

INTERNATIONAL DEVELOPMENT ASSOCIATION AND
INTERNATIONAL MONETARY FUND

ETHIOPIA

**Joint Staff Assessment of the
Poverty Reduction Strategy Paper**

Prepared by the Staffs of the IDA and IMF

Approved by Callisto Madavo and Gobind Nankani (IDA)
and José Fajgenbaum and G. Russell Kincaid (IMF)

August 27, 2002

I. INTRODUCTION

- 1. The Poverty Reduction Strategy Paper (PRSP) of the Government of Ethiopia continues the broad thrust of policies that have been debated and developed internally in Ethiopia over the past decade to reduce poverty.** It builds on the Interim PRSP presented to the boards of the Bank and the Fund in March 2001. The strengths of the strategy are (i) a strong country ownership and a broad-based participatory process; (ii) a sound diagnosis of the poverty situation; (iii) an appropriate emphasis of the importance of rural and agrarian development in the lives of the poor, with a recognition of the importance of private sector development to increase nonfarm income and generate growth; and (iv) a welcome stress on investing in human capacity, as demonstrated by the reorientation of expenditures from military outlays toward social spending.
- 2. However, as recognized by the Government, the PRSP remains a work in progress,** and the strategy needs to be further elaborated in a number of areas, including more detailed work on the costing of programs; a further examination of the linkages between growth and poverty; and, more specific policy measures to encourage private sector and agricultural development, and to tailor the strategy in light of the evolving process of decentralization. The government is working on each of these areas, and an update can be expected by the time of the first annual PRSP progress report.
- 3. Several factors condition the approach to the PRSP in Ethiopia.** First, due to historical circumstances, the government has placed a high priority on the welfare of the poor and the equitable distribution of the benefits of growth to rural areas, and it has adopted a more interventionist approach than generally prevails elsewhere. Second, the scale of the development challenge in Ethiopia is almost unparalleled, with a population of over 65 million people and one of the world's lowest per capita incomes, at only US\$100 per capita. Third, frequent droughts and limited agricultural productivity relative to population pressure have generated an overriding concern about food security.

II. THE PARTICIPATORY PROCESS

4. **In the staff's view, the PRSP accurately describes the deep and wide-ranging set of consultations undertaken by the government in preparing the PRSP.** Free and open consultations moderated by representatives of civil society were held in over 100 out of 550 *woredas* (districts). Comprehensive regional and national-level consultations debated all key policy areas. The consultations were observed and attended by independent and donor observers, in whose view they were open and free of interference by the government or the ruling party. The nongovernmental organizations (NGOs) established an independent NGO task force to contribute to—and monitor—the consultative process, while the Chamber of Commerce established sectoral working groups to feed into the consultations. Both have welcomed the process and expressed their satisfaction with it. The draft PRSP was discussed internally within the government and the Parliament, and with civil society, NGOs, and donors.

5. **The PRSP consultations have constituted an unprecedented participatory process.** This is the first time in Ethiopia that any consultations have been held without government moderators, and they may have established a new set of expectations with respect to public debate of policy issues. The principal drawback was that consultations served mostly to provide reactions to the government's existing policies and programs, rather than to craft new ones. However, it needs to be recognized that this is a new process in Ethiopia, and that the government has already begun to place greater emphasis on issues that were raised during the consultations, especially private sector development reforms and decentralization. The government has indicated its intention to further deepen the participatory process for the implementation and monitoring of the PRSP; however, the institutional arrangements for steering this process and for public monitoring of the implementation of the PRSP have yet to be delineated, and the role of local governments clarified.

III. POVERTY DIAGNOSIS

6. **The PRSP presents a comprehensive description of the levels and spatial distribution of income and non-income poverty,** on the basis of two in-depth household surveys undertaken in 1995/96 and 1999/2000,¹ and of other existing data. The analysis reveals large differences in income poverty and social indicators across regions, which underscores the importance of the government's regionally differentiated poverty reduction strategy. The most recent survey data only became available while the PRSP was being prepared, and more time is needed to review the results and link them more directly to policy actions. Among other things, future work in this area should include an analysis of poverty incidence by sources of income and employment category.

