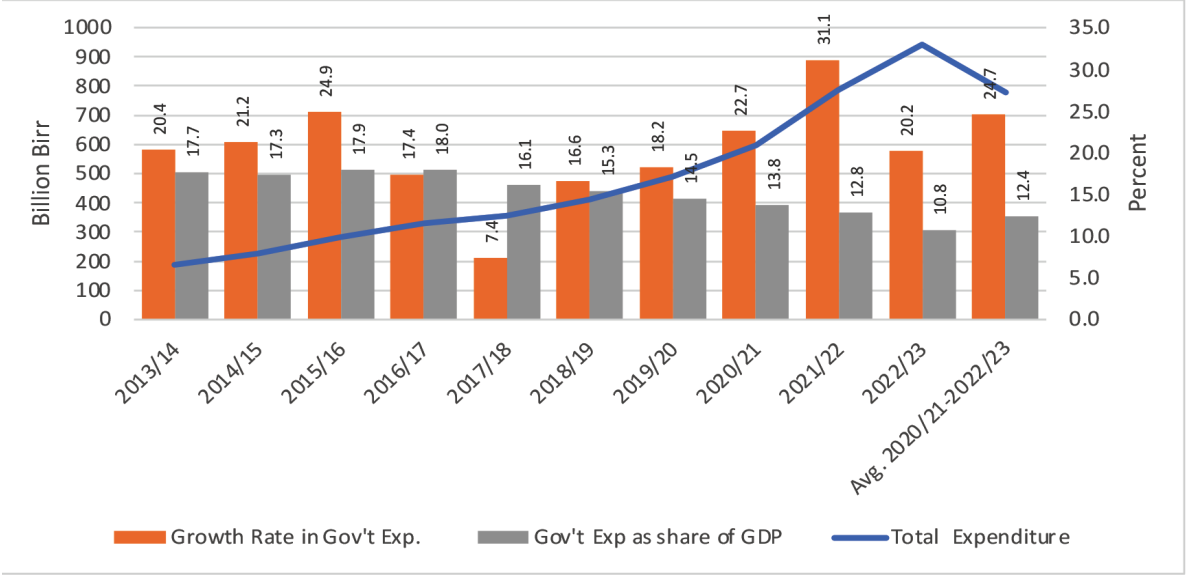
A significant and consistent rise in government expenditure has also been observed in recent years. The annual growth rate of government expenditure in 2020/21, 2021/22, 2022/23 has been 22.7 percent, 31.1 percent, and 20.2 percent, respectively (see Figure 3.8). The growth rate registered in these three years, averaging 24.7 percent, is relatively higher than the 18 percent average registered over the period 2013/14-2019/20. The increase in total expenditure during the recent consecutive years has been observed both in recurrent and capital expenditures. This relatively higher increase

in government expenditure can be attributed to the additional spending needed to respond to the COVID-19 pandemic and other natural and manmade disasters that occurred in different parts of the country. Moreover, the increase in government spending observed in recent years can be attributed to the rising level of inflation and debt servicing costs. During high inflation periods, the increase in government spending needs to be high to maintain real spending levels. Since this is likely to exacerbate the inflationary pressures, it is important to maintain a balance between avoiding erosion of the real expenditure and adopting a tighter fiscal policy needed to control inflation.

In general, when looking at the performance of government expenditures, it is important to take into account the growth rate of the economy, its development needs, fiscal capacity, and debt levels as well as the rate of inflation in the economy. MoF has been trying to strike a balance between supporting economic growth and ensuring fiscal sustainability as well as controlling inflationary pressures. For example, in the 2022/23 fiscal year, growth in government spending slid back to 19.5 percent as the government is conscious of the country's level of indebtedness and is determined to control the rampant inflation rate.

Moreover, we can see that the expenditure-to-GDP ratio has been dropping as part of the government's endeavor to cover its expenditures with domestic sources and reduce the budget deficit. The decade average share of government expenditure in GDP has been 15.4 percent. However, since the fiscal year 2017/18, the government expenditure share in GDP has been consistently declining and reached 10.8 percent in 2022/23. This is not only below the decade average but also the lowest level during the decade.

Figure 3.8: Government expenditure trend from 2013/2014-2022/23

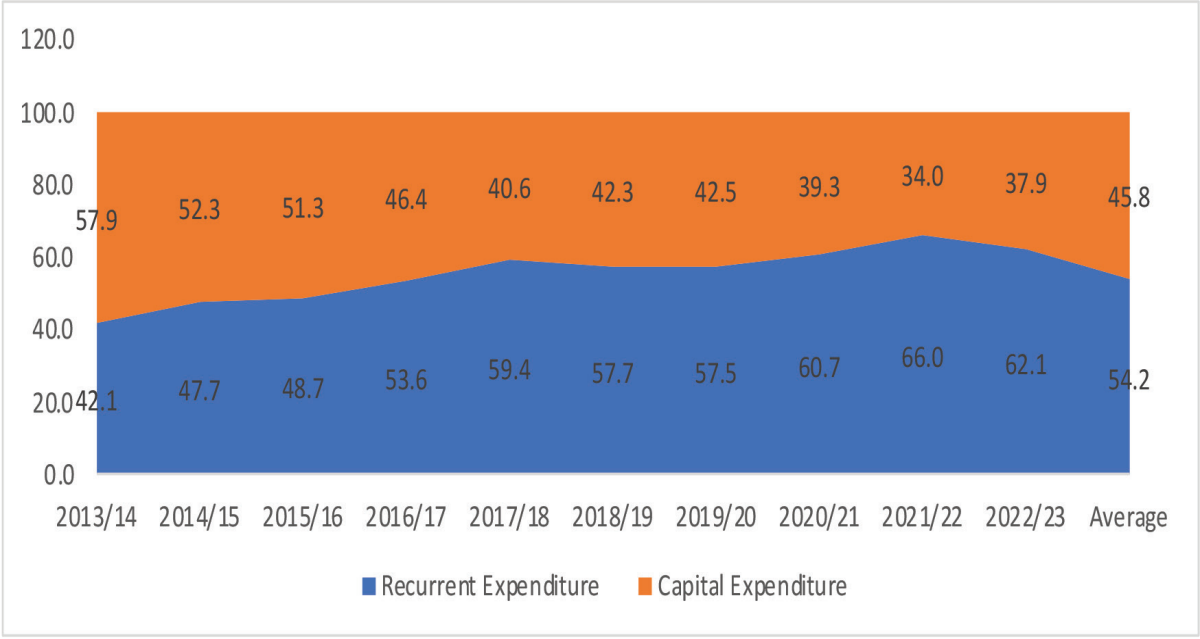


Source: Own computation using Data from the Ministry of Finance.

In alignment with the broad fiscal policy objectives of poverty reduction, provision of basic services, and infrastructure development, the annual budget aimed to allocate more resources toward these critical sectors. Prior to the 2016/17 fiscal year, the majority of government expenditure

was dedicated to capital expenditures, which are crucial for promoting social services. However, since 2016/17, a shift has occurred, with government expenditure becoming increasingly biased towards recurrent expenditure. Consequently, the share of capital expenditure in total government expenditure has experienced a significant decline, dropping from 57.9 percent in 2013/14 to 37.9 percent in 2022/23 (see Figure 3.9)). This trend contradicts the government's firm commitment to allocating a larger proportion of financial resources to capital expenditures and is driven by the multifaceted challenges facing the country. Specifically, the increased government spending required for peacekeeping and law enforcement operations, reconstruction and rehabilitation of conflict-affected areas, humanitarian aid for populations affected by conflicts and other natural disasters, as well as mounting debt service payments, have resulted in a higher share of recurrent expenditure. Despite the initial focus on capital investments, these pressing issues have necessitated a reallocation of funds towards recurrent expenditure.

Figure 3.9: Shares of Capital and Recurrent Expenditures in Total Government Expenditure (in percent)



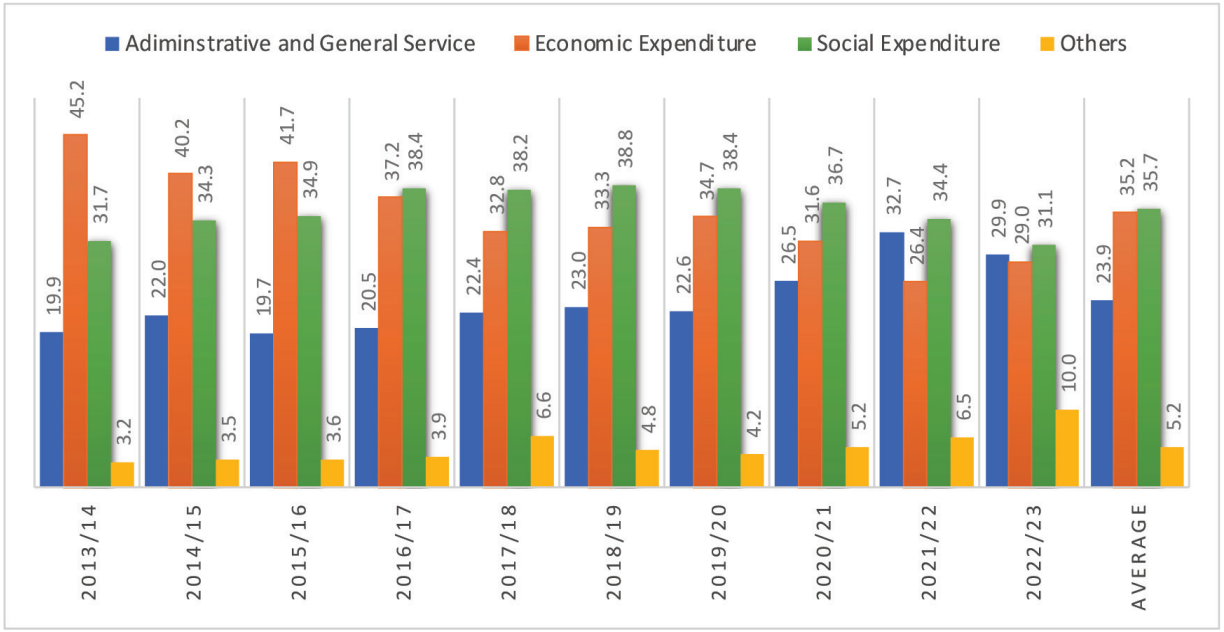
Source: Own computation using Data from the Ministry of Finance.

According to the Classification of Functions of Government (COFOG), expenditures can be categorized as economic, social, and administrative and general service expenditures. Over the past ten years, on average, approximately 70.9 percent of total government expenditure was allocated to social and economic functions, with economic expenditure accounting for 35.2 percent and social expenditure accounting for the remaining 35.7 percent. Although economic and social expenditures had nearly equal shares of total expenditure in the decade average, social expenditure has surpassed economic expenditure since the 2016/17 fiscal year. For instance, in the 2013/14 fiscal year, the share of economic expenditure was 45.2 percent, while social expenditure accounted for 31.7 percent. However, in 2021/22, the share of social expenditure reached 34.4 percent, while economic expenditure's share stood at 26.4 percent. This gap narrowed a bit in the 2022/23 fiscal year, with social expenditure and economic expenditures accounting for 31.1

percent and 29 percent, respectively.

The increase in the share of social expenditure observed in the recent three fiscal years is mainly attributed to the rise in rehabilitation costs for people affected by various factors, such as drought and war. In relation to this, during the 2020/21, 2021/22, and 2022/23 fiscal years, ETB 6.5, ETB 19.2, and ETB 12.0 billion were allocated for rehabilitation efforts, respectively. Moreover, over the recent three consecutive years, the combined share of social and economic expenditures has been declining, while the share of administrative expenditure has been rising (see Figure 3.10). This trend is likely due to increases in defense spending, which has taken up the highest share of expenditures on administrative and general services.

Figure 3.10: Share of Government expenditure by functional from (in percent)



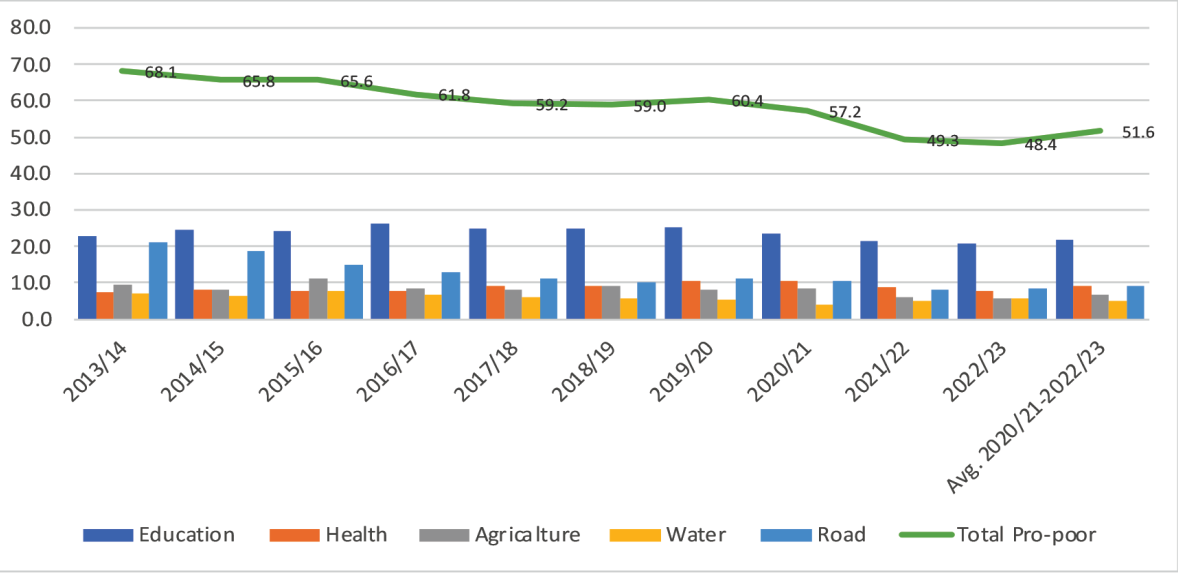
Source: Own computation using Data from the Ministry of Finance.

The government of Ethiopia is striving to enhance the livelihoods of its citizens and eradicate poverty by formulating policies that promote inclusive economic growth, human development, and job creation. The government prioritizes budget allocations to sectors directly contributing to poverty reduction, including agriculture, education, health, and infrastructure development. Concurrently, it leverages tax policy to redistribute wealth and incentivize employment-generating sectors, while deploying productive safety net programs to support the most vulnerable populations. Recognizing that the majority of the poor reside in rural areas, the government places particular emphasis on rural development and the agricultural sector. Furthermore, in addition to promoting economic growth, the government focuses on the provision of essential services and infrastructure such as education, health, water, and roads, which are vital for improving overall living standards.

The Ethiopian government has demonstrated a steadfast commitment to pro-poor sectors over the past decade, despite facing economic challenges and increasing debt service payments. Consequently, over the past decade, the government has consistently allocated a significant portion of its annual budget to finance essential basic services and infrastructure development. The average pro-poor spending during this period amounted to approximately 60.5 percent of

total expenditure, with the education, road, and health sectors receiving the largest allocations. In the 2022/23 fiscal year, pro-poor expenditure accounted for 48.4 percent of total expenditure. The sectoral breakdown of this allocation was as follows: education (20.8 percent), roads (8.6 percent), health (7.7 percent), agriculture (5.7 percent), and water (5.6 percent) (see Figure 3.11). Despite the recent decline, these figures demonstrate the government's ongoing commitment to investing in critical sectors that directly impact poverty reduction and social development.

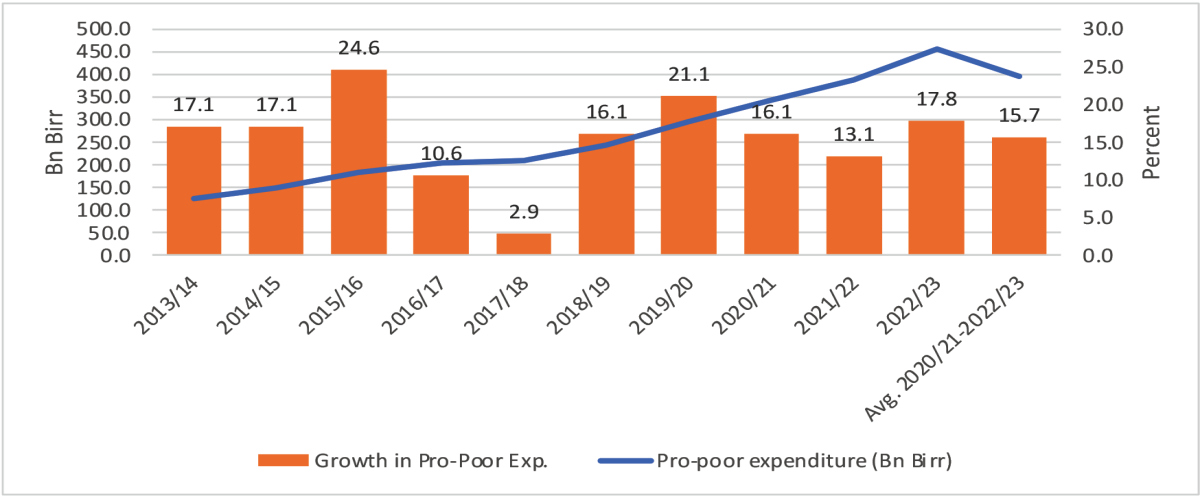
Figure 3.11: Share of Pro-Poor Expenditure and its Components in Total Expenditure (percent)



Source: Own computation using Data from the Ministry of Finance.

The government's commitment to pro-poor sectors remains evident, despite recent decreases in the share of funds channeled to these sectors forced by the multifaceted challenges. While the decade-long average share of pro-poor expenditure to total expenditure was 60.5 percent, it averaged 51.6 percent over the last three years. This slight decline notwithstanding, the growth rate of pro-poor sector expenditure has remained consistent, averaging 15.7 percent annually over both the past decade and the most recent three-year period. Significantly, the 2022/23 fiscal year saw an accelerated growth of 17.8 percent in pro-poor spending, reversing the trend of the previous two years (see Figure 3.12). This sustained allocation and growth in pro-poor expenditure, particularly in the face of multiple economic shocks and mounting fiscal pressures, underscores the government's unwavering dedication to fostering broad-based pro-poor growth, employment creation, and human development.

Figure 3.12: Annual growth of Pro-Poor Sector Government Expenditure (in percent)



Source: Own computation using Data from the Ministry of Finance.

