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POLICY BRIEF

Does fiscal policy have a role in improving child well-being in Ethiopia?

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Taxes, government spending, and public transfers affect the well-being of children and adults, albeit in different ways. There is, however, a dearth of empirical evidence on the impact of these policies on the well-being of children in low-income countries. This policy brief summarizes a recent study by Ambel, Belete, and Fiala (2024), which investigates the effects of fiscal actions on poverty and inequality among children in Ethiopia. The study applies the Commitment to Equity for Children (CEQ4C) methodology on survey data integrated with administrative data. It finds that the fiscal system in Ethiopia is progressive, poverty-reducing, and equalizing for children. However, there are observed differences in the effects of some of the fiscal policy components, as many of these effects are stronger for girls and children in rural areas. The study also highlights the essential role of public services in improving children's well-being.

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INTRODUCTION

In 2022, one in five children in Ethiopia lived in extremely poor households, measured as those living below $2.15 PPP (Salmeron-Gomez et al. 2023). UNICEF and the Central Statistical Agency of Ethiopia estimated that in 2016, about 36.2 million children in Ethiopia were multidimensionally poor, i.e. they were deprived of the fulfillment of multiple rights or needs for basic food or services (CSA and UNICEF Ethiopia 2018). Child poverty varies significantly within the country, both between rural and urban areas, as well as between regions. In Addis Ababa, 18% of children were considered poor, however, this rate is higher than 90% in more remote regions.

Taxes, government spending, and public transfers play an important role in reducing poverty and inequality. Direct taxes (such as income tax) and indirect taxes (such as VAT or excise taxes) reduce a household's income and consequently, consumption. On the other hand, these revenues allow governments to provide cash transfers and run essential services, such as health and education. Taxes and transfers both affect the distribution of income in society and therefore, inequality.

Taxes and transfers impact children in a different way from adults, as children have different demands and consumption patterns. However, the effects of these policies on children haven't been extensively studied (Cuesta, Jellema, and Ferrone 2021). For example, children could be disproportionately affected if taxes add to the cost of goods and services particularly relevant to them.

A recent study by Ambel, Belete, and Fiala (2024) investigates these issues in the context of Ethiopia, using the Commitment to Equity for Children (CEQ4C) framework. This approach has been widely used to analyze the distributional effects of fiscal policies in many low- and middle-income countries but its focus on children is relatively new (Cuesta, Jellema, and Ferrone 2021; Save the Children 2021; Bornukova et al. 2020; Save the Children 2022). The study answered the following questions:

1. How do the burdens of taxation and the benefits from government transfers and spending differ between children living in rural and urban settings, between boys and girls, and between poorer and richer children?
2. What is the contribution of government transfers, spending, and taxes to the reduction of inequality and child monetary and multidimensional poverty?
3. How do potential changes to the social transfer system affect poverty and inequality among children?

DATA AND METHODOLOGY

The Commitment to Equity for Children (CEQ4C) framework (Cuesta, Jellema, and Ferrone 2021; Inchauste et al. 2017; Lustig 2018) combines household survey data with administrative data on government budgets and tax policies. First, the methodology requires calculating the pre-fiscal and post-fiscal income concepts: market income, disposable income, consumable income, and final income. While the underlying household survey captures disposable income using consumption expenditures as a proxy, backward and forward calculations are needed to develop the other income concepts. This study focuses on the individual child as a unit of analysis and therefore allocates expenditures to individual household members based on consumption

patterns, available individual-specific information in the survey, and equivalence scales. A range of assumptions were used when assessing the fiscal incidence for children, i.e. unit costs of education and health services, or how the tax burden is shared by the household.

Second, the CEQ4C methodology calculates poverty and inequality for each income concept. The study estimated both monetary poverty (using FGT indices) and multidimensional child poverty (adapting the AF methods). The latter was developed using four dimensions (child education, child health, water and sanitation, and housing and assets) and ten indicators. Inequality was measured using the Theil index. To comprehend the potential effects of changes in the existing fiscal regimes, the study conducts four child-relevant policy simulations, focusing on universal education and the productive safety net program (PSNP).

The major source of data for the study is the Ethiopia Socioeconomic Panel Survey (ESPS) 2018/19. ESPS is a nationally representative survey implemented by the Ethiopia Statistical Service in collaboration with the World Bank's LSMS-ISA project. The survey included 6,700 households, of which 4,992 households had at least one child (0-17 years) at the time of the interview. The final data was based on a sample of 13,820 children. The survey data was mainly used to calculate the incidence of both spending and revenue-generating activities, as well as poverty and inequality statistics.