¹ The Ethiopian fiscal years cover the period from July 8 to July 7.

7. **The analysis of the determinants of poverty is sound** and integrates qualitative assessments of poverty based on the *woreda*-level consultations. The World Bank and Fund staffs agree with the broad conclusion that overall income poverty has hardly declined over the last five years, although some social indicators—particularly those related to schooling—have significantly improved recently. The PRSP recognizes the link between poverty and rapid population growth, which has led to high dependency ratios, pressures on natural resources, and strains on the education and health systems. The first annual PRSP progress report will need, however, to present a more detailed discussion of the economic, social, and institutional causes of poverty, including by drawing on systematic qualitative poverty participatory assessments and quantitative poverty analyses. The question of vulnerability, particularly food security and HIV/AIDS, is discussed at the aggregate level but could be elaborated further at the household level.

8. **The discussion in the PRSP of the linkages between growth and poverty is welcome, even though it is preliminary and partial.** However, the assessment of the dynamic impact of past policies on poverty and of the links with sectoral strategies needs to be further developed. The staffs welcome the planned in-depth analysis of the actual and potential contribution that various sectors can make to the incomes of the poor. The staffs also encourage the government to conduct with donor support and incorporate in the first annual PRSP progress report **poverty and social impact analyses** in the areas of concern indicated in the PRSP, such as the impact of the introduction of the value-added tax (VAT) in January 2003 and the impact of the recent decline in coffee and cereal prices.

IV. THE POVERTY REDUCTION STRATEGY

9. **The poverty reduction targets for the medium and long term are ambitious but achievable,** and are consistent with the Millennium Development Goals. They include (i) a reduction of income poverty by about half by 2015,² and from 44 percent in 1999/2000 to 40 percent in 2004/05; (ii) a reduction in infant mortality from 97 per thousand in 1999/2000 to 85 per thousand by 2004/05; and (iii) an increase in the gross primary school enrollment rate from 57 percent in 2000/01 to 65 percent by 2004/05.

10. **Underpinned by the maintenance of macroeconomic stability, Ethiopia's poverty strategy focuses on promoting agriculturally led, rural-based growth, while improving the environment for exports and private sector growth.** Although agriculture is expected by the authorities to play the key role in their growth strategy, other sectors, in particular manufacturing, electricity and water, construction and the service sectors, are expected to grow at higher annual average rates. The agriculturally led strategy is espoused both because agriculture is seen as the largest immediate source of primary surplus and because the poor

² The analysis presented in the PRSP indicates that this can be achieved if real GDP grows by 5.7 percent per annum until 2015, assuming constant elasticity of poverty with respect to growth.

are concentrated overwhelmingly in rural areas. This policy is buttressed by an emphasis on investment in education and infrastructure, coupled with improved social services, especially with respect to health and access to safe water. In the last few months, the government has also put considerable emphasis on the need for a major push in capacity building, in order to accelerate decentralization and to intensify efforts in judicial and civil service reform. The broad thrust of this strategy is appropriate and well tailored to Ethiopia's conditions.

11. **A number of important issues have not been adequately covered, such as uneven implementation capacity, the degree of specificity of some aspects of the reforms in agriculture, and private sector development.** On the last one, although measures to encourage foreign and domestic private investment and to promote private sector growth are limited and lack specificity, several recent developments are encouraging, including the authorities' willingness to adopt a new federal urban land lease proclamation and to embark on enhanced consultations with private sector organizations to discuss their ideas.