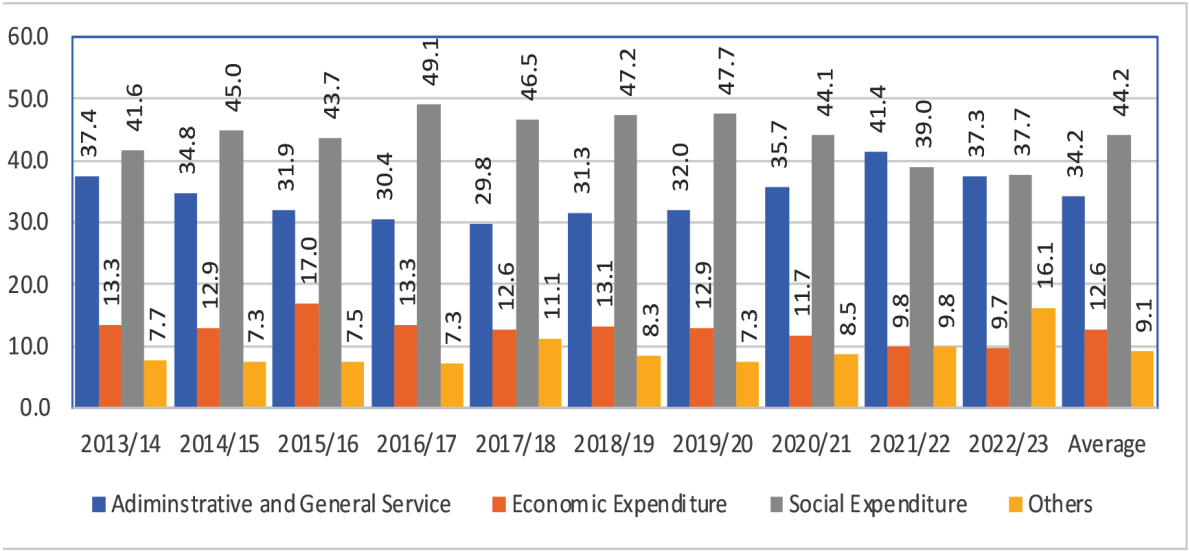
3.2.1 Recurrent Expenditure

Recurrent expenditures refer to operational and day-to-day expenses of the government that recur regularly. This may include government spending to finance the purchase of goods and services needed for running the government's day-to-day operations, wages and salaries of public servants, operational costs, interest payments on government debt, and more. Functionally, recurrent expenditure is divided into administrative and general services, economic services, social services, and others. Administrative and general services largely consist of the organs of the state, justice, police, defense, and general services. Government institutions including finance, planning, statistics, and mapping are part of the general services segment of expenditure. Major expenditure components of economic services include agriculture and natural resources, water, mining, energy, industry, trade, transport, communication, roads, and housing. As the name suggests, social services contain education, health, labor and social welfare, and rehabilitation.

During the 2022/23 fiscal year, the general government's total recurrent expenditure amounted to ETB 583.2 billion, a 12.6 percent increase compared to the ETB 518.1 billion recorded in the preceding year. Social services, general services, economic services, and others accounted for 37.7 percent, 37.3 percent, 9.6 percent, and 16.1 percent of the total recurrent expenditure, respectively. Over the last decade, the average share of social services, general services, economic services, and other expenditures in the total recurrent expenditure was 44.2 percent, 34.2 percent, 12.6 percent, and 9.1 percent, respectively (see Figure 3.13).

In the recent three consecutive years, slight shifts have been observed among the components of recurrent expenditure. The shares of social and economic expenditures have shown a declining trend, reaching 37.3 percent and 9.6 percent in 2022/23, from 47.7 percent and 12.9 percent in 2019/20, respectively. In contrast, the shares of general services and other expenditures exhibited an increasing trend during the same period. For instance, the share of other expenditures in the fiscal year 2022/23 exceeded the one in the fiscal year 2019/20 by 8.8 percentage points. The increase in the share of other expenditures might be attributed to the increasing internal and external debt servicing costs observed in recent years.

Figure 3.13: Recurrent Expenditure by Major Categories (Percentage Share)



Source: Own computation using Data from the Ministry of Finance.

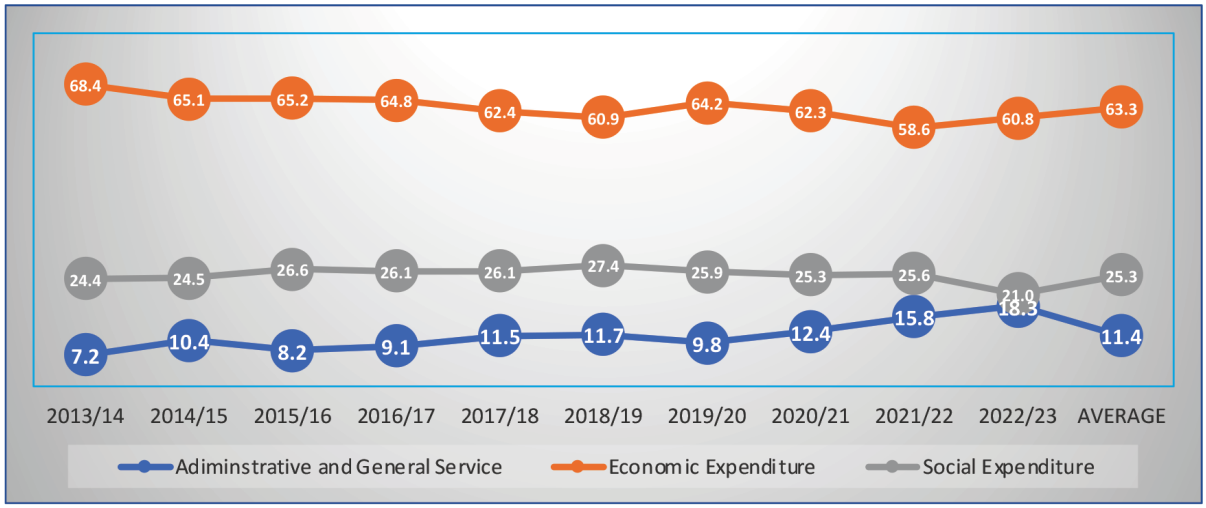
3.2.2 Capital Expenditure

Capital expenditure refers to government spending for the acquisition of assets or construction of infrastructure that provides benefits over an extended period. These may involve spending on the construction of physical assets for government use (for example, office buildings), economic and social infrastructures that benefit citizens, and infrastructures that create an enabling environment for private sector development, such as roads, water, energy, schools, hospitals, clinics, and research. As a result of these, government capital spending is expected to boost economic growth and productivity as well as attract private-sector investment.

The functional classification for capital expenditure is similar to recurrent expenditure and consists of administrative and general services, economic development, and social development. The budgetary institutions under each category are also the same as those for recurrent expenditure. In the fiscal year 2022/23, the general government's total capital expenditure was ETB 355.7 billion, representing a 33.1 percent increase compared to the preceding year (see Figure 3.13). Among the components of capital expenditure, expenditure on economic development accounted for the largest share at 60.8 percent of the total in 2022/23, followed by social expenditure at 21 percent and general services at 18.3 percent. Similarly, over the last decade, the average shares of economic, social, and general service expenditures were 63.3 percent, 25.3 percent, and 11.4 percent, respectively. Overall, no significant shifts were observed among the three components of capital expenditures during this period.

During the fiscal year 2022/23, the share of capital expenditure to GDP was 4.1 percent, showing a slight decrease from the previous year. Approximately 79.8 percent of the total capital expenditure was financed from treasury sources, while the remaining 20.2 percent was financed through external assistance and loans.

Figure 3.14: Share of Sectoral Capital Expenditure from total Capital Expenditure (in percent)



Source: Own computation using Data from the Ministry of Finance.

3.3 Fiscal Deficit and Financing

Governments around the world run fiscal deficits as they aim to promote economic development and social well-being. Running deficits, sometimes excessive deficits, are common among developing countries due to resource constraints, limited domestic resource mobilization, and high development needs. This is acceptable and can even be desirable in order to raise the much-needed funds for development. However, governments should strive to avoid persistently high deficits and should finance the deficit using instruments that do not lead to inflation. If a deficit is not prudently managed, it can result in unsustainable debt accumulation, crowding out private investment, and financing that may cause inflationary pressures and macroeconomic instability.

In view of this, one of the fiscal reforms included in the first Homegrown Economic Reform (HGER 1.0) program was to limit the fiscal deficit to 3 percent of GDP and minimize inflationary financing. Specifically, the government aimed to limit the use of direct advances from the National Bank of Ethiopia (NBE) and eventually abolish their use over time. However, fiscal pressures arose due to the COVID-19 pandemic, natural disasters, the conflict in the northern part of the country, and the lack of budget support from development partners, causing the budget deficit to grow after 2019/20.

Particularly, in the 2020/21 and 2021/22 fiscal years, the deficit widened to 3.6 and 4.2 percent, respectively, exceeding the 3 percent target. Moreover, direct advances taken from the NBE to cover the budget deficit increased significantly during these fiscal years. In 2022/23, as the impacts of some challenges receded, and with the government's strict fiscal policy measures, it was possible to reduce the budget deficit to 2.6 percent of GDP. Consequently, the direct advance taken from the NBE to cover the deficit was significantly reduced compared to the 2021/22 fiscal year. In 2022/23, financing was achieved using both domestic (2.5 percent of GDP) and external (0.3 percent of GDP) instruments (see Table 3.1).

Table 3.1: General Government Budget Financing: 2013/14-2022/23 (in percent of GDP)

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Revenue	**14.0**	**14.4**	**14.8**	**14.1**	**12.3**	**11.5**	**10.5**	**9.6**	**8.1**	**7.8**
Tax Revenue	12.7	12.7	12.1	11.5	10.7	10.0	9.2	8.3	7.1	6.8
Non-Tax Revenue	1.2	1.6	2.6	2.6	1.6	1.6	1.3	1.2	1.0	1.0
Grant	1.1	1.0	0.8	0.7	0.8	1.2	1.2	0.8	0.4	0.4
Expense	**17.7**	**17.3**	**17.9**	**18.0**	**16.1**	**15.3**	**14.5**	**13.8**	**12.8**	**10.8**
Recurrent	7.5	8.3	8.7	9.6	9.6	8.8	8.3	8.4	8.4	6.7
Capital	10.3	9.1	9.2	8.3	6.5	6.5	6.2	5.4	4.3	4.1
Overall, Balance including Grant	**-2.6**	**-1.9**	**-2.3**	**-3.2**	**-3.0**	**-2.5**	**-2.8**	**-3.4**	**-4.2**	**-2.6**
Overall, Balance excluding Grant	**-3.8**	**-3.0**	**-3.1**	**-3.9**	**-3.8**	**-3.8**	**-4.0**	**-4.2**	**-4.7**	**-2.9**
Financing	**2.6**	**1.9**	**2.3**	**3.2**	**3.0**	**2.5**	**2.8**	**3.4**	**4.2**	**2.6**
Domestic Financing	1.3	1.4	1.6	1.8	2.3	1.3	1.2	2.5	4.3	2.5
External Financing	2.0	1.4	1.7	1.6	1.3	1.3	1.8	0.5	0.1	0.3
Privatization	0.0	0.0	0.0	0.6	0.4	0.0	0.0	0.0	0.0	0.0

Source: Own computation using Data from the Ministry of Finance.

4 DEVELOPMENTS IN ETHIOPIA'S PUBLIC DEBT

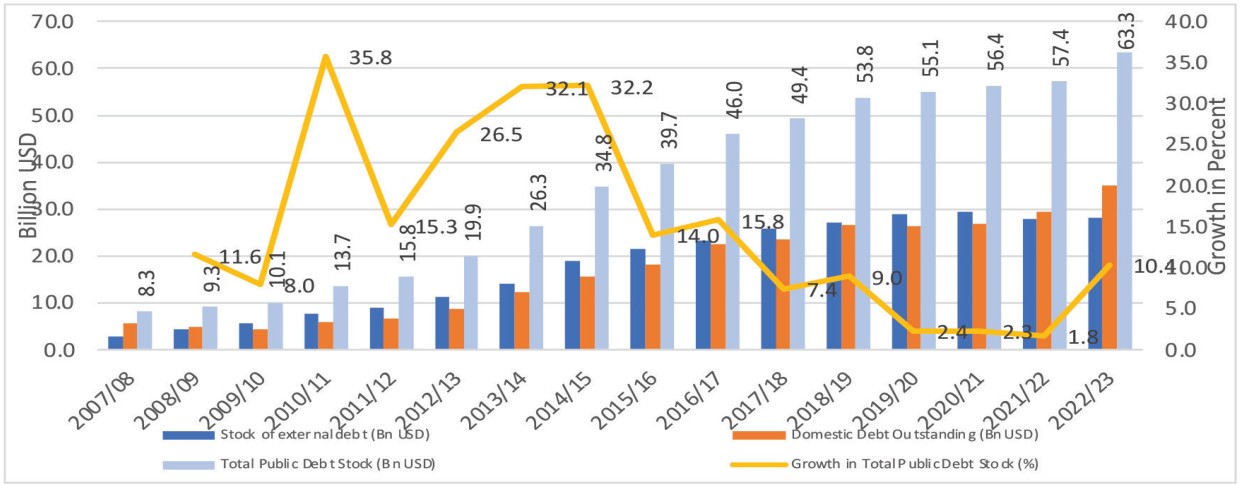
4.1 Ethiopia's Total Public Debt Stock

A country that runs fiscal and trade deficits must borrow money to finance these shortfalls, essentially living beyond its current means. While foreign debt is used to finance a country's import needs, domestic debt is primarily used to finance investment needs. In the case of Ethiopia, the underperforming export sector and limited private transfers through official channels result in foreign exchange constraints. As a result, foreign debt becomes crucial for raising the necessary capital for investment as well.

Especially in the decade leading up to 2017/18, public debt in Ethiopia increased significantly as there was a huge resource requirement to invest in infrastructure and other public sector projects outlined in the two Growth and Transformation Plans (GTP-I and GTP-II). Consequently, the country became heavily indebted because of how the government financed its state-led development agenda and the time and budget overruns in the country's flagship projects. During this period, Ethiopia's public sector debt doubled to reach 50 percent of GDP, with external debt tripling in a decade to reach 31.6 percent of GDP in 2017/18 ((MoF, 2020).

By the end of 2022/23, Ethiopia's total public debt stock (both domestic and external) reached a total of USD 63.3 billion (see Figure 4.1). Compared to the previous year, this is a 10.4 percent increase. However, between the period 2020/21-2022/23, Ethiopia's total public debt stock registered an annual average growth rate of only 4.8 percent. This is a major improvement compared to the pre-reform periods 2009/10-2013/14 and 2014/15-2018/19, which saw 23.5 percent and 15.7 percent annual average growth rates, respectively. Given Ethiopia's capital constraint and foreign currency shortage, taking these loans is fully justifiable. However, it is the lack of efficiency and effectiveness in the use of the proceeds of the loans that resulted in the accumulation of public debt in the country. On top of the dismal export performance, the fact that some of these loans were taken in non-concessional terms contributed to the debt distress the country is facing until now.

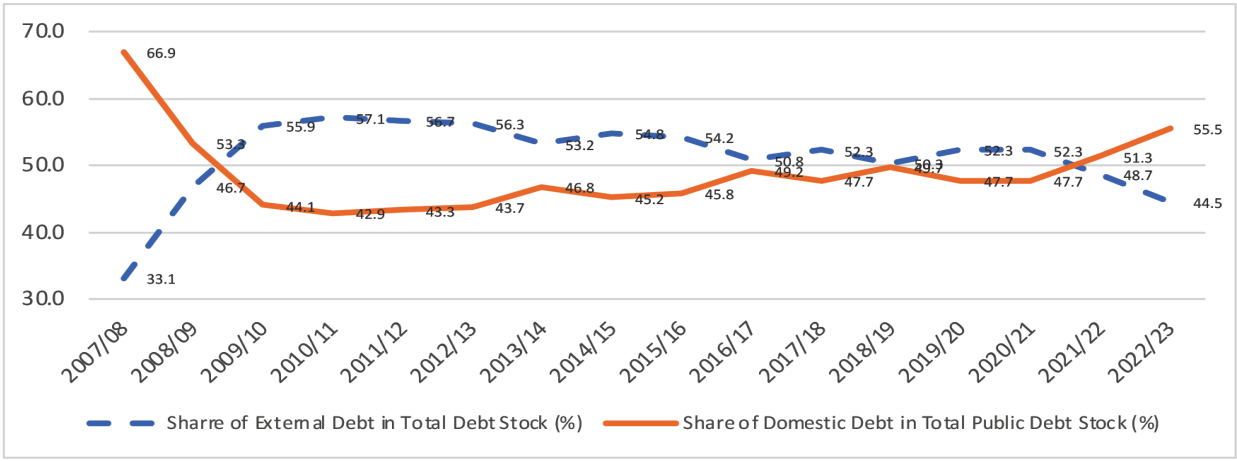
Figure 4.1: Trends in Ethiopia's Public Debt Stock



Source: Own computation using Data from MoF, Public Sector Debt Statistical Bulletin.

Before 2009/10, a relatively higher share of Ethiopia's public debt was domestic debt. It is only after 2009/10 that external debt takes a higher share of Ethiopia's total public debt. After 2020/21, this has been reversed following the drop in external debt and sharp increases in domestic debt observed in recent years. In 2022/23, 55.5 percent of Ethiopia's total public debt was taken from domestic sources. This shift towards a higher share of domestic debt is not unique to Ethiopia but is also observed in the rest of the Sub-Saharan Africa region. This has mostly been the result of COVID-19-related increased financing needs as well as the tightening of global financial conditions, which made external borrowing costly and less attractive, thereby pushing governments to domestic borrowing. In the case of Ethiopia, this shift towards domestic debt is partly explained by the government's strategic decision to limit non-concessional loans. As a result, there have been no government-guaranteed external loans to SOEs in the last four years, and only a small disbursement from existing SOE external loans has been made.

Figure 4.2: Trends in Shares of Domestic and External Debt Stocks in Total Public Debt Stock (%)



Source: Own computation using Data from MoF, Public Sector Debt Statistical Bulletin.

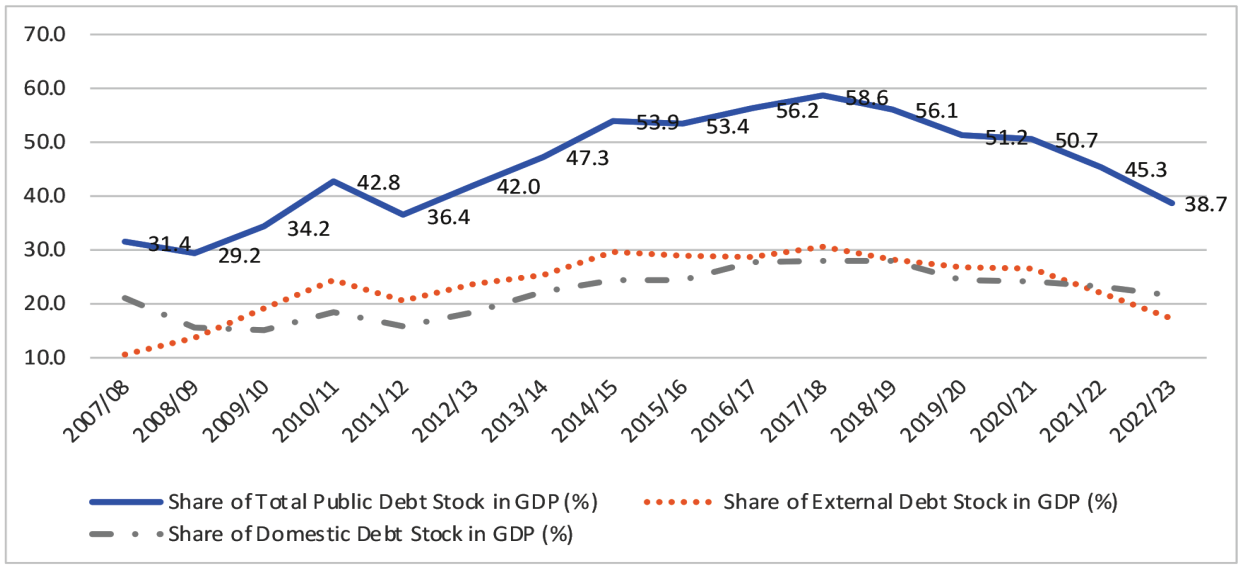
The need for servicing the country's accumulated debt is still putting a heavy fiscal burden on the government. The recent debt accumulation is partly due to exchange rate depreciation/ devaluation, growing interest payments, and the different local and global shocks that the country has faced in the last three to four years. The government has taken several measures to reduce the country's external debt vulnerability. These measures include putting a pause on non-concessional external loans, bilateral debt service restructuring, applying for the G20's Debt Service Suspension Initiative (DSSI), and requesting debt relief under the Common Framework (CF). Moreover, the government plans to develop a new Medium-term Debt Management Strategy, which will be made available by the end of the 2024/25 fiscal year.