The study complements the survey data, with administrative data obtained from various ministries and their subsidiary agencies. These include public revenues and expenditures for the 2018/19 fiscal year, school enrollment, kerosene subsidies, and wheat subsidies. The data shows that revenue collection was equivalent to 13.5% of GDP, with more than half (57%) obtained through indirect taxation. Government spending was equivalent to 20.8% of GDP, the majority (39%) of which went towards social development, followed by economic development (33%) and general services (18%).

RESULTS

On average, the study finds the fiscal system in Ethiopia to be progressive and fair, and one that reduces monetary and multidimensional child poverty. However, there are important differences in the distribution of different kinds of taxes and expenditures. Indirect taxes, e.g. VAT and excise taxes are regressive and account for more than two-thirds of taxes relevant to children, which means taxes make up a higher share of income for families with children who have deprivations (Fig. 1). In contrast, direct taxes, such as income tax, are progressive.

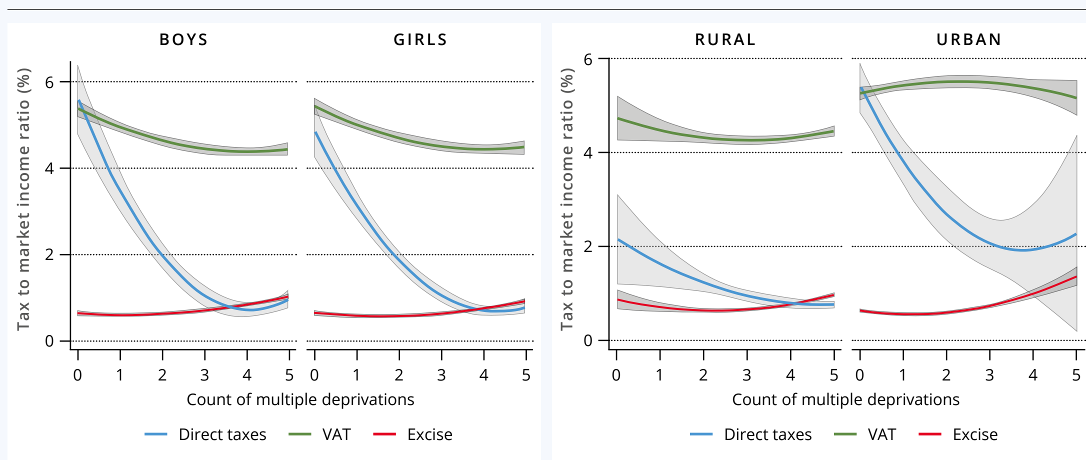
On the transfer side, direct transfers (such as cash transfers) and indirect in-kind transfers (spending on social services and in the case of Ethiopia, predominantly on education) are found to be progressive (Fig. 2). Spending on primary education is progressive, which means transfers account for a higher proportion of the incomes of families with children who have deprivations. In contrast, secondary education spending is regressive, as children from poorer backgrounds are often less likely to attend secondary schools – a finding in line with comparable studies in other countries (Cuesta, Jellema, and Ferrone 2021; Save the Children 2021). Overall, public spending on health is progressive. While the study does not find significant differences in incidence by gender, there are noted differences between rural and urban areas. In rural areas, primary education and health spending are

neutral and do not show the progressivity seen in urban areas.

To understand the full effect of fiscal policy on poverty and inequality, both taxes and transfers need to be compared across different stages of the fiscal system (before and after different taxes and transfers). In Ethiopia, the study finds that the fiscal system reduced