A. Macroeconomic Framework

12. **The macroeconomic framework presented in the PRSP is consistent with the Poverty Reduction and Growth Facility (PRGF) macroeconomic framework for 2002/03.** However, for the outer years, a more ambitious scenario is presented, based on a 7 percent annual real GDP growth rate compared with 6 percent under the PRGF-supported program, and larger financing requirements.³ Similarly, consumer price inflation is to be limited to 5 percent, compared with 3 percent under the PRGF-supported program. The PRSP envisages a decline in the overall fiscal balance (including grants and special programs⁴) from 9.9 percent of GDP in 2001/02 to 6.7 percent in 2004/05, compared with a decline to 4.7 percent in the PRGF-supported program. The PRGF macroeconomic framework is based on identified financing, measures to improve revenues, such as the introduction of the VAT in January 2003 and further improvements in tax administration, and the continued reallocation of expenditure from defense spending toward poverty-targeted outlays. While the macroeconomic scenario for the outer years presented in the PRSP envisages a larger development program to accelerate programs aimed at reducing poverty, achieving the growth objective depends on unsustainable high growth rate in agriculture and, therefore, seems too ambitious (see para. 13). Moreover, a prudent fiscal policy to limit recourse to domestic financing—which is critical to maintaining macroeconomic stability—

³ As discussed at the time of the HIPC Decision point (EBS/01/174, 10/16/01; and IDA/R 2001-01681), even the PRGF baseline scenario, although achievable, will require continued implementation of sound policies and favorable exogenous developments.

⁴ Special programs include the demobilization and reintegration program, and the emergency recovery and rehabilitation program supported by the World Bank. They amounted to 2 percent of GDP in 2001/02, and are ending in 2003/04. The first annual progress report of the PRSP should discuss the implementation of these programs.

and to external financing other than on highly concessional terms—which is key to ensuring external debt sustainability—needs to be maintained. The Government has indicated that it will maintain as a baseline the macroeconomic framework in the three-year PRGF arrangement. Nevertheless, once additional external financing on appropriate terms becomes available, higher development expenditures than envisaged in the PRGF-supported program could be supported, provided that macroeconomic stability and debt sustainability are maintained.

13. **The underlying uncertainty in implementing Ethiopia’s PRSP program is whether the proposed economic growth target will be achievable.** The target of annual real GDP growth of even 6 percent is ambitious, as the outcome is highly dependent on adequate rainfall, favorable external developments, the pursuit of an aggressive reform agenda, and sound macroeconomic policies that would promote higher private savings and investment. The first annual progress report should include alternative macroeconomic scenarios with the downside risks.

B. Sectoral Policies

14. **The broad thrust of the sector strategies presented is sound. While the matrix of medium-term policy measures represents a good start toward implementation of the program articulated in the PRSP, there is a need for further refinement in the areas of prioritization, specificity, and timing.** The first annual PRSP progress report will need to incorporate new sectoral strategies, particularly private sector development, and agricultural development strategies.

15. **The strong emphasis put by the PRSP on agriculture, rural development, and food security is appropriate.** The PRSP signals a renewed recognition of the importance of the private sector in agricultural development and makes a frank assessment of the benefits and costs associated with the widespread provision of government credit guarantees for fertilizer purchase—a policy that has constituted the heart of the program in the recent past. This approach represents the continuation of a slow shift away from state domination of the agricultural sector. However, detailed policy actions need to be clearly spelled out, including an assessment of which interventions have the greatest impact, in order to help prioritize them. This will also facilitate the identification of specific policy measures to improve the environment for private agricultural markets. Particular areas for attention include (i) a clear statement of fertilizer policy and of other measures to improve the functioning of agricultural input markets; (ii) measures to overcome implementation constraints on irrigation; (iii) a streamlining of the land lease policy; and (iv) measures to enhance the rural credit system, including its separation from the extension system, and elimination of state guarantees. The recognition of the special situation of pastoral people and the tailoring of the strategy to different agro-ecological zones are welcome. As the emerging food shortages demonstrate, the development of a new, comprehensive **food security** and safety net strategy, with the support of donors, is clearly needed.