[1]MoF Twitter July 11, 2022. The IMF supports the idea of a permanent, comprehensive, and credible mechanism to address the sovereign debt crises, and argues that the G20-Common Framework is the closest to this. The IMF further argues that this process should be faster, more inclusive, and cover all creditors. In addition to Ethiopia, Chad, Zambia, and Ghana are seeking debt restructuring via the Common Framework (World Bank, 2023a).

In general, as the country's public debt burden increases, the dilemma between sustaining economic growth/development and reducing the risk of debt vulnerability becomes a major issue. However, making public debt sustainable is undoubtedly a very important issue as unsustainable debt is a barrier to development and can even undo decades of development gains (World Bank, 2023b). For this reason, the government's fiscal policy focus has been supporting quality economic growth while ensuring debt sustainability through increased revenue mobilization and efficiency of government spending (MoF, 2020).

In recent years, the country has registered some encouraging results in reducing its debt distress. This has been mainly through improvements in the country's public debt management, export, and GDP growth performance. Specifically, after reaching a peak of 58.6 percent in 2017/18, Ethiopia's total public debt to GDP ratio started to decline and reached 50.7, 45.2, and 38.6 percent of GDP in 2020/21, 2021/22 and 2022/23, respectively (see Figure 4.3).

Figure 4.3: Trends in Ethiopia's Total Public Debt Stock in GDP (%)

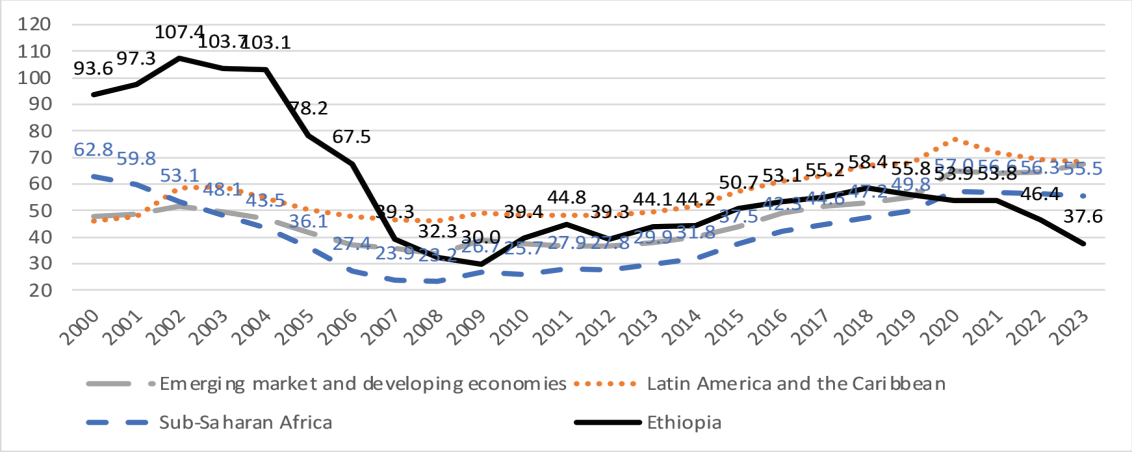


Source: Own computation using Data from MoF's Public Sector Debt Statistical Bulletin and GDP data obtained from MoPD.

As can be seen from Figure 4.4, prior to 2019, Ethiopia's total public debt as a percentage of GDP was relatively higher than the averages for Sub-Saharan Africa and Emerging Markets and Developing Economies. However, over the last four years, Ethiopia has significantly reduced its public debt-to-GDP ratio, which decreased from 51.2 percent in 2019/20 to 38.6 percent in 2022/23. This remarkable reduction can be attributed to the rapid growth in GDP and a decline in external debt. Consequently, Ethiopia's total public debt as a share of GDP is now lower than the averages for Sub-Saharan Africa and Emerging Markets and Developing Economies. During the past three years, while Ethiopia's average total public debt as a percentage of GDP stood at 45.9 percent, the Sub-Saharan Africa region averaged 56.1 percent. Only a few Sub-Saharan African countries have a debt-to-GDP ratio lower than Ethiopia's. Furthermore, the Present Value (PV) of

Ethiopia's total public debt as a share of GDP (35.4 percent for 2022/23) is below the 55 percent threshold for low-income country debt sustainability, a requirement for nations with medium debt-carrying capacity.

Figure 4.4: General Government Gross debt (Percent of GDP): Ethiopia vs. other developing regions



***Source: Own computation using Data from* ("World Economic Outlook Database," n.d.).**

Enhancing Ethiopia's debt sustainability necessitates addressing inefficiencies in public spending, improving project implementation capacity, and bolstering export performance. Moreover, it is imperative to implement rigorous fiscal consolidation measures, intensifying domestic resource mobilization efforts and minimizing the need for additional debt financing.

In the following sections, we will review developments in Ethiopia's external and domestic debt, with the aim of providing a comprehensive analysis by further disaggregating the data based on the composition of lenders, the purpose of the loans (sectoral allocation), and the status of various debt obligation payments. This in-depth examination will offer valuable insights into the country's debt situation.

4.2 External Debt Outstanding

Ethiopia's stock of external debt has been increasing over time reaching its all-time high of 29.5 billion USD in 2020/21. The issuance of the USD one billion bond in 2014 contributed to the buildup of Ethiopia's external debt, which started its dramatic growth in 2008/09. Since 2020/21, Ethiopia's external debt has started to decline and reached USD 28.2 billion in 2022/23. The growth of external debt has been declining since 2019/20 and registered a growth rate of 2.2 percent in 2020/21, -5.1 percent in 2021/22, and only 1.1 percent in 2022/23. This decrease in the growth of external debt can partly be attributed to the government's decision to suspend all non-concessional loans since 2019, SOEs, except EAL, not taking any new loans in the past four years, higher principal payments compared to new disbursements, the appreciation of the US dollar against other currencies resulted in a decline of external debt in USD terms, and changes in the global environment where there is a problem of accessing sufficient financing at an affordable cost. This trend is consistent with one of the objectives of the Macro-financial reforms of the HGER 1.0 agenda, which aims to reduce the risks and vulnerabilities associated with the accumulation of external debt.

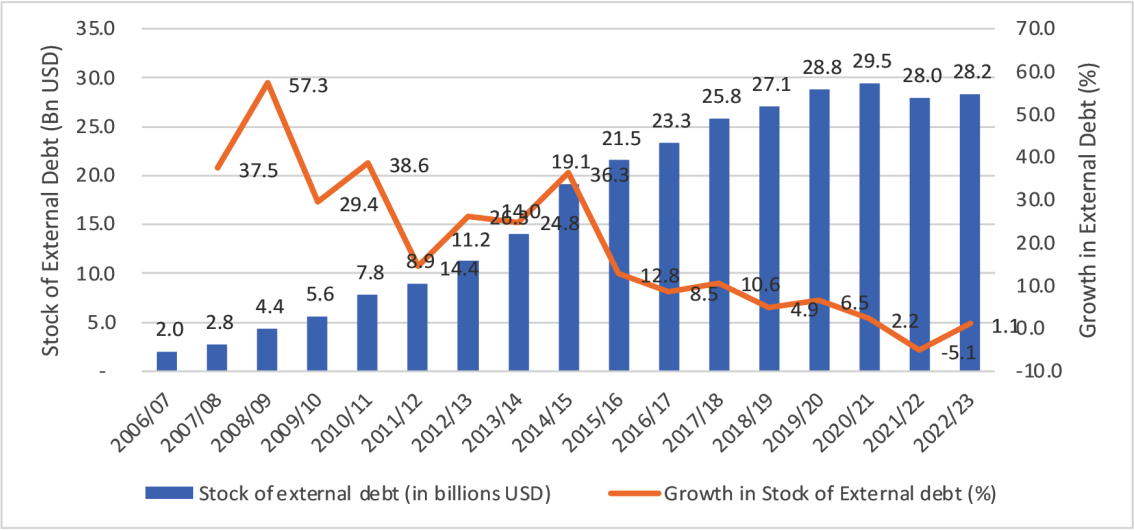
Similarly, Ethiopia's share of external debt in total public debt is declining. In 2020/21, the share of external debt was 52.3 percent and in 2020/21 this has declined to 48.7 percent. Ethiopia's external debt has become lower than its domestic debt for the first time since 2008/09. In 2022/23, the share of external debt decreased further and as of this year, only 44.5 percent of Ethiopia's total public debt is owned by foreigners (see Figure 4.5 and Figure 4.2).

Ethiopia's external debt situation has shown improvement in recent years, with the debt-to-GDP ratio declining from 30.6 percent in 2017/18 to 17.2 percent in 2022/23. Similarly, the Present Value (PV) of Ethiopia's external debt to GDP ratio declined from 22.1 percent in 2018/19 to 18.9 in 2020/21 and 2021/22 and 12.8 percent in 2022/23. This is within the low-income country debt sustainability threshold of 40 percent (for medium debt-carrying capacity).

However, Ethiopia breaches certain liquidity thresholds, such as the Present Value (PV) of external debt to export and debt service to export ratios. As of 2022/23, the PV of the external debt-to-export ratio stands at 182 percent, slightly higher than the 180 percent threshold, although it has improved significantly from 262.1 percent in 2019/20. Specifically, as of 2022/23, the PV of Ethiopia's external debt-to-export ratio is 182 percent. This is a bit higher than the 180 percent threshold and showed a lot of improvement over the years – from 262.1 percent in 2019/20 to 237.9 percent and 196.6 percent in 2020/21 and 2021/22, respectively. Although Ethiopia's debt service to export ratio has also dropped from 27.3 percent in 2018/19 to 22.4 percent in 2021/22, 20.8 percent in 2021/22, and 16.6 percent in 2022/23, it is still higher than the 15 percent threshold.

In sum, although Ethiopia's external debt-to-GDP ratio has declined and remained within the low-income country debt sustainability threshold, the country still faces challenges regarding the liquidity indicators. This warrants continued monitoring and prudent debt management strategies and redoubling efforts to increase export performance.

Figure 4.5: Trends in External Debt Stock and its Growth



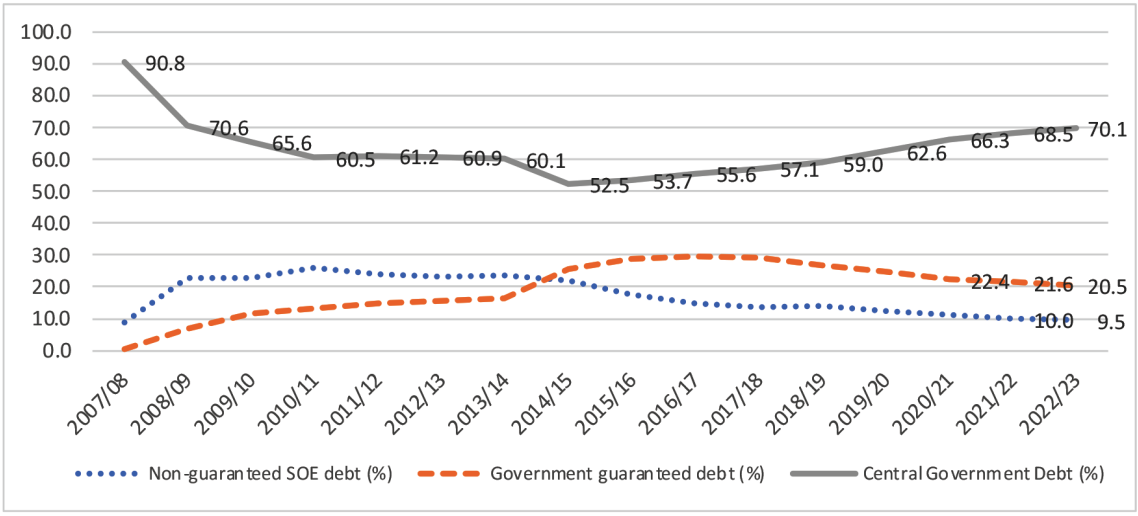
Source: Own computation using Data from MoF, Public Sector Debt Statistical Bulletin.

4.2.1 External Debt Composition

Ethiopia's external public debt stock comprises borrowings by the federal government, federal government-guaranteed SOE debt, and non-guaranteed SOE debt. The majority of the country's external debt is owed by the central government, whose share has steadily increased from its lowest level of 52.5 percent registered in 2014/15 to 70 percent in 2022/23.

Ethiopia's non-guaranteed external debt is mainly attributed to external loans taken by Ethiopian Airlines (EAL) and Ethio-Telecom. However, in recent years, only EAL has been taking new external loans and Ethio-telecom has reduced its new borrowings and disbursements. As a result, the share of non-guaranteed external debt stock has reduced from a high of 26.2 percent in 2010/11 to 12.5 percent, 11.3 percent, and 10 percent in 2020/21, 2021/22 and 2022/23, respectively. Similarly, the federal government-guaranteed external debt stock has also declined in the past five years. It declined from its historical height of 29.7 percent in 2017/18 to 25.1 percent in 2020/21, 22 percent in 2021/22, and 21.8 percent in 2022/23, respectively (see Figure 4.6).

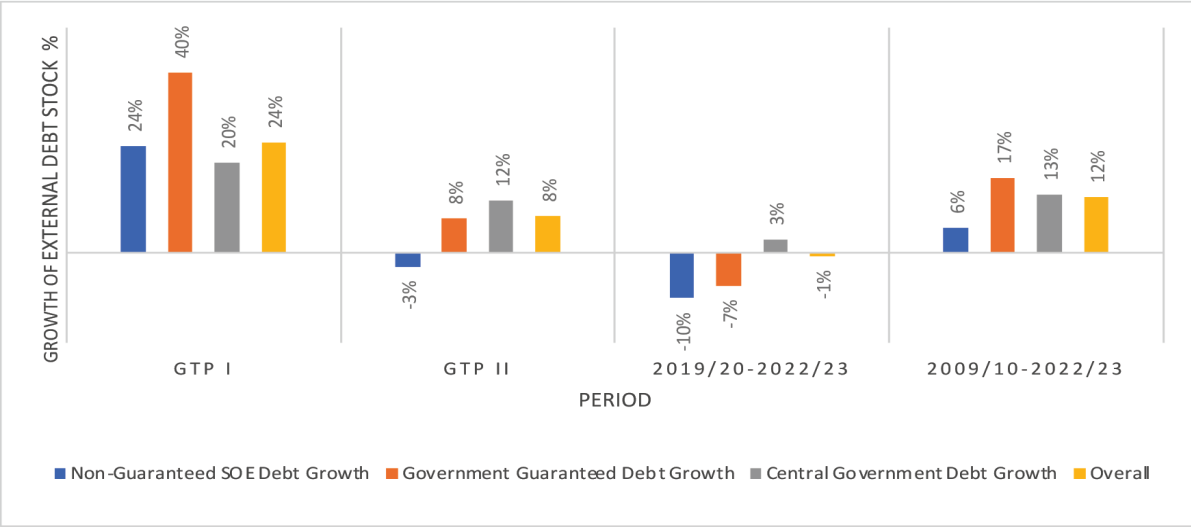
Figure 4.6: Composition of Ethiopia's External Debt (Percentage Share of Total Public Debt)



Source: Own computation using Data from MoF, Public Sector Debt Statistical Bulletin.

The growth of external debt stock has been the highest during the GTP I period (2020/11-2014/15). During these years, overall external debt stock has registered an average growth rate of 24 percent. In GTP II period, this declined to 8 percent and further declined in the four years after 2019/20 to -1 percent. While government-guaranteed debt stock has registered the highest (40- percent) average growth in the GTP I period, the non-government-guaranteed debt stock registered an average growth rate of 24 percent in the same period. The government-guaranteed debt stock has continued to register a positive but lower (8 percent) growth rate in the GTP II period, in the period after that it registered a negative 7 percent average growth rate. On the other hand, the non-government guaranteed debt stock has registered a negative growth rate in both the GTP II period (-3 percent) and the period after 2019/20 (-10 percent) (see Figure 4.7).

Figure 4.7: Growth of External Debt Stock by Debt Holder



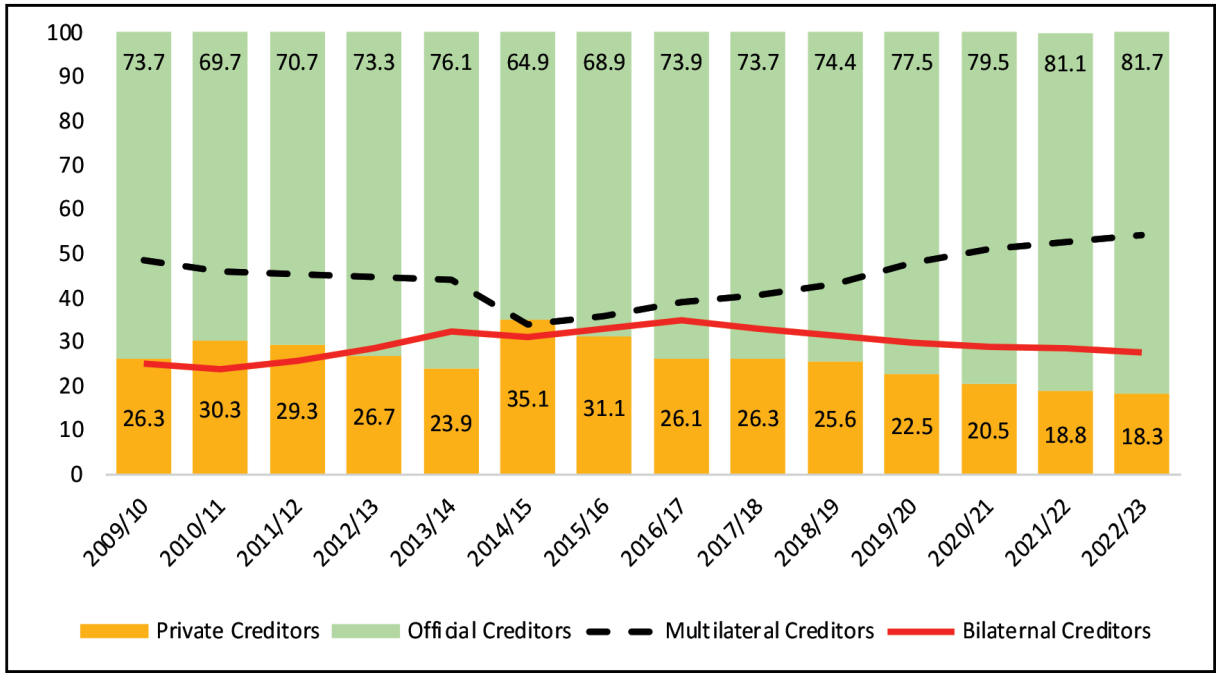
Source: Own computation using Data from MoF, Public Sector Debt Statistical Bulletin.