Figure 1

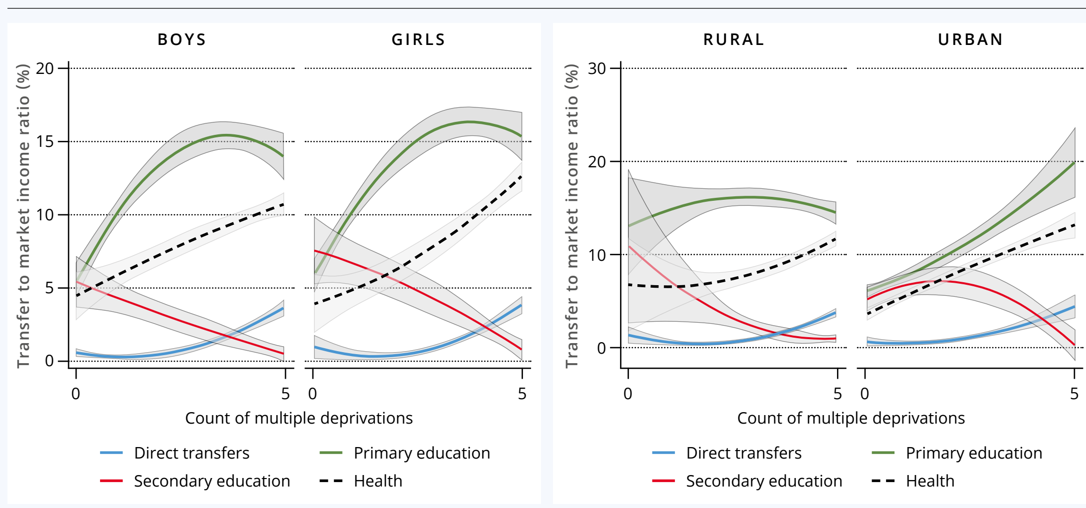
Taxes as percent of market income by child deprivation status, gender and location



Source: Ambel, Belete, and Fiala (2024).

Figure 2

Transfers as percent of market income by child deprivation status, gender and location



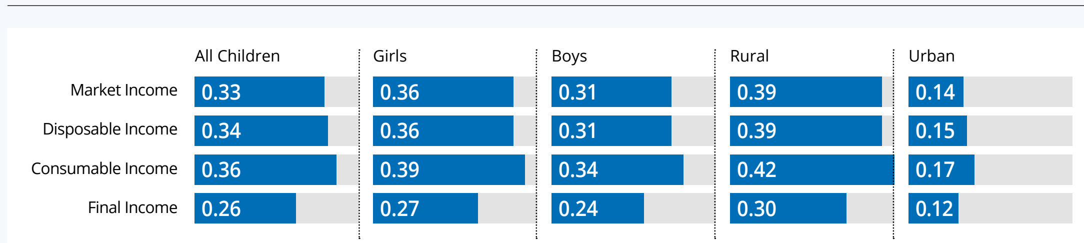
Source: Ambel, Belete, and Fiala (2024).

monetary child poverty by 21% and the poverty gap by 33%. This effect is stronger for girls than for boys, as well as for children in rural areas compared to their urban peers (Fig. 3). These findings suggest that overall, the fiscal system (including in-kind benefits) reduced inequalities in poverty rates among different groups of children. However, this decrease is driven by in-kind fiscal transfers – mainly government spending on education and health. When these transfers are excluded, poverty rates increased for all groups, suggesting that the fiscal system is not well calibrated for reducing poverty. This is a stark reminder that those public services not only play an essential role in delivering on fundamental child rights but are also important investments in reducing poverty.

Finally, the study also estimates the potential welfare impacts of four fiscal policy simulations that are relevant to children in Ethiopia, including providing universal public education, changes to benefit levels and distribution of the productive safety net program. Across the various specifications, the study finds significant decreases in poverty and inequality with various distributional effects of such changes by gender and location. For example, enrolling universally out-of-school children would decrease the multidimensional child poverty headcount ratio by 2.2% and the monetary child poverty headcount ratio by 3.2%, with higher effects in urban than in rural areas. If the amount of PSNP transfers to existing beneficiaries was doubled, the monetary poverty headcount rate would decrease by 1.9% and inequality by 0.9%, with higher effects for girls and children in rural areas. Such simulations are an important toolkit in determining the potential impacts of fiscal policies and allowing policymakers to better understand the impacts of new budget proposals on children.

Figure 3

Poverty headcount at different income concepts, by gender and location



Source: Ambel, Belete, and Fiala (2024).

KEY MESSAGES

Child-focused fiscal incidence analyses, such as this one in Ethiopia, provide essential insights into the role of different taxes and transfers, as well as their combined effects, on child poverty. The study highlights the following key messages.

- The fiscal system, driven by direct taxes and in-kind transfers, is progressive, poverty-reducing and equalizing.
- Government spending on education and health led to a reduction in poverty and inequality, with larger benefits for girls and children living in rural areas.
- There are differences in the distributional effects of specific taxes and transfers. Direct taxes and in-kind transfers, in general, are progressive. However, indirect taxes and subsidies are regressive. These differences are important in designing fiscal policies aimed at improving child well-being.

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