16. **The PRSP adequately stresses the importance of private sector development.** For the first time, the government is elaborating a comprehensive private sector development strategy, in consultation with the private sector, which includes attention to the investment climate, the financial sector, exports, and the rural economy. In particular, the government is committed (i) to rapidly improving the investment climate through freer access to land and effective enforcement of a competition law; (ii) to completely liberalizing the agricultural input and output markets, focusing on the marketing of agriculture products, and encouraging nonfarm rural activity; (iii) to developing incentive structures that will foster export diversification; (iv) to expanding infrastructure by allowing private—including foreign—sector participation; and (v) to improving the soundness of banks and the banking environment. However, while these commitments are very positive, they lack specific implementation measures, which need to be elaborated in consultation with the private sector and sequenced in ways that can build quickly the credibility of the reform program. Measures to enhance competition in the financial sector should also be adopted, and the authorities' commitment to keep all options open for the planned restructuring of the state-owned Commercial Bank of Ethiopia is welcome. Enhancing competitiveness and maintaining an appropriate exchange rate policy are also important for the success of the export strategy.

17. **The PRSP proposes a major expansion of the education sector, with a continued increase in primary school coverage** and a new emphasis on increased postsecondary and technical skills development to relieve critical bottlenecks in development capacity. This strategy could benefit from a better articulated policy framework, with a special emphasis on improving the quality of the primary education system; a deeper look, along with donors, at the affordability of the overall plan; and an enumeration of ways to raise overall implementation capacity (both administrative and technical), particularly in light of the planned program to decentralize service delivery to the *woreda* level. In addition, the respective roles of the government and the private sector in financing post-primary education will need elaboration as part of the long-term policy.

18. **The health strategy presented in the PRSP appropriately places high priority on primary and preventive health care, and candidly acknowledges the difficulties faced in implementing the health sector program to date.** There is a good degree of specificity in terms of the measures and targets proposed. The program, however, places heavy emphasis on health care facilities and could benefit from (i) more attention to the questions of personnel, incentives, and systems management; and (ii) an explicit examination of the most cost-effective interventions to reduce the burden of disease, which falls heaviest on the poor, as a basis for prioritizing the strategy. The multisectoral emphasis placed on fighting HIV/AIDS in the PRSP is welcome; however, it is important that implementation of the program be intensified.

19. **The PRSP recognizes the strong link between poverty and environmental degradation in Ethiopia,** especially as the poor are those most dependent on the natural resource base for their livelihoods. The establishment of the Environmental Protection Authority and the formulation of a national action plan to combat desertification and the effects of drought are particularly welcome initiatives. The ongoing process of preparing

Regional Conservation Plans should provide a basis for more explicit, prioritized, and costed measures.

20. **The PRSP also recognizes the additional disadvantages that women face with respect to poverty**, and lays out a series of specific actions, with a particular emphasis on the effort to improve the enrollment rate of girls in school during the PRSP period and to define agricultural extension packages for poor women farmers.

C. Governance and Decentralization

21. **The emphasis placed on democratization, improved service delivery, and good governance is welcome.** The PRSP provides a candid assessment of the challenges, including the implementation of the Civil Service Reform Program at the local level and the need for development of sound intergovernmental systems within regions, as well as for a multifaceted approach to promoting democratic values and practices in both public and private institutions. However, while the measures identified in the PRSP to build a fair, transparent, efficient, and ethical civil service are appropriate, more specific measures need to be developed to strengthen the justice system, deepen civil service reform at the regional level, and enhance transparency and combat corruption. A realistic timetable for the implementation of the National Capacity Building Program should be adopted, while ensuring that adequate synergies with the reform of incentive structures be established.