4.2.2 External Debt by Source

The sources of external debt can be broadly categorized into three: Multilateral, bilateral, and private creditors. The major multilateral creditors include the World Bank, IMF, the African Development Bank (AfDB), the African Development Fund (AfDF), the International Development Association (IDA), the European Union (EU), Arab Bank for Economic Development for Africa, the OPEC Fund for International Development, etc. On the other hand, Ethiopia's Bilateral creditors include the Paris Club members (Italy, France, Exim Bank of Korea, Government of Japan, etc.) and non-Paris Club members including Exim-Bank of India, Kuwait Fund, Saudi Fund, ABU DHABI FUND, China (CDB, EXIM-BANK OF CHINA, ICBC) etc. Ethiopia's private creditors are mainly foreign commercial banks, suppliers, and bond and note holders (Eurobond holders). While the loans taken from private sources carry commercial rates, parts of the multilateral and bilateral loans are extended on terms substantially more generous.

The majority of Ethiopia's external debt is owed to official creditors (bilateral and multilateral). In the last three years, the shares of official creditors have been 79.5 percent, 81.1 percent, and 81.5 percent in 2020/21, 2021/22, and 2022/23, respectively. Of the official sources, the contribution of multilateral creditors has been on the rise since 2014/15, reaching 54.4 percent in 2022/23, the share of bilateral creditors has been on the decline since 2016/17 and reached its lowest level of 27.2 percent in 2022/23. On the other hand, the share owed to private creditors reached its maximum of 35.1 percent following the issuance of the Eurobond in 2014/15 and has been on the decline since then, reaching 18.5 percent in 2022/23. The decline in the shares of bilateral and private sources can be attributed to the government's conscious decision to put a pause on non-concessional loans and a decrease in disbursements and new borrowings by the SOEs.

Figure 4.8: Total Public Sector Debt Outstanding by Major Creditors (percentage shares)



Source: Own computation using Data from MoF, Public Sector Debt Statistical Bulletin.

4.2.3 External Debt Average Terms and Grant Elements

The important elements/terms of any external loan include the interest rate payable on the loan, the grace period, and the maturity period. Together, these terms determine the grant element of the loan, which is a measure of its concessionality. This is also important to see how costly the debt is and to what extent it may lead to a debt servicing burden. For this reason, it is important to look at the evolution of the average borrowing terms of the country's external debt stock. Favorable terms like longer grace and maturity periods entail lesser immediate debt obligations. When coupled with low interest rates, we see an increase in the grant element of the loan. The grant element is important in determining if the loan can be considered concessional or not – according to the IMF, a loan with a grant element of 35 percent or above is a concessional loan.

Since 2019, following the launch of the HGER 1.0, the government of Ethiopia put in place a policy of taking loans with higher grant elements (concessional loans) only. As a result, the average grant elements, interest rate, maturity, and grace periods of loans taken in recent years showed noticeable improvements. The average grant element of central government's loans taken in the period 2020/21-2022/23 is 57.4 percent, and this is much higher than the 48.5 percent average grant element on loans taken in the period 2010/11-2019/20. The average grant element of the central government's loans taken in 2022/23 is 62.5 percent. Similarly, the average maturity (35.0 years) and grace (9.5 years) periods for loans taken in the 2020/21-2022/23 period are longer than the average maturity (33.8 years) and grace (7.7 years) of loans taken in the period 2010/11-2019/20. For the years 2020/21, 2021/22, and 2022/23, the average interest rates of loans taken by the central government were 0.8 percent, 0.5 percent, and 0.3 percent, respectively. The average interest rate payable for loans taken in the period 2020/21-2022/23 has been much less than the

average interest rate (1.3 percent) payable on loans taken in the period 2010/11-2019/20.
Loans taken by other public bodies (SOEs), guaranteed and non-guaranteed SOE loans, have less favorable terms compared to the loans taken by the central government. For the 2022/23 fiscal year, they have an average grant element of only 7.8 percent, which is 54.7 percentage points lower than the grant element in central government loans. The maturity and grace periods for SOE loans are also shorter, 12.5 years and 0.3 years, respectively. The 3.6 percent average interest rate payable on loans by other public bodies is 3.3 percentage points higher than the interest rate payable on central government loans. When we compare the average borrowing terms for the period 2010/11-2018/19 against the average terms for the period 2019/20-2022/23, we see that there is a significant improvement in the grant elements (5.1 percentage points higher) and average interest rate payable on the loans (1.3 percentage points lower).

Table 4.1: Public External Debt, New Commitment, Amount, Average Terms & Grant

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	Average (2010/11-2018/19)	Average (2019/20-2022/23)
Grand Total															
Committed Amount (Bn USD)	2.6	2.7	7.8	5.4	3.6	3.2	3.8	2.6	2.8	4.7	2.0	0.3	1.3	3.9	1.2
Interest Rate (avg. percent)	1.4	1.4	2.3	2.2	2.9	1.4	2.0	2.1	1.7	1.2	1.0	0.4	2.0	1.9	1.1
Maturity (avg.yrs)	23.5	27.8	21.9	23.8	22.6	30.2	24.1	31.1	28.5	15.7	31.5	12.7	25.8	24.9	23.3
Grace period (avg.yrs)	6.1	5.7	5.2	6.1	6.4	5.4	6.1	5.9	5.8	5.4	5.0	0.7	4.9	5.8	3.5
Grant Element (avg percent)	41.0	33.0	38.9	34.4	21.1	40.1	31.3	33.1	36.7	30.1	46.3	26.4	35.2	34.0	36.0
Central Government															
Committed Amount (Bn USD)	1.4	1.5	2.6	2.9	2.6	2.4	3.0	1.6	2.0	1.5	1.6	0.0	0.8	2.2	0.8
Interest Rate (avg. percent)	1.3	1.8	1.0	1.1	3.0	0.8	1.6	1.0	0.7	0.8	0.8	0.5	0.3	1.3	0.6
Maturity (avg.yrs)	32.7	37.1	37.4	34.2	27.0	37.3	27.2	42.8	34.9	27.8	35.9	30.0	39.1	33.8	35.0
Grace period (avg.yrs)	8.3	9.2	6.9	8.7	8.1	6.2	7.0	7.6	7.9	7.5	6.1	13.0	9.5	7.7	9.5
Grant Element (avg percent)	49.7	50.6	61.3	53.7	23.5	52.7	38.2	54.1	52.6	48.9	51.8	57.9	62.5	48.5	57.4
Other Public Sector															
Committed Amount (Bn USD)	1.2	1.2	5.2	2.4	1.0	0.8	0.8	1.0	0.8	3.3	0.4	0.3	0.5	1.8	0.4
Interest Rate (avg. percent)	1.6	2.1	2.9	3.6	2.6	3.3	3.6	3.8	4.3	1.3	1.8	0.4	3.6	2.9	1.9
Maturity (avg.yrs)	12.3	16.2	14.3	11.4	11.5	8.0	12.2	13.4	11.5	10.2	11.9	12.0	12.5	12.1	12.1
Grace period (avg.yrs)	3.5	1.4	4.4	3.0	2.1	2.7	2.2	3.3	0.3	4.5	0.3	0.3	0.3	2.7	0.3
Grant Element (avg percent)	25.9	16.8	27.4	10.7	14.1	8.9	9.2	9.5	3.4	24.9	17.8	25.9	7.8	15.1	17.2

Source: Own computation using Data from MoF, Public Sector Debt Statistical Bulletin.

4.2.4 External Debt Disbursement and Debt Service

How effectively and efficiently the debt is used is as important as the interest rate and maturity/grace periods. The allocation of debt money is very important – it has to be spent in sectors and projects that bring higher yield/returns – in terms of speeding up economic growth. Debt that is put to good use will not be a burden for future generations. The Government of Ethiopia seriously considers the implications of taking new external loans on the debt burden on future generations. Accordingly, every loan agreement goes through a stringent approval process and is finally approved by the House of Peoples' Representatives. To ensure transparency and accountability, every loan agreement signed is published on the Negarit Gazeta.

External debt disbursement by Economic Sectors

In terms of external loan allocation by sector, in the period 2010/11-2019/20 the transport and communication, highway transport, electricity, gas, and steam sectors received the highest share of external loan that Ethiopia received in the period. These sectors, on average, received 24.3 percent, 19.6 percent, and 17.5 percent of the external loans taken during the indicated period. In the period 2020/21-2022/23, this sectoral allocation remained more or less the same with the exception that the agricultural sector received the second-highest share (13.7 percent) of the external loan extended to Ethiopia during the period. In addition to agriculture, other pro-poor sectors like public and social administration, waterworks and supply, and PBS sectors received a relatively larger share of the external loan disbursed in the 2020/21-2022/23 period (see Table 4.2).

Table 4.2: Public Sector External Debt Disbursement by Economic Sectors (Percentage)

Sectors	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	Average (2010/11-2018/19)	Average (2019/20-2022/23)
Agriculture	0.7	2.0	6.2	9.2	1.6	14.6	17.9	6.8	8.9	6.9	17.8	13.9	9.5	7.5	13.7
Transport and Communication	42.1	21.8	34.4	44.5	24.0	3.9	8.9	16.6	31.5	15.1	24.9	25.8	37.2	24.3	29.3
Highway Transport	14.3	16.2	13.4	10.1	30.0	45.3	28.1	20.8	10.5	7.6	11.4	11.1	10.0	19.6	10.8
Electricity, Gas, Steam	17.0	29.9	15.0	14.4	16.0	14.5	17.0	28.4	6.7	16.4	11.9	15.2	8.2	17.5	11.8
Industry and Tourism	5.5	9.4	7.1	5.1	19.2	11.0	14.4	7.7	7.7	1.4	0.6			8.8	0.6

Source: Own computation using Data from MoF, Public Sector Debt Statistical Bulletin.

External debt service: Net-Flows and Net-Transfers

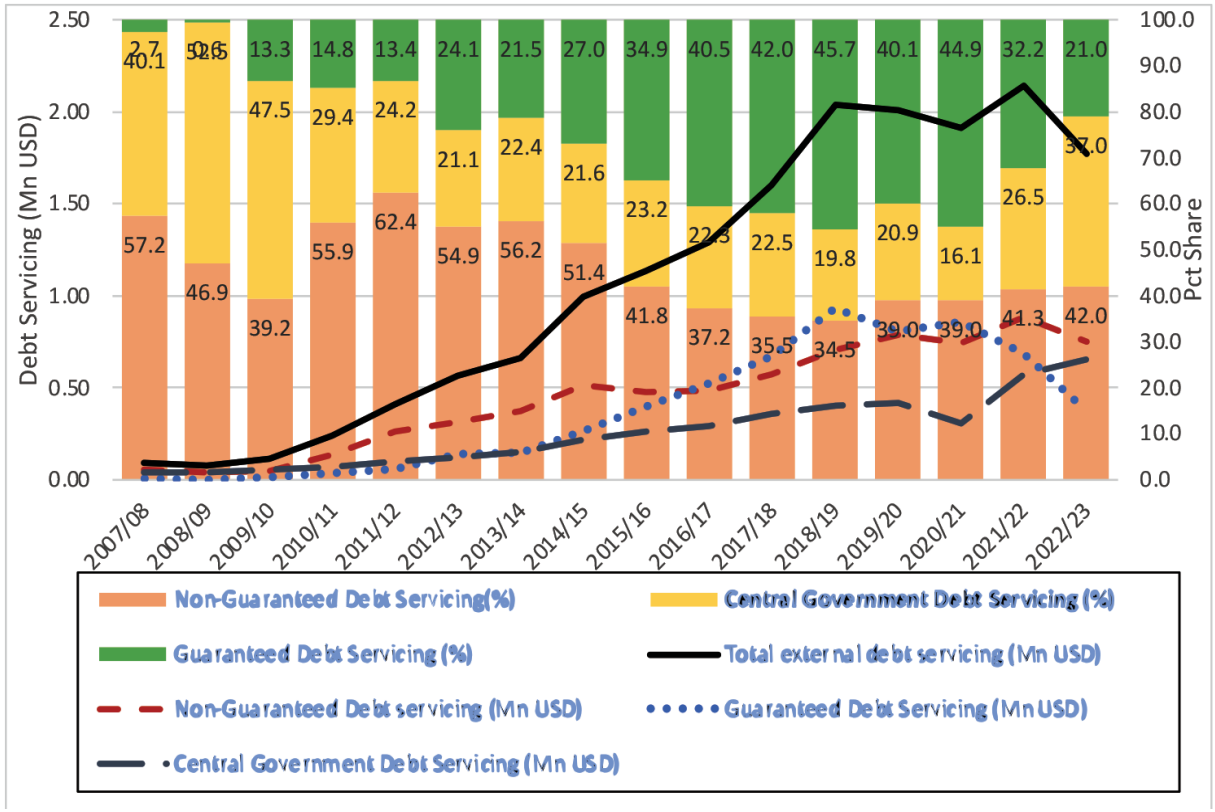
As a result of the debt that has been built up over the years, a substantial part of which is commercial debt, Ethiopia is faced with high external debt service payments, which has been increasing dramatically since 2009/10. The increased borrowing from private creditors, due to declines in multilateral and bilateral creditors that normally extend loans with generous terms, has undoubtedly contributed to the rising debt servicing costs that Ethiopia has faced. The external debt service payments have increased in recent years as most of the SOE loans have matured and principal payments have been made.

The overall external debt service payment has increased dramatically since 2009/10 (see Figure 4.9). This increase in debt payment has continued until 2018/19 and stabilized afterward. In the period 2009/10-2022/23, an average of 72.2 percent of the total debt service payment goes to payments of principal. Especially after 2016/17, principal payments have increased substantially mainly due to the maturity of most of SOE debts. In the period 2020/21-2022/23, principal payments account for 75.7 percent of the total external debt service payment, the remaining 24.3 percent covering payments of interest rate and other fees.

In 2020/21 and 2022/23, there have been declines in debt service payments and this can be attributed to the debt suspension agreements Ethiopia is making with its bilateral creditors. Specifically, the decline in debt service payments observed in 2020/21 is associated with the Debt Service Suspension Initiative (DSSI). Similarly, the decline observed in 2022/23 is due to the agreement between the GoE and its official bilateral creditors for a time-bound suspension of debt service due from 1 January 2023 to 31 December 2024. This agreement was coordinated through the Official Creditor Committee (OCC) of Ethiopia under the Common Framework, and it is in addition to the bilateral agreement between China and Ethiopia. These agreements are believed to provide Ethiopia with temporary liquidity relief ahead of discussions on a wider debt treatment.

In recent years, the local currency cost of external debt servicing has increased dramatically because of the continuous devaluation of the Ethiopian birr. Coupled with the limited access to resources for refinancing, this is putting a lot of pressure on the government budget.

Figure 4.9: External Debt Service Payments: Trends in Payment and Share of Each Debt Holder



Source: Own computation using Data from MoF, Public Sector Debt Statistical Bulletin.

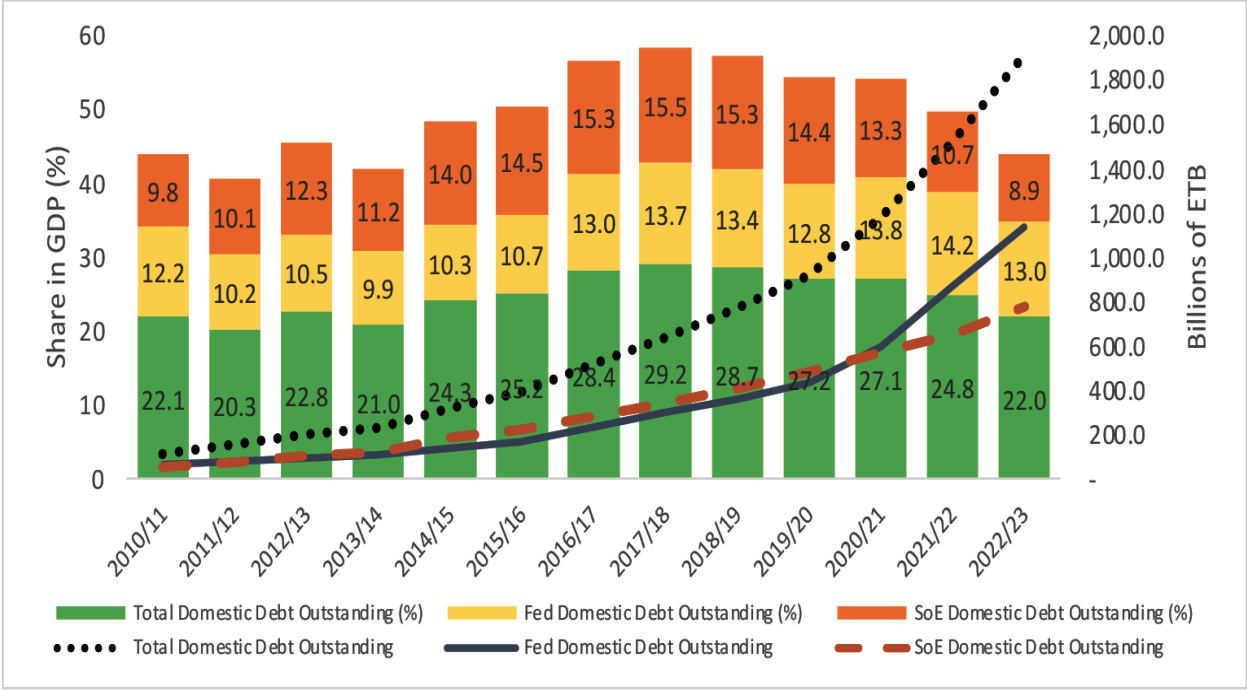
4.3 Domestic Debt Outstanding

Compared to external debt, domestic debt reduces the risk of a debt crisis as it does not involve a foreign exchange risk. Domestic debt is serviced in the local currency and does not lead to increases in the local currency cost of servicing the debt following a depreciation or devaluation in the exchange rate of the local currency. However, unless used efficiently and effectively, domestic debt can also have its macroeconomic ills – increases in inflation, the balance of payments pressures, crowding out private investment, and potential instability of the financial system if the government fails to service its domestic debt on time. Moreover, domestic debt may carry interest rate risk or rollover risk.

In recent years, the government of Ethiopia has increasingly relied on domestic sources of financing, partly due to the COVID-19 pandemic and other domestic and external shocks that led to increased government expenditure demands and limited access to affordable external finances. As a result, a steep increase in the stock of domestic debt has been observed, particularly after 2018/19, and the stock of domestic public debt reached ETB 1.2 trillion, ETB 1.5 trillion, and ETB 1.9 trillion in 2020/21, 2021/22, and 2022/23, respectively (see Figure 4.10). The growth in total public-sector domestic debt has accelerated in the last three years, registering an annual average growth rate of 27.5 percent, higher than the 20.9 percent annual average growth rate recorded in the preceding three years (2017/18-2019/20). Consequently, the share of domestic debt in total public debt has risen significantly, reaching 51.3 percent in 2021/22 and 55.5 percent in 2022/23, taking a higher share of total public debt for the first time since 2008/09.

