

The Bang for the Birr

Public Expenditures and Rural Welfare in Ethiopia

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During the past decade and a half, Ethiopia's approach to promoting development and improving the lives of the country's rural population has been driven by a government strategy called Agricultural Development–Led Industrialization (ADLI). This strategy's main goal is to encourage fast, broad-based development within the agricultural sector in order to power economic growth. While ADLI considers regulatory, trade, market, and other policies to be key engines of agricultural growth, it also focuses on increasing public expenditure in agriculture and road infrastructure, as well as in social sectors that are perceived as contributing to agricultural productivity.

Thus, Ethiopia's public expenditure policy is at the heart of the policy measures emerging from ADLI. Given budget constraints, it is essential to examine the relative contributions that different types of public investments make to welfare. An improved understanding of investment outcomes will have important implications for expenditure policy, especially in terms of the portfolio composition of public resources.

This research report explores and compares the impacts of different types of public spending on rural household welfare in Ethiopia. Most previous studies examining the link between public expenditure and development outcomes either explore how the size of *overall* public expenditure or public investment affects growth or poverty, or they correlate spending in one economic sector with outcomes in that sector or with broader measures of welfare. Both types of studies can provide useful input into policymaking decisions. However, there is a striking lack of research aimed at examining how the *composition* of public spending affects key development outcomes—a particularly policy-relevant question.

This study fills that gap. It compares the impact of different types of public spending through a three-stage analysis. The first stage assesses the impact of access to different sector-specific services on rural household consumption and

the productivity of households' private assets, differentiating these effects by geographic region. The second stage determines the contribution of different types of public spending to key sector-specific outcomes. The final stage of the analysis draws on the first two to estimate the effect on rural welfare of a unit increase in public spending across different sectors.

FINDINGS

The report's analysis shows the following results:

- Returns to public investments in road infrastructure are by far the highest. Evidence even suggests that building up existing road networks can provide increasing returns to investments. However, the geographic variability of welfare returns to public spending on roads is higher than that in other sectors. This regional variability in returns to road investment suggests the need for careful region-specific investment policies in the road sector.
- The household welfare impacts of public expenditure in agriculture are—perhaps surprisingly—smaller than the effects of road spending and are not statistically significant. The results of the first- and second-stage analysis suggest that the lack of significance derives from the poor link between public expenditures and the performance of the agricultural sector, and not from a limited role of agriculture in promoting rural welfare. In fact, the first-stage analysis shows that the performance of the agricultural sector contributes significantly to rural consumption, both when considering its role on average in Ethiopia and when assessing its regionally disaggregated effects. While, on the margin, overall agricultural expenditure does not affect productivity as substantially as would be expected, there is some evidence that the most significant effects of agricultural expenditures on rural households are observed in the rural areas of the most urbanized regions. This suggests the potentially important impact of market proximity on returns to public interventions in agriculture.

- In contrast to the road infrastructure sector, returns to expenditures in education are characterized by wider reach, more homogeneity, and less intensity. Education spending has widespread effects on welfare that are positive, statistically significant, and similar across a broad range of regions (in contrast to returns to expenditures in the road sector, which are strongly concentrated in a few regions). The magnitude of these returns is more constrained than in the road sector, but is still larger and more significant than those to investments in agriculture.
- Rural welfare returns to spending in the health sector do not emerge strongly, with significant returns in only one region and a relatively low magnitude of birr-for-birr returns. This, together with other findings in the empirical work, suggests that non-income measures of well-being should be considered in the analysis of future public expenditures.

household consumption is affected by public expenditure, the study's findings could be used to simulate the poverty effects of public spending. Additional research into the various components of government investment in agriculture is also needed: future efforts to compensate for the present lack of regionally disaggregated time-series data on spending would allow researchers to examine individual elements, such as agricultural extension, agricultural research, and food security spending.

A final issue that goes beyond the scope of this report but is clearly worthy of additional study is the efficiency of public spending. The utility of public investments for household welfare and poverty reduction depends on at least two things: (1) the portfolio of the public budget and the appropriateness of the allocation of resources across sectors and (2) the efficiency with which resources are used in any given sector or subsector. This report focuses on the former issue, provoking an inquiry into the second question.

Such an inquiry is particularly important with regard to Ethiopian agricultural investments, both because agriculture strongly dominates Ethiopia's economy and because the government's development strategy emphasizes the agricultural sector. A substantial body of research suggests that a strategic focus on agriculture may be appropriate, given Ethiopia's stage of development. Therefore, an investigation into the drivers of efficiency in the country's agricultural public spending may be the next important step in policy research in Ethiopia.

NEXT STEPS

These findings point toward future steps that could be taken to strengthen the analysis and provide new insights into the relative effectiveness of different types of public spending. Data on public expenditure and households should be brought up to date, to cover the years after 2000—the most recent year for which data were available for this report. Furthermore, while this report assesses how rural

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