22. **The high degree of autonomy granted to regions of Ethiopia's decentralized system has undeniable benefits but complicates the process of specifying and agreeing on nationwide policies**, such as the specification of sectoral targets and spending levels by the regional governments. This situation is further complicated by the deepening of the decentralization process now underway. Under the new system, 550 *woredas* are responsible for setting priorities, delivering services, and determining budget allocations at the local level, within the framework of broad national policies. This opens up tremendous opportunities to increase the responsiveness of services to the poor, but it will stretch the limited capacity at the local level. This system also introduces some uncertainty in achieving PRSP goals and outcomes. In the coming year, it is important that the government pursue its commitment to focus at the *woreda* level on (i) setting benchmarks; (ii) developing the administrative mechanisms for transferring resources; (iii) building capacity; and (iv) conceptualizing the monitoring systems for the new arrangements. The first annual progress report should include an evaluation of the early experience with decentralization.

D. Costs, Budget, and Financing

23. **The budget allocation proposed in the PRSP continues the trend started in 2000/01 of reallocating outlays from defense to poverty-targeted spending** in education, health, agriculture, and rural infrastructure. Defense spending would decrease from 13.2 percent of GDP in 1999/00 to 4.3 percent in 2004/05, while poverty-targeted outlays would increase from 8.4 percent of GDP in 1999/2000 to 19.9 percent in 2004/05. The staffs welcome this shift in the composition of expenditure; additional poverty-reducing spending

will be possible if further reductions in defense spending are effected. The first annual PRSP progress report needs to discuss additional possible shifts in allocation between these different sectors, and their implications in meeting poverty reduction targets.

24. **The costing of the PRSP programs is mainly based on sectoral development programs, but in some cases it is partial, and will likely be affected by new decentralization arrangements.** Cost estimates for health and education will be refined in the forthcoming public expenditure review, on the basis of a more detailed study of unit costs and comparisons with international benchmarks. Better-costed programs are expected to be integrated in next year's updated medium-term expenditure framework and presented in the first annual PRSP progress report.

25. **As mentioned above, the medium-term expenditure framework presented in the PRSP is based on ambitious assumptions** regarding the real GDP growth rate, the revenue effort, and concessional and grant financing. In addition, as recognized in the PRSP, the full costs of the programs exceed the fiscal envelope envisaged in its medium-term framework. It would therefore be critical that the government develop contingency plans that prioritize the core programs, identify potential areas of adjustment, and examine the scope for efficiency gains. These plans are even more necessary if proceeding with the proposed fiscal framework for 2003/04-2004/05 were to endanger macroeconomic stability and debt sustainability. The staffs share the government's expectation that the international donor community will continue to provide appropriately concessional external assistance to Ethiopia at its current level, or higher. However, the government recognizes that, over time, sustained poverty reduction will depend critically on the success of current efforts to strengthen revenues. The PRSP correctly stresses that the poverty reduction effort will also require more effective use of aid through better coordination, improved integration of external assistance into the budget, particularly of food aid, and simplification of disbursement procedures. The PRSP provides a potential platform for the government to mobilize greater levels of external assistance. In this respect, the recent formation of a joint donor group on budget support is encouraging, and the Consultative Group meeting that will be held in the coming months should play a critical role in fostering support for the PRSP program.⁵ A significant proportion of the proposed financing would have to be in grants to ensure debt sustainability.

26. **The high priority given recently to the implementation of a comprehensive program to improve public expenditure management is welcome.** The program will strengthen the government's capacity to track overall expenditure, including poverty-reducing outlays. It includes the introduction of a new, detailed budget classification system at all levels; an expediting of the reconciliation, closing, and auditing of public accounts;

⁵ Ethiopia is among the pilot countries under the donor harmonization initiative. The objectives of this initiative are to align donor programs with PRSP priorities, improve aid effectiveness by reducing transaction costs, and build country capacity for aid delivery and management.

improved reporting and control of expenditure; a strengthening of internal and external audit functions; and the introduction of an integrated financial information system. The staffs consider these reforms to be adequately comprehensive and ambitious, and urge the authorities to implement them vigorously.