The total domestic debt stock to GDP ratio has started showing a faster increase since 2013/14. Starting at a 21 percent share in 2013/14, it grew continuously reaching a peak of 29.2 percent in 2017/18. However, thanks to a faster growth rate of GDP, it starts to decline subsequently, with the ratio of total domestic public debt stock in GDP decreasing to 27.1 percent in 2020/21, 24.8 percent in 2021/22, and 22.0 percent in 2022/23.

Figure 4.10: Trends in Total Domestic Public Debt and Share in GDP



Source: Own computation using Data from MoF, Public Sector Debt Statistical Bulletin.

4.3.1 Public Domestic Debt by Debt Holder

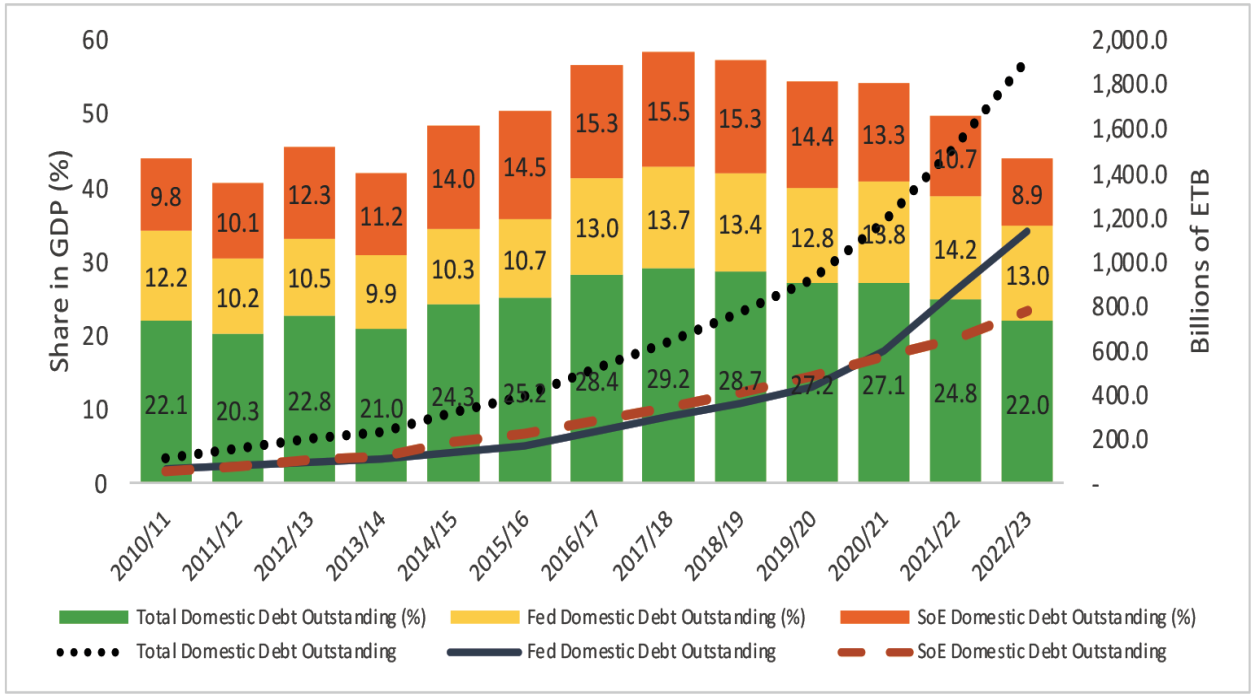
The country's total public-sector domestic debt stock discussed above can be divided into debt incurred by the federal government and debt taken by SOE from local sources in the form of corporate bonds and short- and long-term loans.

In the last three years, following the much faster increase in the central government's domestic debt stock that started in 2020/21, the central government's domestic debt stock has become higher than the domestic SOE debt stock for the first time in a decade. In 2022/23, the central government holds 59.2 percent of the total pubic-sector domestic debt stock, while SOEs own the remaining 40.8 percent (see Figure 4.11). This shift is partly attributable to the federal government's reduced access to foreign resources from development partners, coupled with the country's dramatically increasing expenditure needs arising from the multifaceted challenges it is facing.

SOE debt taken from local sources, mainly from the state-owned Commercial Bank of Ethiopia (CBE), has threatened the health and soundness of the financial sector as SOEs account for a significant share of the bank's overall loans. This has been acknowledged in the HGER 1.0 and some remedial measures have been taken to minimize this risk. The necessary care is also being taken to make sure that the recent dramatic increase in domestic borrowing by the central government

and delayed payments through debt reprofiling do not lead to severe liquidity constraints in the banking sector.

Figure 4.11: Trends in Central Government and SOE Debt Stock and Shares in Total Domestic Debt Stock



Source: Own computation using Data from MoF, Public Sector Debt Statistical Bulletin.

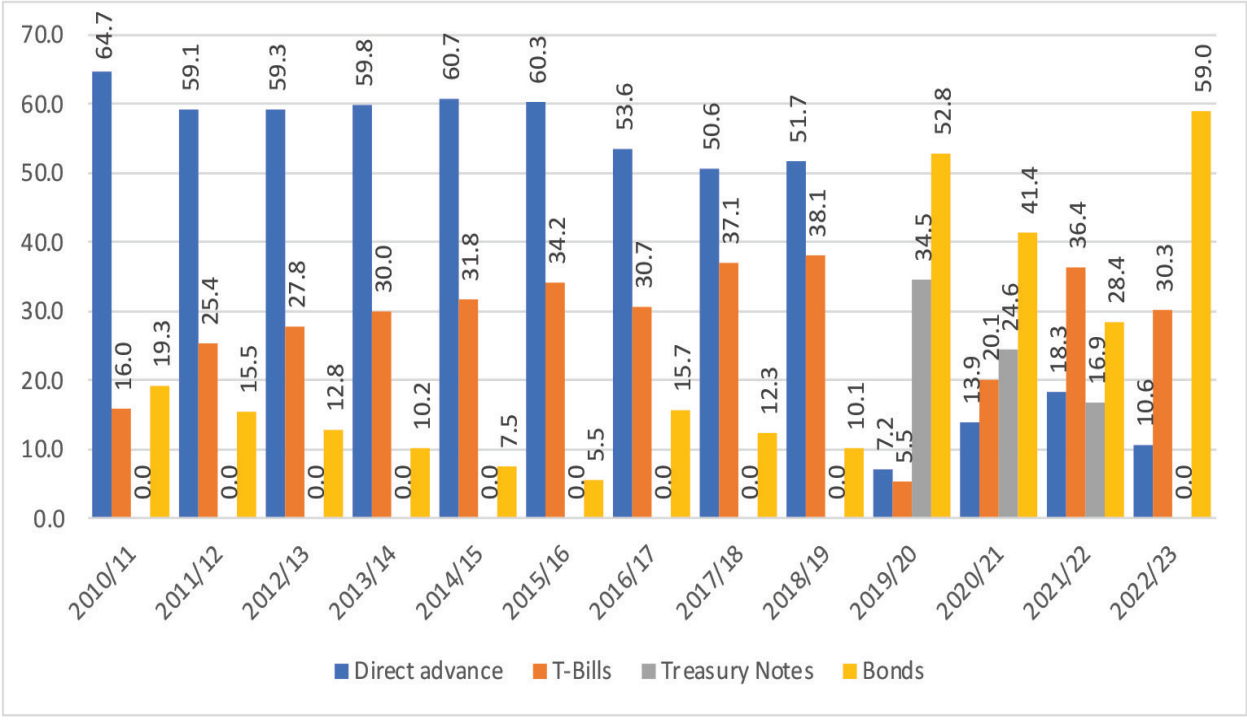
4.3.2 Domestic Borrowing by Instrument Type

Loans to the central government can be either in the form of direct advances (DA) from the NBE, T-bills, bonds, or Treasury Notes. The government tries to avoid inflationary sources of financing its deficit. As part of the HGER 1.0 program, the government decided to significantly limit the use of DA and phase them out over time. Accordingly, at the start of the reform program, the government's reliance on DA decreased from 51.7 percent in 2018/19 to 7.2 percent in 2019/20. However, due to the mounting challenges facing the country, this improvement in reducing the use of DA has been eroded, and over the last three years, 2020/21-2022/23, the share of DA in the central government's total domestic debt outstanding has averaged 14.3 percent. This represents a significant improvement compared to the 57.7 percent average share registered over the period 2010/11-2018/19 (see Figure 4.12). This improvement was partly achieved by converting, in December 2019, the stock of DA debt into a 25-year bond with a 10-year grace period.

Bonds became important only in 2019/20, following the HGER 1.0 reform program; before that, their use had not been significant. In the period 2010/11-2018/19, bonds, on average, accounted for only 12.1 percent of the central government's domestic debt share, while in the period 2020/21-2022/23 this has increased to 42.8 percent. Recently, in November 2022, the NBE issued a directive that requires all commercial banks to use 20 percent of their new loan disbursements to buy the government's 5-year treasury bonds. This has increased the share of bonds in the central government's debt stock from 28 percent in 2021/22 to 59 percent in 2022/23.

The government has also introduced a market-based auction system for treasury bills. This move has the effect of increasing the government's cost of borrowing since, before 2019, NBE auctioned treasury bills at a fixed interest rate ranging from 0.8 (for 28 days bills) to 5 percent (for 364 days bills), and since then, the interest rate payable on treasury bills has increased. However, this is a commendable move in terms of reducing inflationary financing of the deficit as well as reducing financial repression. In December 2019, the stock of treasury bills was also converted to a three-year treasury note. In the period 2020/21-2022/23, 29 percent of the central government's domestic debt stock was in Treasury Bills, and this does show much difference compared to the period before 2019. The use of treasury notes has been new to the Ethiopian public finances, it was started in 2019/20 following the launch of the HGER program. In the period 2020/21-2022/23, on average, 13.8 percent of the central government's domestic debt stock was held in the form of treasury notes, and the stock of this treasury note was finally, in 2021/22, converted in long term bond.

Figure 4.12: Central Government Debt Stock by Instrument Type (Percentage Share)



Source: Own computation using Data from MoF, Public Sector Debt Statistical Bulletin.

4.3.3 Domestic Debt Service

In the past three fiscal years, debt servicing has taken up a substantial portion of the government's budget. For instance, in 2022/23, 20.3 percent of the federal government's recurrent expenditure was spent on payments of interest rate and charges on total public debt (both domestic and external), while 15.5 percent was spent on interest payments on the stock of domestic public debt.

In the last three years, from 2020/21 to 2022/23, the government spent a total of ETB 20.6 billion, ETB 56.2 billion, and ETB 48.8 billion in total domestic debt servicing. On average, while 25.8

percent was spent on principal payments, the remaining 74.2 percent was allocated for interest rate payments. Over these three years, on average, a significant majority (74.6 percent) of the debt servicing payment was made by the central government, while SOEs contributed only 25.4 percent of the total debt servicing payment was only 25.4 percent of the public sector domestic debt servicing payment.

Furthermore, in the period 2020/21 to 2022/23, on average, 91.1 percent of the central government debt servicing payments were attributed to interest rate payments, whereas for SOEs, a relatively higher percentage (39.2 percent) was spent on principal payment (see Table 4.3). The higher repayment of SOE loans is consistent with the HGER 1.0 agenda, which stipulates the need to increase the soundness and health of the state-owned banks and protect them from risks that might come from loans given to SOEs. As part of this, the government established the Liabilities and Asset Management Corporation (LAMC) to better manage SOE debts so that the SOE debt burden doesn't make the CBE vulnerable. For details on this see Section 5.1.

Table 4.3: Domestic Debt Service Payment (in billions of Birr)

	2015/16	*2016/17*	*2017/18*	*2018/19*	*2019/20*	*2020/21*	*2021/22*	*2022/23*
Central Government	**4.8**	**5.4**	**5.8**	**7.8**	**7.7**	**17.9**	**21.6**	**48.4**
Principal	1.1	0.8	0.3	0.5	0.5	2.6	0.4	5.0
Interest	3.7	4.5	5.5	7.3	7.2	15.3	21.2	43.4
SOEs	**13.0**	**14.8**	**24.1**	**22.8**	**43.5**	**2.8**	**34.6**	**0.5**
Principal	0.8	1.6	4.8	3.3	13.3	0.5	34.1	0.0
Interest	12.2	13.2	19.3	19.5	30.1	2.3	0.5	0.5
Total Domestic Debt service	**17.8**	**20.2**	**29.9**	**30.6**	**51.2**	**20.6**	**56.2**	**48.8**
Principal	1.9	2.4	5.1	3.8	13.8	3.0	34.6	5.0
Interest	15.9	17.7	24.8	26.8	37.3	17.6	21.7	43.9
Percentage of Total Domestic debt service								
Central Government	**27.2**	**26.7**	**19.4**	**25.6**	**15.1**	**86.6**	**38.5**	**99.0**
Principal	23.4	15.7	5.1	6.6	6.7	14.4	2.0	10.3
Interest	76.6	84.3	94.9	93.4	93.3	85.6	98.0	89.7
SOEs	**72.8**	**73.3**	**80.6**	**74.4**	**84.9**	**13.4**	**61.5**	**1.0**
Principal	6.2	10.8	19.8	14.6	30.6	16.5	98.6	2.3
Interest	93.8	89.2	80.2	85.4	69.4	83.5	1.4	97.7
Total Domestic Debt service	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Principal	10.9	12.1	16.9	12.5	27.0	14.7	61.5	10.2
Interest	89.1	87.9	83.1	87.5	73.0	85.3	38.5	89.8

Source: Own computation using Data from MoF, Public Sector Debt Statistical Bulletin.

Part II:
FISCAL POLICY DEVELOPMENTS AND FISCAL RISK ANALYSIS

5 RECENT FISCAL POLICY DEVELOPMENTS

5.1 Establishment of the Liability and Asset Management Corporation (LAMC)

The Liability and Asset Management Corporation (LAMC) was established in February 2021, by the Council of Ministers regulation No. 483/2021. It was established with the specific intention of serving as an interim measure to address the high domestic debt burden of public enterprises in Ethiopia. This means that it is a temporary solution designed to provide immediate relief and stability. The MoF is assigned to be the supervising authority for the Corporation. According to the proclamation, the main objectives of the corporation include:

- Taking over the liabilities of public enterprises as per the list it receives from the Ministry of Finance and servicing such debt using capital to be allocated from the Industrial Development Fund, revenue generated from its business activities and other resources that may become available to it;
- Takeover the residual assets and liabilities of public enterprises that are being partially or wholly privatized or the liquidation of public enterprises upon their dissolution;
- Invest the capital injected by the Government for debt service payments of public enterprises and other resources until it is used for repayment of such loans.

The corporation absorbs and administers the debts of SOEs that are highly indebted so that their accumulated debt will not make the CBE vulnerable. Generally, this debt restructuring helps to stabilize the macroeconomy by ensuring the stability of the financial sector, improving the financial health of the SOEs, and addressing the risk of contingent liabilities the SOEs' distressed debts leave on the government (MoF, 2021a).

Accordingly, upon its establishment, seven SOEs were identified as under a high risk of debt distress and LAMC absorbs parts of their debts. Specifically, a total liability of ETB 398.7 billion has been transferred to LAMC, mostly, by December 2020. The SOEs that contributed to this liability were the Ethiopian Electric Power (48.1 percent), Ethiopian Electric Utility (0.8 percent), Ethiopian Railway Corporation (18.3 percent), Ethio-Engineering Group (4.1 percent), Chemical Industry Corporation (3.1 percent), and the Sugar Corporation (25.5 percent). This is done in an agreement that involves four parties – CBE, the relevant SOE, LAMC and MoF, where the latter is the guarantor, and transfers 20 to 100 percent of the SOEs' debt stock to LAMC. The SOE domestic loan that was transferred to LAMC reached ETB 420.7 billion and ETB 540.2 billion in 2021/22 and 2022/23, respectively.

5.2 Excise Tax Reform

The Excise Tax Proclamation (Proclamation No. 1186/2020) that was issued in 2020 was amended following the Excise Tax amendment (Amendment) Proclamation No. 1187/2023. This amendment proclamation enters into force by the end of April 2023, and has the following three major objectives:

1. Lower the excise tax rate on some items including new imported motor vehicles (now the average tax on imported vehicles is reduced to 121 percent) and items like ethyl alcohol (from 60 to 10 percent); some forms of edible animal or vegetable oils and fats

(from 40 to 30 percent), all types of sugar (excluding molasses, maple sugar and maple syrup), chewing gum and chocolates and sweets (from 20 to 10 percent); salt (from 25 to 10 percent); fuel (from 30 to 15 percent); some textile fabrics (from 8 to 5 percent), and carpet (from 30 to 15 percent).

2. Eliminate some privileges that were granted to some persons and organizations. The argument for this is that it is not appropriate to grant special privileges to imported goods that can have negative impact on the environment. Accordingly, the list of excisable items has been revised by excluding several goods, persons, and organizations that used to enjoy a special privilege. For example, the exemptions of all goods imported or locally purchased by investors as per the Investment Incentives Regulation are removed. The investors and manufacturers are compensated by an across-the-board reduction in the tax rates imposed on raw materials and intermediate and capital goods.
3. Imposing a 5 percent excise tax on communication services. This is aimed at generating additional domestic revenue.

The revised First Schedule (for excisable items) and Second Schedule (for exempt goods that meet the conditions) are released together with the amendment proclamation. The government expects to lose around ETB 5.5 billion from the tax cut on vehicles. However, due to other changes that took place around the same time, it is difficult to estimate the revenue loss from this amendment.

5.3 Introduction of Social Welfare Levy on Imported Goods

On August 2022, the government issued a regulation (Regulation No.519/2022) that imposes a social welfare levy on all imported goods with exemptions given to: 1) goods imported by persons and organizations with diplomatic privileges; 2) goods that are already subject to sur-tax; 3) goods that are exempt from import taxes and tariff by a directive to be issued by MoF due to social and economic reasons.

The main objective of levying this tax is to raise funds necessary for the rehabilitation and construction of education, training, and health facilities and the expansion of other social services in parts of the country affected by the conflict.

The 3 percent Social Welfare Levy is calculated on the sum of the cost, insurance, and freight (CIF) value of applicable imports. The levy does not serve as a base for any other tax imposed on imports. From this tax, the government collected ETB 11.3 billion in the first eight months of 2023.

5.4 Customs Reform

In September 2021, the Ministry of Finance introduced a comprehensive customs reform. This involved updating the decade-old customs tariff book, making it more simplified, harmonizing it with that of the World Customs Organization (WCO), and enhancing the competitiveness of local producers by shifting the tariff burden away from raw materials and intermediate goods to final goods.

In line with the government's industrial policy, the Ministry of Finance exempted capital and investment goods (especially machinery) from the payment of customs duty and other import taxes. The reform changed the previous customs duty rate structure from 0 percent, 5 percent, 10 percent, 20 percent, 30 percent, and 35 percent to 0 percent, 5 percent, 15 percent, 25 percent, and 35 percent based on the value addition. Raw material and capital goods attract lower duty rates while final goods attract higher duty rates of up to 35 percent.