27. **As recognized in the PRSP, realizing the benefits from the public expenditure management program may take some time, and careful management of fiscal decentralization will be needed to protect the gains made.** The delegation of a significant amount of poverty reduction spending to local governments will require appropriate monitoring and accountability mechanisms to ensure the proper and effective use of resources. Further work also remains to be undertaken to examine the financial relations among, and control mechanisms of, the various levels of government. In particular, a system for reporting to the central government regular and detailed information on actual spending from the *woredas* needs to be introduced. Current efforts to consolidate federal, regional, and local governments' budgets and accounts need to be vigorously pursued.

E. Targets, Indicators, and Monitoring

28. **The PRSP provides a clear set of indicators and targets for monitoring and evaluating the implementation of the strategy in the social sectors.** Further work needs to be done to include more specific year-by-year targets and translate priority actions to indicators in the other areas, particularly private investment, food security, and employment. Indicators also need to be further differentiated by region and gender. The definition of intermediate output indicators, such as budgets and program delivery goals, will require the close collaboration of regional and local governments.

29. **A major requirement for the PRSP monitoring system as it develops over the next few years will be to address the links between central data collection and analysis and the monitoring of inputs, outputs, and outcomes at the local level.** Over the past five years, the government has made impressive progress in setting up and developing a welfare-monitoring system, including the establishment of regular household consumption surveys and a system of welfare monitoring that allows the linking of nonincome outcomes with poverty status. There is a long-term need to build capacity at all levels, but particularly at the *woreda* level. A key requirement will be to involve nongovernmental stakeholders in both the generation of data and its analysis and use. In addition, the arrangements for participatory poverty monitoring by nongovernmental stakeholders still need to be articulated.

F. Risks and Vulnerability

30. **The PRSP presents a substantial development agenda for the next three years.** While the past record attests to the government's commitment to reach its policy objectives, there are some risks. First, the commitment to implement the PRSP remains largely untested at the local level. Second, institutional weaknesses and lack of capacity may delay implementation of the poverty reduction program. Third, insufficiently aggressive action to implement the reform agenda could jeopardize achievement of the required growth

objectives. Finally, the medium-term targets of the PRSP are ambitious and based on the assumption that substantial, appropriately concessional external financing will be available in addition to the Initiative for Heavily Indebted Poor Countries (HIPC Initiative) debt relief. Moreover, unexpected expenditure in non-priority areas or a slowdown in economic activity may hamper achievement of the PRSP objectives.

31. Although more detailed analysis is required, **the PRSP recognizes the vulnerability of Ethiopia to exogenous shocks** and suggests that the country's ability to respond to these shocks has increased. It is, therefore, essential to make rapid progress in developing and implementing specific strategies to mitigate the potential impact of these shocks, particularly HIV/AIDS, the deteriorating terms of trade, and unfavorable weather conditions.

V. CONCLUSIONS

32. **The analyses and policies contained in the PRSP should result in substantial progress in Ethiopia's fight against poverty.** The PRSP is strongly owned domestically and based on a wide consultative process that has revitalized the dialogue among government, NGOs, and donors on key policy issues, and has set high expectations for government's performance. However, as indicated in this joint staff assessment, there are several areas where there are gaps in the strategy, and these form an agenda for further work. **It is recommended that the first annual progress report include the following:** (i) a further articulation of the strategy for promoting private sector development, including agriculture, with specific policy measures and an implementation timetable; (ii) alternative macroeconomic scenarios, with a more thorough evaluation of the downside risks associated with the strategy and of ways to mitigate them, as well as an examination of the linkages among macroeconomic policies, structural reforms, and poverty; (iii) a refinement of costing of PRSP programs, the scope for reallocation among the sectors, and a rationalization of the gaps between unconstrained program costs and available financing; and (iv) an evaluation of the early experience with decentralization.

33. The staffs of the World Bank and the IMF consider that the poverty reduction strategy presented in Ethiopia's PRSP provides a sound basis for World Bank and Fund concessional assistance. The staffs recommend that the respective Executive Directors of the World Bank and the IMF reach the same conclusion.