In its effort to promote the local manufacturing sector, the government used to grant preferential customs duty treatment to selected local producers through the second schedule scheme. Although the scheme was effective in terms of promoting local production and attracting foreign direct investment, it becomes clear that it is creating a huge administrative burden, being heavily misused, and creating distortions in the economy. Cognizant of these issues, the Ministry of Finance removed the second-schedule scheme from the tariff book and instead granted the sector duty-free or preferential customs treatment for imports of raw materials, intermediate inputs, and capital goods.

5.5 SUR Tax Reform

As part of the comprehensive customs reform, the government reformed the SUR tax payments on imports. When introduced in April of 2007, as per the Import Sur-Tax Council of Ministers Regulations No.133/2007, the revenue from this tax was to be used as a temporary means to respond to the urban food price hike that occurred in 2007/08. However, it has remained a key part of the tax system, raising around 20% of the foreign trade tax revenue for the government until FY 2020/21. According to this regulation, the SUR tax was levied on all imported goods except fertilizer, petroleum and lubricants, capital goods, motor vehicles for freight and passengers, and special purpose motor vehicles, and aircraft, spacecraft, and parts thereof.

The SUR tax reform introduced together with the customs reform removed the SUR tax on all goods with a customs duty rate of 15 percent or less. This is directed at reducing the SUR tax on key imports that include raw materials and intermediate inputs because of their importance to the overall economy. The 10 percent SUR tax will continue to be levied on imported goods with a customs duty of above 15 percent. However, it needs to be noted that the government is planning to phase out the SUR tax entirely and this reform can be considered as the first step towards this.

5.6 Reforming the Tax Incentive System

The GoE issued the Investment Incentives Regulation (Council of Minister Regulation No. 517/2022) in July 2022. This is issued pursuant to Article 17 of the Investment Proclamation (Proclamation No. 1180/2020) and Article 129 of the Customs Proclamation (Proclamation No. 859/2014 (as amended)). This regulation is aimed at rationalizing the investment incentives and lists the investment incentives and the eligible sectors by geographical area. As part of this reform, some incentives such as the duty-free importation of pickup and station wagon vehicles for investors and civil society organizations were removed. The regulation applies to income Tax and Duty incentives granted to encourage investment in sectors eligible for incentives.

According to this regulation, income tax exemptions can be granted to new investments, expansions, or upgrading of existing investments (by at least 50 percent), investors exporting products or services, or firms that supply at least 60 percent of their outputs to exporters. In terms of the customs duty incentives, the regulation specifies the exemptions granted to imports of capital goods, construction materials, and motor vehicles from customs duty. The regulation also specifies the incentives for investments in the mining, petroleum, and geothermal sectors. It allows for duty-free imports of equipment, machinery, and consumables that are required for their operations. The regulation stipulates the control mechanisms and administration of tax incentives, with the roles and responsibilities of the different institutions involved. One element of this has been the centralization of the incentive process. Before the issuance of this regulation, tax exemptions were administered by more than 35 government ministries/entities including the regional government without much coordination. This resulted in substantial revenue loss for the government and paved the way for corruption. So, it was necessary to centralize the administration of the exemption process and the Ministry of Finance has been tasked with this.

Among others, the regulation grants the Ministry of Finance the power to issue directives necessary for the implementation of the investment incentives regulations. Pursuant to this, the Ministry of Finance issued accompanying directives, namely "A Directive to Provide for the Application of Tax Incentives for Expansion/Upgrading of Investment" (Directive No. 941/2023) and "A Directive to Provide for the Type and Quantity of Vehicles allowed to be Imported Duty Free for Development Projects" (Directive No. 942/2023). In general, these directives stipulate the level of the incentives, the conditions and criteria for enjoying the incentives, and the sectors and types of entities that are eligible for the incentives.

6 DISASTER-RELATED FISCAL RISK ANALYSIS

6.1 Fiscal Risk Quantification

The Ministry of Finance uses a five-year rolling budget planning instrument called the Medium Term Macroeconomic and Fiscal Framework (MEFF) to prepare its annual budgets. The MEFF prepared by MoF provides five-year forecasts of government revenues, capital and recurrent expenditures, deficit financing etc., and sets out the overall government resource envelope and expenditure ceilings. However, because of the realization of disaster-related hazards, the fiscal outturns may deviate from forecasts presented in the MEFF and used in the annual budget, causing fiscal risks. Fiscal risks are deviations of fiscal outcomes from what was forecasted in the MEFF and/or during budget preparations and pose a challenge to the sustainability of the government's fiscal position.

Although fiscal risks can originate from different sources, our focus here is on disaster-related fiscal risks that can cause deviations in (shocks to) government revenues, expenditures, assets, and liabilities from forecasts made in the MEFF. Natural disasters can reduce government revenue by slowing down economic activities and increasing government expenditure through their impact on explicit or implicit contingent liabilities.

It is thus important to identify, quantify, analyze, manage, and disclose disaster-related fiscal risks to understand the sustainability of the government's fiscal stance, increase fiscal transparency, and minimize the risks that such disasters may pose. This is consistent with the Fiscal Risk Analysis and Management pillar of IMF's Fiscal Transparency Code (IMF, 2018) and helps to ensure sound public finances, macroeconomic stability, market confidence, and credibility in the government's management of public finances (IMF, 2016).

Acknowledging that fiscal risk monitoring and reporting is one of the areas in which Ethiopia gets the lowest PEFA score (World Bank, 2019), the MoF is taking active measures in identifying and quantifying disaster-related fiscal risks. Specifically, with technical support from the Building Resilience in Ethiopia-Technical Assistance (BRE-TA), MoF is making an effort to develop a fiscal risk-modeling capacity to quantify and analyze disaster-related fiscal risks, integrate this with the MEFF, and publish a Fiscal Risk Statement (FRS). Fiscal risks are typically presented as supplements to the government's fiscal forecasts like the MEFF as they may not be reflected in official forecasts of government revenue, expenditure, or borrowing owing to their uncertain or contingent nature (IMF, 2018). Publishing an FRS with the MEFF would help, among other things, to improve risk management, provide prompt and smoother policy responses, reduce borrowing costs, and increase the country's attractiveness for FDI (IMF, 2018, 2016).

Understanding that the identification and quantification of fiscal risks constitute the first step in managing disaster-related fiscal risks, in 2019 MoF developed a fiscal risk registry, and an FRS was prepared with support from IMF. This process identified several potential sources of fiscal risks in Ethiopia and provided a qualitative assessment of their impact on the government's fiscal position. This can be considered as the first step towards recognizing the importance of fiscal risks

and the need to capture these in the government budget process. However, this FRS fell short of systematically quantifying and analyzing the potential impacts of the identified disasters on the government's fiscal position.

Because of interest in taking this exercise further, MoF has developed a disaster-related fiscal risk quantification model. This is a tool that the MoF uses to quantify the macro-fiscal impacts of natural disasters that Ethiopia is prone to. Accordingly, the disaster-related fiscal risk quantification tool helps to make a forward-looking assessment of fiscal risks that take into account different return periods or levels of severities of major natural disasters facing the Ethiopian economy (MoF and Vivid Economics, n.d.). So far, the model captures the impacts of drought, flood, and locust-infestation-related disasters, and the results of the model for drought and flood have been published in MoF's 2021 Annual flagship Report (MoF, 2021b). Since then, the model for locusts, epidemics, SOE and PPP-related contingent liabilities has been developed and the model has been used to inform the preparation of the Disaster Risk Financing Strategy for Ethiopia. Moreover, the financing instruments have been refined to include feasible and optimal financing options that are developed in synch with the preparation of the DRF strategy. The model has also been updated with recent data on macroeconomic variables and below we present some results based on the upgraded and updated fiscal risk quantification model.

6.2 Impacts of Natural Disasters on Fiscal Outcomes

Natural disasters put significant pressure on public finances through their impact on government revenue and trade balance (via the macroeconomic channel) and increased government expenditures. This pressure on public finances can be summarized by fiscal health indicator variables like deficit-to-GDP ratio, debt-to-GDP ratio, and Gross External Financing Requirements (GXFR). MoF's disaster-related fiscal risk quantification tool calculates the impacts of disasters on these fiscal health indicator variables as disasters will lead to increases in the budget deficit, debt accumulation, depletion of international reserves, and put pressure on the value of the local currency (MoF and Vivid Economics, n.d.).

6.2.1 Drought-Related Fiscal Risks

Among the different natural disasters that Ethiopia is exposed to, drought causes the most serious socio-economic damage. Agricultural production and hydropower generation are the sectors that are directly affected by drought. Drought could affect the fiscal outlook through both the revenue and expenditure channels. First, drought could directly affect the outputs of the agricultural and hydropower sectors through a water shortage. These, coupled with knock-on impacts on other sectors, will in turn lead to reduced economic activity and output in the overall economy. Because of the resulting lower-than-expected GDP growth rate, government revenue from tax and non-tax sources will become lower than expected. Second, on the expenditure side, the loss in agricultural production leads to additional number of people, beyond the typical PSNP caseload, in need of humanitarian assistance.

For each level of drought intensity, 1-in-5 to 1-in100, Table 6.1 below presents estimates of the impact of drought on agricultural output, hydropower generation, the value of GDP loss, and the

resulting revenue loss. The tool calculates the total cost of each level of drought, by multiplying the additional number of people affected by drought (on top of the normal PSNP caseload) by the per-beneficiary annual cost which is estimated based on the HRD cost structure at USD 106.8. To make estimations for droughts that are similar to the 2015/16 drought, the model applies a probabilistic distribution function to the historical data and incorporates this drought as a 1-in-38-year type of drought.

Table 6.1: Fiscal Implications of Varying Levels of Drought in Ethiopia

Drought magnitude 2	*Agriculture GVA Loss (%)*	*Hydropower Loss (%)*	*Loss of GDP (%)*	*Loss of Tax Revenue* (%)*	*Additional Number of people that need assistance (in Mn)***	*Expenditure need (Mn USD)*
1 in 5	0.24%	1.33%	0.18%	0.17%	7.46	797.25
1 in 10	0.53%	3.18%	0.40%	0.38%	9.52	1,017.03
1 in 30	1.06%	6.02%	0.79%	0.74%	12.67	1,353.01
1 in 38	1.06%	6.02%	0.86%	0.85%	12.67	1,565.17
1 in 50	1.30%	7.37%	0.96%	1.01%	13.90	1,887.08
1 in 100	1.64%	9.44%	1.21%	1.69%	15.26	1,405.82

Source: MoF's Disaster-Related Fiscal Risk Quantification Model, MOF.

*This includes tax and non-tax revenue of both the Federal and Sub-national Governments. The loss is calculated as the share of the baseline revenue. In addition, we assume the buoyancy of the agriculture sector to be zero. ** Note that this number is in addition to the PSNP safety net recipients under a typical year.

To put this into perspective, if the 2015/16 type drought (a 1-in-38 year) occurred again in 2022/23, tax revenue would decrease by USD 94.7 million or 0.85 percent of the baseline tax revenue. Out of this revenue loss, USD 6 million is from SOE direct revenue loss. The government's spending need, on the other hand, would increase by USD 1,565.2 million. This is equivalent to 8.9 percent of the total government budget for the 2022/23 fiscal year. Drought could also cause fiscal risks through SOE/PPP-related contingent liabilities. For a 1-in-38-year type drought, however, default by any of the SOEs is assumed unlikely, and hence no triggered debt obligation is assumed.

[2]The return period is the time period over which Ethiopia should expect to see a drought of the same severity and magnitude in terms of its capacity to cause crop and other associated losses. For example, a 1-in-10-year return period refers to a drought that happens, on average, once per 10 years. In other words, such a drought has a 10% probability of happening in a given year.

[3]The total Tax Revenue for the 2022/23 fiscal year is ETB 593.3 billion (or USD 11.1 Billion). The total government budget for the 2022/23 fiscal year is ETB 938.9 billion (or USD 17.6 billion).

6.2.2 Flood-Related Fiscal Risks

Ethiopia also faces a high risk of flooding, particularly in the low-lying river basins. Like drought, flood affects the fiscal outlook of the government through two main channels . First, flood affects agricultural production by damaging croplands. Through the backward and forward linkage of the agriculture sector with the rest of the economy, the initial shock is propagated throughout the economy leading to a decline in economic activity and output. On top of this, flood leads to a loss in non-agricultural sectors value added through its impact on the proportion of years of business interruption. The reduced economic activity and output in the agricultural and non-agricultural sectors lead to a lower-than-expected GDP and hence lower government revenue.

Second, floods will also lead to an unanticipated increase in government expenditure. This is because people displaced by the flood will need humanitarian assistance and the infrastructures (schools, health facilities, roads, and railways) damaged by the flood will need to be reconstructed. The ensuing expense for humanitarian assistance to feed the displaced people and the outlays to maintain the damaged infrastructure will lead to unforeseen increases in government expenditures. The disaster-related fiscal risk quantification tool applies a probabilistic distribution function to historical data on floods to calculate the magnitude and frequency of floods occurring in the country. Accordingly, it uses four flood scenarios (frequency and severity) as in 1-in-10, 1-in-30, 1-in-50, and 1-in-100-year flood types. This is then used to calculate the fiscal implications of floods in Ethiopia.

The loss in agricultural value added is calculated based on the total agricultural land exposed to the flood and the average per hectare value of cropland. Accordingly, for each level of flood, the agricultural value-added loss as a percentage of the baseline (current) agricultural production is given in Table 6.2 below. The loss to other sectors of the economy is calculated by multiplying the proportions of business days affected by the non-agricultural GDP. The share of non-agricultural sector production loss in GDP calculated in this way is given in Table 6.2 below. By taking the multiplies of these into account, the total GDP loss and hence loss in total tax revenue loss are calculated.

On the expenditure side, the total cost of each level of flood is given as a sum of humanitarian support plus the total cost of reconstructing damaged infrastructure. The humanitarian cost is calculated by multiplying the population exposed to each level of flood severity by the proportion of the number of days in a year the affected people need humanitarian assistance. This is then multiplied by the cost per person per year, which is calculated as 194.2 USD. This cost differs from the assistance cost used for drought which is based on HRD.

The reconstruction cost is, on the other hand, calculated by multiplying the number of education and health facilities exposed to flood by the maximum value of potential damage.

[4]Floods can also cause fiscal risks by triggering SOE/PPP contingent liabilities, and this is discussed below and added to the total cost of the disaster.

This is added to the cost of reconstructing transport infrastructure. That is, by multiplying the total Kilometers of roads, railways, and bridges exposed by the total damage per Kilometer. The total cost of reconstruction calculated in this way is given in Table 6.2 below. The total cost of the flood, represented by the sum of humanitarian and reconstruction costs, is an unanticipated increase in government expenditure causing a fiscal risk.

Table 6.2: Fiscal Implications of Floods of Varying Magnitude Ethiopia

Flood magnitude	*Agricultur GVA loss (%)*	*Other sector loss*	*GDP loss (%)*	*Loss of Total Tax Revenue (%)#*	*Cost of Humanitarian Aid (Million USD)##*	*Cost of Reconstruction (Million USD)*	*Total Cost of Disaster (Million USD)*
1 in 10	0.32%	0.07%	0.28%	0.31%	32.50	91.32	123.82
1 in 30	0.38%	0.09%	0.40%	0.49%	59.94	112.45	172.39
1 in 50	0.40%	0.10%	0.48%	0.66%	74.55	123.70	198.25
1 in 100	0.45%	0.12%	0.70%	1.25%	99.01	145.81	244.81

Source: MoF's Disaster-Related Fiscal Risk Quantification Model, MOF

Note: # This includes tax and non-tax revenue of both the Federal and Sub-national Governments. The loss is calculated as the share of the baseline revenue. In addition, we assume the tax elasticity of the agriculture sector is zero. ##This cost was calculated using USD 194.2 per person per year.

To put this in context, let's consider the fiscal implications of a 1-in-10-year type of flood that occurred in 2020 in Ethiopia, happening again in 2022/23. Such a flood will reduce the total tax revenue by USD 34.2 million (0.31 percent of the initial tax revenue) from its forecasted value, while the federal government's expenditure will increase by USD 123.8 million. Given the budget for 2022/23, this additional and unanticipated fiscal cost amounts to 0.7 percent of the total federal government budget.

6.2.3 Locust-Related Fiscal Risks

Desert locust infestation is another natural disaster that can potentially cause a fiscal risk for the Ethiopian government by severely affecting the agricultural sector and people's livelihoods. Locust infestation can create fiscal risks through similar channels as droughts but with lower likelihood and potentially higher severity (MoF and Vivid Economics, n.d.). As discussed above, fiscal risks following locust invasion arise because of deviations of both the government revenues and expenditures from their forecasted values.

On the revenue side, locust infestation reduces government revenue by reducing agricultural output and the knock-on effect of this on the rest of the economy. The resulting decline in outputs and economic activity (GDP) will lead to a loss of government revenue. On the expenditure side, on the other hand, locust infestation affects government expenditure through humanitarian assistance needed to support people whose crops are damaged by the locust and due to the increased spending needed to monitor and control the spread of the locust infestation.
The latter includes spending on fuels, airplane rental, pesticides, communication, IT equipment, etc.

[5] Locust infestation can also trigger contingent liabilities. It can, for example, expose the government to agricultural SOE liabilities by disrupting the production and cash flow of the Ethiopian Sugar Corporation, which is a highly leveraged industry (MoF and Vivid Economics, n.d.).

Unlike the cases of drought and flood, which use probabilistic estimates to generate disaster scenarios of different levels of frequency and severity, the locust model uses historical estimates to create scenarios. The scenarios used for locust are based on relative severity to the 2019-2020 event, rather than the likelihood of an event happening in a given year. Specifically, we demonstrate the fiscal implications using scenarios where the hectares affected are multiplied by a factor of one-half and two – i.e., half the severity of the 2019-2020 infestation and double the 2019-2020 infestation.

The locust infestation impacts agricultural output by affecting crop and pasture land. The total cereal production loss is calculated by multiplying the weighted average price of crops by the total cereal production loss due to the locust infestation. The latter is calculated by multiplying the per-hectare cereal losses by the total area of cropland affected by the locust. Similarly, the total livestock production loss is calculated by multiplying the producer price of livestock assets per farm by the total number of households affected and the share of which resorted to damaging coping strategies – selling and consuming livestock assets. The sum of cereal production and livestock production losses gives us the total agricultural production loss due to the locust infestation (see Table 6.3).

The additional spending required for humanitarian assistance is calculated by multiplying the additional number of people needing emergency food assistance by the annual cost per beneficiary, which is calculated based on the HRD cost structure per beneficiary. Similarly, the pest monitoring and control-related expenditure is given by the total area treated, litters of pesticides used, and other control costs like the costs of pesticides, straying planes and staff, and other control strategies. The total cost of locust infestation is therefore given by the sum of the humanitarian support and the total cost of pest control.

Table 6.3: Fiscal implications of varying levels of locust infestation in Ethiopia

Flood magnitude	*Agricultur GVA loss (%)*	*GDP loss (%)*	*Loss of Total Tax Revenue (%)#*	*Cost of Humanitarian Aid (Million USD)##*	*Cost of Pest Control (Mn USD)*	*Total Cost of Disaster (Mn USD)*
2019-2020 Infestation	0.16%	0.16%	0.12%	106.80	118.00	224.80
Half Severity 2019-2020 Infestation	0.08%	0.08%	0.06%	53.40	59.00	112.40
Double Severity 2019-2020 Infestation	0.31%	0.31%	0.23%	213.60	236.00	449.60

Source: MoF's Disaster-Related Fiscal Risk Quantification Model, MOF

Note: # This includes tax and non-tax revenue of both the Federal and Sub-national Governments. The loss is calculated as the share of the baseline revenue. In addition, we assume the buoyancy of the agriculture sector is zero. ##This cost calculated Based on the HRD cost structure per beneficiary, which is set at USD 106.8.

To make a better sense of this, let's consider the 2019-2020 locust infestation event and estimate the fiscal implication if it happens again in 2022/23. The overall revenue impact of such a disaster happening in 2022/23 will be a reduction of the total tax revenue by USD 12.9 million. On the expenditure side, the humanitarian aid and pest control costs increase government expenditure by a total of USD 224.8 million. Given the projected budget for 2022/23, the fiscal cost of this amounts to 1.28 percent of the total federal government budget.

6.2.4 Epidemics-Related Fiscal Risks

Another disaster that can potentially lead to a fiscal risk in Ethiopia is epidemics. Epidemics can impact fiscal risks through several channels.

On the revenue side, like any other disaster, epidemics can result in reduced outputs and economic activity, although it does so through different channels and affecting different sectors. First, epidemics can reduce economy-wide productivity through absenteeism and presenteeism, thereby leading to reduced economic activity and government revenue. Second, because of the social distancing and safety requirements that come with epidemics, it will have a severe impact on the tourism, transport, entertainment, and hospitality sectors that will propagate to the rest of the economy.

On the expenditure side, an epidemic outbreak can also cause an unanticipated increase in government expenditure through its impact on an increased need for humanitarian assistance and public health expenditure. Because of a lack of adequate data on epidemic outbreaks and associated expenditure needs, for now, we couldn't quantify the fiscal impacts of epidemics.

Despite efforts to quantify the economic impacts of epidemics, limited data availability has hindered the generation of comprehensive results for inclusion in this year's report.

6.2.5 SOEs and PPP-Related Contingent Liabilities

In terms of disaster-induced SOE and PPP-related contingent liabilities that may have an impact on the government's fiscal outcomes, the model considers impacts of Direct SOE Transfers to the Treasury, SOE Transfers to the Industrial Development Fund (IDF), Triggered Debt Obligations, and Contingent PPP Obligations. Below we present the underlying assumptions and provide fiscal impact estimates for each of these categories of contingent liabilities across the disaster types analyzed.

Direct SOE Transfers to the Treasury

Some SOEs in Ethiopia transfer their surpluses or dividends to the treasury. Following a disaster, the profits of these SOEs may be negatively impacted, resulting in fewer (or no) transfers. The SOE direct loss is fed through to the macroeconomic impact as a direct revenue loss to the government

[6] Epidemics can also trigger contingent liabilities through its economic activity disruption impacts particularly by affecting the performance of SoEs in the transport industry.

The majority (over 95%) of direct SOE surplus transfers in the last 5 years have been received from the National Bank of Ethiopia (NBE) and the Commercial Bank of Ethiopia (CBE). Direct transfer to the treasury from the other SOEs is not substantial. Since the NBE's main activities relate to creating a stable macroeconomic environment, we decided not to consider it as part of the fiscal risk modeling. Hence, we consider the impact of the disasters on CBE only.

Potential impacts on direct revenue loss in the cases of drought and floods may occur: firstly, since these disasters may result in more defaults to CBE loans as borrowers involved in the production of drought-sensitive products, that are sensitive to the price of goods dependent on water (e.g. food manufacturing with sales contracts locked in), or companies whose facilities or assets have been destroyed by floods and are unable to borrow to refinance their debt (e.g. factories) or to generate enough revenue. Secondly, depositors are more likely to withdraw funds from CBE following a disaster if they are impacted in a similar way to defaulters. Thirdly, a slowdown in business activities and spending could lead to less profit for the bank.

In the model, the impact of drought is set to 0 percent except in the most severe scenarios. For the 1-in-100-year drought scenario, we have set the expected revenue loss to 50 percent of the average transfer. For the 1-in-50-year scenario, we have put in 10 percent of the average transfer, while for the 1-in-38-year (the 2015 types) drought, we use a 5 percent expected loss. The 5 percent expected loss would account for a bit less than 1% of the total cost of disaster under the current model inputs. Anything below this could be considered immaterial, especially considering the uncertainty around the assumptions.

In the case of flood, since the flood scenarios are generally less severe than the drought scenarios (of the same return period), we have assumed a smaller impact. Specifically, we set the expected loss to 25 percent (for a 1-in-100-year scenario), which is equivalent to USD 30 million. For the 1-in-50-year, we set the expected loss to 5 percent of the average transfers from CBE.

SOE Transfers to the Industrial Development Fund (IDF)

The remaining SOEs in Ethiopia make transfers to the government to be invested in development projects. Following a disaster, the profits of these SOEs may be negatively impacted, resulting in the investment in development projects being delayed or canceled. As such, there is likely to be an impact on Ethiopia's exports and GDP. Assuming that this is already captured in the model through the multiplier effects of the disasters considered, we do not model it separately to avoid double counting.

Triggered Debt Obligations

The Government acts as a guarantor for SOE debt, except for Ethiopian Airlines and Ethio-Telecom. In the event of a disaster, an SOE could be severely impacted to the extent they default on their debt, triggering the government's guarantee obligation. The Ethiopian Electric Power (EEP) is treated separately because of its relative significance in the share of SOE debts.

Contingent liabilities from triggered SOE debt obligations are calculated by multiplying the stocks of SOE debts by the proportion of their debt that is expected to be triggered. The proportion reflects the probability of occurring and how much of the liability would be triggered.

The contingent liabilities from triggered SOE debt obligations are included in the contingent liabilities section as a 'SOE guarantees' loss and are added to the total cost of the disaster under consideration. One caveat here is that this is assumed to occur immediately, whereas in practice, the cost to the government may be spread over multiple years in line with the repayment schedule of the debt.

Another important issue here is that a triggered debt obligation may not mean that the government will have to pay out all of the remaining debt. This is also known as loss-given default. The product of loss-given default and probability of default is used as an input in the model. For a starting point, we have suggested a model input broadly equivalent to a 10% chance of Ethiopian Sugar Corporation defaulting in the 1-100-year drought scenario with the government being liable to around 50% of the debt (5% of total SOE debt). There is a smaller chance of this happening in the 1-50-year scenario. Specifically, we assume that 2.1 percent and 4.3 percent of the total 'other SOE debt is expected to be paid following a 1-in-50-year and a 1-in-100-year drought, respectively. For EEP, we assume that only 1 percent of the debt is expected to be paid following a 1-in-100-year drought.
In the case of flood, we adopt a similar approach to drought, except including infrastructure debt in the exposure. This will mean the expected cost of disaster will be larger. For EEP, we expect they are less likely to be impacted by flood than drought. Specifically, while we set the expected proportion of debt paid following a 1-in-100-year type flood at 1 percent, for other SOE this set at 1.3 percent and 2.6 percent for a 1-in-50-year and a 1-in-100-year flood, respectively.

Public-Private Partnership (PPP) Obligations
PPP-related contingent liabilities could arise from contractual responsibilities such as minimum payment guarantees, reimbursement for losses if the PPP project is canceled, additional investment required to repair damages, or the implicit obligation to step in to provide support in the event of the failure of the private partner.

The likelihood and magnitude of PPP contingent liabilities being triggered, therefore, depend not only on the vulnerability of the projects to the disasters but also on the risk allocation within the PPP arrangements. No one risk allocation model fits all sectors and PPP contracts. Risk allocations differ from project to project and will depend on the risk appetites of the parties involved.

The fiscal risk quantification model captures PPP-related contingent liabilities as a product of exposure to PPP contractual obligations and the proportion of these obligations triggered. This is fed through to the contingent liabilities section for the PPP contractual obligations and included in the total cost of the disaster under consideration.

There are several PPP projects in different phases of development, including hydropower projects, solar power projects, expressway projects, housing projects, health projects, logistics, and tourism development projects. Some of these projects are in feasibility studies and most of them are not yet operational. Moreover, some of the projects are unlikely to be impacted by the natural disasters we consider in this model. The disasters modeled here may not necessarily be those that trigger PPP obligations. Other events, including project-specific risks, could also trigger PPP contingent liabilities. Hence, the scenarios illustrated here may not be the most appropriate to manage PPP-specific contingent liabilities.

7 THE OPPORTUNITY COST OF COVID-19-INDUCED BUDGET REALLOCATIONS

7.1 Introduction

In countries where the fiscal space is constrained and there are limited pre-arranged risk financing instruments or agreements in place, reactive approaches are often the only option for disaster relief and recovery. This means that governments might use existing budgets to finance essential disaster-related relief and recovery, which can result in public expenditure on other important sectors being reduced or crowded out, creating an opportunity cost in terms of forgone or delayed returns. The disaster risk finance literature often points to the direct and indirect costs of disasters to governments; this study attempts to identify and quantify part of the latter – the opportunity cost associated with diverting funding – using COVID-19 as a case study to analyze public expenditure decisions, with a focus on what was not spent as a result of the pandemic.

This report provides information on how the GoE financed its COVID-19 response, and at what cost. In particular, it focuses on the use of budget reallocations to meet unplanned needs. The purpose of the report is to provide valuable information for GoE policymakers to consider when deciding how to finance future emergencies. By quantifying COVID-19-related opportunity costs, the report aims to provide an assessment of the relative costs and benefits of ex-post-disaster financing measures, compared to ex-ante measures (which do not currently exist for disaster response in Ethiopia). This analysis will inform decisions about how to prepare financially for future emergencies. Lastly, the report aims to build the case in favor of donors and multilateral institutions making more financial support available earlier in the onset of an emergency to safeguard essential spending from cuts.

7.2 Context

PFM in Ethiopia has undergone significant improvements in the last decade, driven by strong government leadership. The GoE has further committed to building a green and shock-resilient economy in its 10-Year National Development Plan, deepening its commitment to shock preparedness and decreasing fiscal risks. Nevertheless, the country remains vulnerable to disasters, which continue to represent a significant source of fiscal risk to the GoE, even in the absence of a pandemic.

Prior to COVID-19, the country faced consistently underperforming and low revenues, with the tax-to- GDP ratio declining for the third consecutive year in FY 2018/19, to only 11.5% of GDP. By the end of 2019, the country was reaching the limits of open market borrowing, which forced the GoE to turn to the International Monetary Fund (IMF) for support. The IMF approved the Ethiopian authorities' request for almost US$ 3 billion of loans under its Extended Credit Facility and Extended Fund Facility to support the home-grown economic reform agenda.

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[7] This is a condensed version of a study undertaken by the Building Resilience in Ethiopia programme, in partnership with the Centre for Disaster Protection, on the opportunity cost of reallocating budgets in response to disasters.

[8] The fiscal risk model developed by Building Resilience in Ethiopia estimates that if a drought of the severity of 2015/16 occurred again in 2019/20, tax revenue would decrease by US$ 195.6 million and spending needs would increase by US$ 1.0 billion. This would result in a total fiscal cost estimated at US$ 1.2 billion, equivalent to 16% of the federal GoE budget for the 2019/20 fiscal year.

Despite strong domestic revenue collections in Quarters 1 and 2 of 2019/20, by March 2020, when the first case of COVID-19 was detected in Ethiopia, the country had limited fiscal space to respond to the crisis. With the COVID-19 pandemic hitting the country just a few months after some initial gains in increasing fiscal space had been made, the efforts to mitigate vulnerabilities proved to be too late. This put the country in a particularly precarious position due to its inability to fund the economic and health response required to combat the effects of the virus.

We can categorize the timeline of the COVID-19 pandemic, and the response to it, in Ethiopia into three stages. The first stage ('preparation') included activities such as preparing isolation and quarantine centers and buying toolkits and personal protective equipment. The second stage ('response') included testing, treatment, ensuring food security, and policy support to businesses. The third stage ('recover') included interventions to help the country return to its pre-COVID-19 economic situation.

Institutional and legal framework for COVID-19 response: The GoE developed a multisectoral national emergency response plan for COVID-19, by compiling line ministries' preparedness and response plans, including assistance needs, interventions, and resource requirements.

Public health response: Ethiopia faced challenges in healthcare resources during COVID-19 but fared relatively well with around 490,000 cases and 7,500 deaths as of June 2022. Emergency actions included contact tracing, screening, testing, treatment facilities, training health workers, and mobilizing vaccines with 43 million people vaccinated by July 2022. While declaring a state of emergency, Ethiopia avoided strict lockdowns to ease pressure on the informal sector.

Fiscal and monetary measures: In response to the pandemic, the GoE announced and executed a fiscal stimulus package, with measures largely financed through budget reallocations from underspending programs, debt repayment rescheduling, external assistance from development partners in the form of grants and concessionary loans, and public contributions, both in-kind and cash. According to IMF reporting, total COVID-19-related general government spending (including health and non-health sectors) was ETB 52.4 billion in FY 2019/20, which is equivalent to 13% and 3% of the federal government budget and GDP, respectively (IMF, 2021).

Support to households: The COVID-19 pandemic affected the extreme poor and vulnerable households. Cognizant of this, the GoE expanded its safety net program vertically by providing cash transfers of ETB 1.4 billion to 2.8 million existing beneficiaries and food transfers of 8,227 metric tons. It also expanded horizontally by distributing ETB 3.6 million to 891,843 new beneficiaries who were non-PSNP. Moreover, lump-sum double distributions were made to minimize infection risks (MOA, 2020/21 annual report).

Macro-fiscal impacts: The COVID-19 pandemic significantly harmed Ethiopia's economy - GDP growth slowed to 6.1% in 2019/20 against a 10% target, tourism lost $1 billion in revenue, and foreign trade taxes fell (National Bank of Ethiopia, 2020, Ethiopian News Agency, 2020). Fiscal constraints worsened as revenues declined while external grants weren't realized. Economic

impacts were likely exacerbated by the internal conflicts. Per capita expenditure on key social sectors, including agriculture and water, declined in real terms. Rising donor contributions may compensate for some of this decline, but prospects for a recovery of government budgets, the main funding source, are slim.

7.3 Methodology

Overarching approach: The overarching question this study seeks to answer is: How did the GoE use budget reallocations as an instrument to finance the COVID-19 response, and at what cost? Informing this, are three subsidiary research questions:

i. How has public expenditure deviated from existing plans, on account of COVID-19?
ii. What formal laws and processes govern budget reallocation decision-making? Were they followed in wake of COVID-19? What informal criteria guided decision-making around budget reallocation?
iii. What has been the broader impact (in terms of opportunity cost) of these budget reallocations?

In order to answer these research questions, the study developed a four-pillar methodology, as discussed below.

Approach to Pillar 1: Counterfactual Development: The counterfactual reflects the best-guess estimate of expenditure composition in a world where the pandemic did not occur. In order to isolate the estimated impact of the pandemic, first an estimate of what spending might have looked like in Ethiopia had the pandemic not occurred, the spending counterfactual, is developed and compared against the actual expenditure.

The **EFY 2008–2011** (2015/16–2018/19) Ethiopian budget is used to estimate the median budget execution ratio (normal time deviation). The ratio has been calculated by comparing executed funds with **approved budgets,** i.e. excluding any adjustments made in the supplementary budgets of those years. This is then applied to the approved expenditure in 2019/20 to develop the counterfactual in ETB.

Given the large variability in the counterfactual and approved expenditure for some institutions included in the project-level analysis, different methodologies were employed to adjust the counterfactuals and provide a more useful expenditure analysis.

In the case of the Ethiopian Roads Authority (ERA), the authority recorded an overspend relative to the counterfactual, but a high underspend against the approved budget. Based on information collected in the KIIs, the research team decided to utilize the 2019/20 approved budget instead of the counterfactual. This was because, first, ERA's budget mainly relies on the GoE Treasury, and as a result, it is deemed the most vulnerable entity for reallocations. Second, information obtained through KIIs revealed that part of ERA's budget that was to be financed by external assistance and loans did not materialize for various reasons.

The budget allocated for the irrigation sector increased dramatically in 2018/19 and 2019/20. Accordingly, budget utilization of the irrigation and drainage program declined significantly, from about 99% in 2017/18 to 22% by 2019/20. It is plausible that the decline is partly due to limited capacity to implement irrigation projects, and we have accordingly adjusted the counterfactual. For the adjusted counterfactual, the median budget utilization rate of 98% is applied to a constructed 2019/20 budget, generated by applying a 38.5% growth rate to the 2018/19 budget of ETB 11.87 billion.

Approach to Pillar 2: Expenditure Analysis: The expenditure analysis encapsulates the second pillar of the analysis, focusing on answering the first research question: how has public expenditure deviated on account of COVID-19? This aspect of the analysis involves comparing detailed outturn data to the counterfactual established under pillar 1, revealing the incidence of spending cuts across the year of analysis. Both the sector 'winners' and 'losers' were identified through this stage, tracking how and when money moved between budget lines.

Approach to Pillar 3: Procedural Analysis: Pillar 3 of the analysis sought to understand what informal criteria guided decision-making around budget reallocations during the COVID-19 pandemic and to what effect. Since the quantitative expenditure analysis cannot tell us the explanations and logic behind underspends, a qualitative analysis is required to understand the processes around how, when and why budget reallocations were made, alongside the potential impact. This analysis is done through document analysis and KIIs.

Approach to Pillar 4: Impact Analysis: To determine the impact that public expenditure changes have had on the Ethiopian economy, this report utilizes both a macro approach and a case study approach to calculate the opportunity cost of budget reallocations. Two methodologies have been used to determine the impact of budget reallocation.

The fiscal multiplier was used to give a single, headline figure of the cost of reallocations in monetary or GDP terms. It is a measure of the short-term impact of discretionary fiscal policy on output, defined as the ratio of a change in output to the change in spending/taxation. We used two fiscal multiplier estimates. Firstly, a range of 0.21–0.624 was applied to the aggregate expenditure under the 'bucket approach'. Second, the IMF approach is applied separately to capital and recurrent expenditure, with multipliers of 0.82 and 0.42, respectively.

An alternative aggregate measure uses the average marginal cost of funds as a means of estimating the marginal value of public finance for selected sectors. The MCF represents the social cost of raising an additional tax dollar, accounting for distortions like labor market impacts from taxation. Tax systems being imperfect, the MCF varies but averages above 1. An MCF estimate of 1.28 was used to analyze the impact of budget reallocations across irrigation, education, and roads.

7.4 Findings

7.4.1 Budgetary instruments used to respond to COVID-19

In FY 2019/20, the GoE spent ETB 52.4 billion (US$ 1.67 billion) on both the health and non-health response to COVID-19, equating to 13% of the federal government budget (IMF, 2021). This expenditure was financed through budget reallocations, supplementary budgets, external borrowing and assistance by development partners, and public contributions.

Budget reallocation: The MoF used capital and recurrent budget reallocations to finance the COVID-19 response. In EFY 2012 (FY 2019/20), the GoE reallocated funds from debt resettlement, the Irrigation Development Commission, the Ministry of Education (with a particular focus on higher education), the Ministry of Culture and Sport, and the National Election Board of Ethiopia, for the COVID-19 response. For example, it is estimated that ETB 10 billion was reallocated from irrigation projects for the COVID-19 response, equivalent to 70.1% of the original budget for irrigation projects.

The economy function experienced an overall reduction in funding in 2019/20 due to COVID-19 **(Error! Reference source not found.).** In contrast, the social and administration functions saw increases to their budgets to combat COVID-19. Section 7.4.2 provides further detail on the sub-functions and institutions affected by budget cuts.

Supplementary budget: Supplementary budgets are used in Ethiopia as a mechanism to finance emergency responses and economic challenges. Two supplementary budgets were approved in the second half of FY 2019/20 (EFY 2012). The first was approved in February 2020; the second was approved in June 2020. The second supplementary budget contained an increase in expenditure of ETB 48.6 billion, returning the domestic financing requirement to just above the original budgeted amount, while also financing the COVID-19 response measures. The second supplementary budget contained ETB 40.4 billion of recurrent expenditure, allocated to 'Other'. This is understood to have funded the COVID-19 response measures.

Contingency budget: The 2019/20 contingency budget for unforeseen events was ETB 14 billion, 3% of the total federal government budget, and was appropriated under the MoF. As the contingency budget is not specifically tagged to disaster response, it was fully utilized prior to COVID-19 and was thus unavailable to the GoE in planning the response to COVID-19. Regardless, the size of the contingency budget would have made it insufficient as the main source of funds for the response, with an original appropriation equivalent to only 27% of the GoE's total COVID-19 response in 2019/20.

The GoE's contingency budget is managed by the MoF and can be drawn upon in an emergency. **However, there is no legislation specifying the size of the contingency, and there is limited**

[9] The reallocation from capital to recurrent cannot be done directly: it must be transferred to the contingency budget, from which it can be used for either recurrent or other capital-related spending.

guidance on its use in the Federal Government of Ethiopia Financial Administration Proclamation, Article 26.

As seen above, the GoE's disaster response budgetary instruments are predominantly reactive in nature. The GoE typically uses external borrowing, external donor assistance, contingency funds, budget reallocations, supplementary budgets, and public contributions to respond to disasters. Given the absence of proactive measures and the fiscal pressures, the GoE was forced to rely on budget reallocations to fund much of its COVID-19 response.

Prior to making budget reallocations, the MoF undertakes assessments. It considers the performance of projects (preparation and contractual agreements), **budget execution, program objectives, the perspective of line ministries and foreign exchange availability.** These assessments are guided by internally developed criteria as opposed to a formal policy and are undertaken at the discretion of the MoF. After finalizing the assessment, the GoE moves money from poorly performing projects towards new priorities. It takes more than one month to collect the money and one week for the MoF to disburse it, resulting in a process that takes six weeks at a minimum.

The KIIs with the Irrigation Development Commission and the ERA indicated that although the GoE appropriated significant budgets for the irrigation and road sectors, projects were delayed and postponed due to cash shortfalls, resulting from shortfalls in revenue collection and budget reallocations. MoF respondents, however, justified the reallocations on the basis that the Commission did not spend significant amounts of the allocated budget due to inefficiencies and operational constraints.

While there are proclamations that allow the MoF to undertake the budget reallocation, the KIIs indicated that there were **limitations in the process** and that the **performance assessments undertaken by the MoF are weak.** The KIIs also indicated that as a result of reallocations, **several capital projects have either been delayed or postponed,** incurring **political** (lack of trust in government), **social** (loss in social benefit from the projects), and economic (inflation) costs.

Furthermore, the lack of timeliness of the budget reallocation process, which lasts more than six weeks, **prevents the MoF from utilizing it as a fast, flexible response to emergencies.** It can also result in the use of indirect budget reallocations, such as cash restrictions, which bypass performance assessments.

The review of the processes followed in response to COVID-19 suggests that improvements could be made to the budget reallocation process, such as by developing formal internal guidelines, to increase the timeliness of the reallocations, and to ensure that the opportunity cost does not outweigh the benefit. In addition, it is evident in the supplementary budget that the GoE needs alternative budgetary mechanisms to respond to disasters, to reduce its reliance on debt as a source of funding.

7.4.2 COVID-19 and deviations in public expenditure

This section assesses how GoE expenditure deviated due to COVID-19, by comparing actual expenditure with the counterfactual developed, i.e. the estimate of expenditure had COVID-19 not occurred. Both capital and recurrent expenditures were lower than their respective counterfactual expenditure in 2019/20, indicating possible underspending at the institution, program, and project levels.

Table 7.1 shows that in 2019/20 the total amount of underspend compared to the counterfactual was ETB 19.8 billion, indicating that the GoE extracted an estimated ETB 19.8 billion from the planned spending of line ministries and budget institutions and reallocated it. To put this number into context, ETB 19.8 billion is equivalent to 38% of total COVID-19 expenditure in 2019/20, or 5% of total expenditure in 2019/20.

Table 7.1: Total underspending by functional classification

Function	EFY 2012 underspend compared to the counterfactual (in billions of ETB)		Share of underspend out of total underspend		Share of underspend out of actual expenditure	
	Capital	Recurrent	Capital	Recurrent	Capital	Recurrent
Administration and General	1.5	3.3	23%	25%	1%	2%
Economy	4.5	-0.2	68%		3%	
Social	0.6	10.1	9%	75%	0.3%	5%
Total	6.6	13.2	100%	100%	4%	6%

Source: Authors' computation.

Note: The analysis only covers parts of economic components, institutions, programs, and projects that have low execution ratios compared to the counterfactual. Consequently, all overspends are not evident. The 'Other' component of expenditure is excluded from the analysis. The negative figure indicates an overspend.

Recurrent expenditure: Recurrent expenditure registered a large underspend of ETB 13.4 billion, or 6% of the actual recurrent expenditure (Table 7.1). The social function experienced the largest underspend, at 75% of the total, largely due to underspending on prevention and rehabilitation under the National Disaster Risk Management Commission (see Box 1).

Capital expenditure: The total underspend in capital expenditure in 2019/20 (FY 2012) amounted to ETB 6.6 billion (US$ 211 million) or 4% of actual capital expenditure. The value of the capital underspend was almost equivalent to 2% of total revenue. The economy function accounted for the largest portion (68%) of the total underspends. This was followed by the general service and social functions, which accounted for 23% and 9% of the underspends relative to the counterfactual, respectively.

[10] The prevention and rehabilitation appropriation funds the following programmes: improving management and administration, disaster risk reduction and rehabilitation, preparedness and response, food and non-food stocking and distribution, and disaster risk management research and training.

Of capital expenditure, the water, resource, and energy sectors registered the highest underspend. In 2019/20, a budget of more than ETB 17 billion was approved for the sector, 82% of which was earmarked for the Irrigation Development Commission. Nonetheless, only 22% of the funds earmarked for irrigation development activities were utilized, well below the median budget execution ratio of around 90%, consistent with the findings from the KIIs where the GoE reallocated around ETB 10 billion from irrigation projects. It appears that the MoF reallocated the budget from the Irrigation Development Commission for the COVID-19 response due to a view that the Commission faced operational constraints. This must be weighed against information from the second-round KIIs, where the Irrigation Commission revealed that yearly approved budgets are not fully deployed to the Commission due to federal government cash limitations (due to limited fiscal space and budget reallocations).

Box 1: Prevention and rehabilitation

Due to limited fiscal space, the GoE does not allocate sufficient funds for anticipated disasters; rather, it relies on ex-post financing. As a result, the actual recurrent expenditure for prevention and rehabilitation is significantly different from the approved budget due to the ex-post funding of disasters from the budget line. For instance, the four-year average (2015/16–2018/19) approved recurrent budget for prevention and rehabilitation was ETB 119 million, but the average actual recurrent expenditure was ETB 14 billion, indicating that on average only 0.8% of the funding required to respond to disasters was planned ex-ante.

In 2019/20, the actual expenditure on prevention and rehabilitation was again high, at ETB 7 billon, relative to the approved budget of ETB 215 million. However, when compared to the counterfactual – or the estimated spend had COVID-19 not occurred – the actual expenditure was low, likely reflecting the different nature of the disaster that arose from COVID-19, which saw increases in health expenditure in response to the disaster, as opposed to more traditional disaster responses.

This situation makes it clear that it is difficult to compare a 'disaster year' with a 'non-disaster year' since Ethiopia is highly vulnerable to humanitarian and natural disasters. Thus, if the GoE had wider fiscal space, there would be an argument for allocating around ETB 14 billion in 2019/20 for prevention and rehabilitation based on past trends (i.e. applying the evidence-based budgeting rule). As this is not the case, a significant overspend is registered against the original budget, of approximately ETB 6.7 billion, and a significant underspend is registered against the counterfactual, of ETB 14 billion.

7.4.3 The impact (opportunity cost) of COVID-19 reallocations

This section assesses the impact of the COVID-19 reallocations utilizing the various methods detailed in Section 7.3.

Fiscal multiplier: As described in Section 7.3, the fiscal multiplier was utilized to develop an estimate of the macro impact of budget reallocations. Two fiscal multiplier estimates were used: one applied to the aggregate under-expenditure ('the bucket approach') and the other applied to the under-expenditure based on economic classification ('the IMF approach').

The 'bucket approach': When applied to the total underspend of ETB 19.8 billion, the 'bucket approach' estimates an impact in the range of ETB 24 billion to ETB 32.2 billion. That is, in addition to the direct impact of the unexpended ETB 19.8 billion, ETB 4.2 to 12.4 billion of value has been lost. If loans from donors had not been received, it can be assumed that additional budget reallocations would have occurred; in this case the total underspend could be estimated to increase to ETB 25.8 billion (US$ 832 million) and the impact would be in the range of ETB 31.2 billion to ETB 41.9 billion (US$ 1–1.34 billion).

The IMF approach: this is applied separately to capital and recurrent expenditure, with multipliers of 0.82 and 0.42, respectively, used. This elicits a result of ETB 30.8 billion: ETB 12 billion in capital and ETB 18.7 billion in recurrent. That is, in addition to the direct impact of the unexpended ETB 19.8 billion, ETB 11 billion of value has been lost.

These results and the multipliers utilized indicate that reallocating capital expenditures can have significant economic impacts, due to the large multipliers estimated.

The MCF approach: As outlined in the methodology, the MCF approach is applied to the capital expenditure of three institutions to estimate the impact of expenditure deviations. As the MCF approach is applied only to the limited sample it does not consider the variability in expenditure (both over and under) and can thus be inconsistent with the multiplier results.

Optimality of expenditure: As outlined in the methodology; to determine the impact of budget reallocations, a judgment must be made on the optimality of expenditure, as this determines its marginal benefit.

Although Ethiopia has ample potential for irrigation (See You, 2008), the GoE budget allocation for irrigation is deemed moderately excessive compared to the capacity to implement. The GoE has only recently started increasing investment in the irrigation sector. However, the ability to efficiently execute projects is at the nascent stage.

In the KIIs, respondents highlighted that the budget allocation for higher education in Ethiopia is insufficient. They argued that laboratories are ill-equipped due to a lack of resources. However, in analyzing the data, GoE expenditure on higher education is found to be higher than the comparator countries. GoE expenditure on tertiary education per student as a percentage of GDP per capita in Ethiopia is more than double that of Uganda and Rwanda. Thus, the GoE budget allocation is deemed to be optimal.

Finally, the GoE's allocation to the ERA was considered moderately insufficient. While budget execution is typically low (70%), the KIIs indicated that the ERA receives 82% of funding from the GoE Treasury. The remaining finance is secured from external loans and assistance, which, while committed or assumed in budgetary approvals, do not always materialize. This indicates that more reliable funding sources may be required to improve the ERA's budget execution.

Utilizing the optimality of expenditure estimates, Table 7.2 shows the calculation of the estimated value lost due to the underspends in the capital budgets of the three ministries. The estimated value forgone in 2019/20 is estimated to be ETB 29.2 billion (US$ 931 million). The estimated value lost is 25% higher than the monetary value of the cuts. In other words, had there been an alternative financing mechanism available that avoided the budget reallocations, the country could have generated ETB 6.9 billion in additional value (or 0.3% of GDP). These figures provide an estimate of the impact of reduced expenditure on the broader economy and include consideration of the subsequent impacts on employment.

These numbers indicate that the impact of budget reallocations was significant and could have been reduced. The result is driven by the high marginal benefits of public funds in Ethiopia and the substantial budget reallocation away from productive sectors. While documented guidelines do not exist for budget reallocation, discussions with the affected sectors indicate that budget execution performance was a key indicator for reallocation. As budget execution can be a crude measure of impact, a more formal assessment of budget reallocation could reduce substantially the opportunity costs of reallocations.

Table 7.2: Impact analysis calculations 2019/20 (ETB, billions)

Institution	Total underspend against relevant counterfactual (2)	Optimality of expenditure (3)	Explanation (4)	Sectoral marginal benefit of funds (5)	Estimated value loss of underspend 6=5x2
Irrigation Development Commission	7.5	Moderately excessive	The capacity to implement irrigation projects is limited. There are limitations from the design stage to the implementation stage.	1.18	8.87
Ministry of Science and Education	1.05	Optimal	Ethiopia spends much more than the comparator countries in higher education as a percentage of GDP per capita. Nonetheless, KIIs reveal the demand for an increased budget for high-quality education.	1.28	1.34
ERA	13.74	Moderately insufficient	Despite the high share of GoE expenditure going into the road sector, funding is considered moderately insufficient.	1.38	18.96
Total	22.3				29.17

Source: Expenditure analysis and authors' assessment.

7.4.4 Results of the impact analysis

The results summarized in Table 7.3 all tell a similar story, despite different methodologies and their application to different data.

Table 7.3: Results of the impact analysis (ETB, billions)

Method	Applied to	Result	Value lost
Bucket approach	Aggregate budget reallocation	24–32.2	4.2–12.4
IMF approach	Government consumption	18.7	5.5
	Capital investment	12	5.4
	Subsidies and transfers	-	-
	Total	**30.8**	**11**
MCF	Capital expenditure, three ministries	29.7	6.9

The fiscal multiplier, applied to both capital and recurrent expenditure utilizing the IMF approach, indicates an opportunity cost of approximately ETB 30.8 billion. This result considers overspends and underspends across these economic classifications that offset each other, resulting in one

aggregate impact on the economy. The result of the MCF approach is in line with the results of the multiplier approach, emphasizing the impact of underspends on the capital expenditure of the three institutions, totaling ETB 29.7 billion, without offsetting over-expenditure due to COVID-19. Finally, the cost-benefit analysis illustrates the impact of delayed projects due to the inability to capitalize on the economic benefits in the short term and increases in the cost of the projects over the long term.

Taken together, these results indicate that the opportunity cost of budget reallocations is in the order of ETB 30 billion, with approximately ETB 11 billion of the additional value of the investments lost due to reallocations. To illustrate the scale of this: if that ETB 11 billion lost was invested in capital projects, it could finance the equivalent of three of the Welmel irrigation projects , potentially benefitting 66,000 households.

7.5 Conclusions

The findings presented in this report show that by doing more to promote financial resilience in Ethiopia, the effects of shocks such as COVID-19 on the economy can be significantly reduced. Even before COVID-19 Ethiopia had a limited fiscal space, which forced the GoE to utilize budget reallocations and supplementary budgets, instead of responding with adequate pre-planned financing. This report estimates a forgone economic value at 55% above spending cuts, totaling ETB 30.8 billion (US$ 931 million), due to reallocation processes to curb COVID-19. Value lost from cuts to education, roads, and irrigation was 25% above the cuts themselves. Reallocating from capital investment is especially costly given its higher returns.

The results presented in this report suggest that efforts must be made to improve the GoE's budgeting and budget processes. This will help to ensure that costs are reduced when disasters strike and funds are urgently required to respond. In addition, the GoE will be able to respond in a timelier manner, further decreasing the indirect costs that result from slow responses. Furthermore, greater certainty should be provided by donor partners on funding, as the delayed receipt of funds appears to have affected the efficiency of GoE institutions and the reliability of budgets.

At the same time, efforts should also be made to increase and improve Ethiopia's access to financing for emergencies. This will help the GoE provide sufficient finance when it is needed, as limited financial capacity means that while budgeting and budget process improvements will help mitigate the impacts of emergencies, they will not be able to provide all the required finance to respond to the most serious disasters.

7.6 Policy options for consideration

Strengthening budgeting and budget processes are important tools to reduce the effects of shocks on the economy. Options that could be undertaken by the MoF include the following:

Formalize/develop a disaster response plan for the MoF, to guide decision-making on budget reallocations. Having a plan and process in place for when budget reallocations must take place

can reduce the opportunity costs and the time required for such reallocations. This work can be undertaken prior to a disaster and would involve steps such as undertaking a budget-tagging process to identify spending lines that are unviable, underspending, or of low priority, developing a framework for decisions on underspending for use ex-post disaster, and clearly setting out the policies and processes to be followed in undertaking budget reallocations.

- **Improve existing budgetary mechanisms.** This could include reviewing budget allocations to ensure that the optimal allocation of funds is achieved to increase budget execution and reduce wastage, and reviewing the budget process to ensure that adequate information is received from line ministries to inform budget reallocation processes.
- **Develop rules to guide the appropriation to and use of, the contingency fund.** Calculating the appropriate contingency requirements and developing rules to guide their usage, such as by restricting what percentage of the fund can be used following a disaster, could ensure that funds are available at the onset of a disaster, and allow time for other funding sources, such as insurance, budget reallocations, or donor support, to be triggered.
- **Deepen understanding of the GoE's liabilities (explicit and implicit) during and after a disaster.** Understanding what the GoE may spend (and on what) will help in designing financing mechanisms that are appropriate to future needs. Moreover, a strengthened PFM system, where disaster-related liabilities are known, would allow the GoE to make better-informed decisions about how to mitigate impacts financially.
- **Consider increasing the appropriation to prevention and rehabilitation.** Funding for the prevention of, and rehabilitation following, disasters is significantly below the amount required. By increasing the appropriation towards the previous year's spending levels, either through additional domestic funds or donor support, the GoE would have the ability to respond to disasters in a timelier manner, and pressure on budget reallocations would decrease, decreasing the ex-post costs of disasters.

On a national level, the GoE could consider building broader financial capacity to respond to disasters. The options in this regard include the following:

- **Explore additional risk financing instruments that could be available to the GoE in times of need.** Additional instruments could include utilizing disaster reserve funds, exploring contingent credit that can supplement the funds available through reserve funds, and exploring risk transfers for governments, such as public asset insurance and sovereign insurance.
- **Develop a comprehensive risk-layering approach to cover the GoE's liabilities.** A comprehensive risk-layering approach would enable the GoE to draw upon a range of financing instruments (not just budgetary instruments) that are proportionate to the needs and costs of disasters.
- **Continue to protect the most vulnerable people.** The poorest members of society are also those who suffer the most when disasters and crises occur, and their needs require special attention. To ensure their needs are met, continue to strengthen scalable social protection mechanisms, such as the PSNP, to meet unplanned needs.

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