FISCAL POLICY IN ETHIOPIA

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1. INTRODUCTION

Fiscal policy, through the instrument of taxation, in addition to transferring resources from taxpayers to the government, changes the incentives of producers and consumers of goods and services as well as owners of factors of production. For instance, import duties generate revenue, but at the same time provide protection, thereby encouraging the development of inefficient import-substituting industries. Similarly, heavy export tax on coffee is a major source of revenue, but by reducing the income of coffee producers may lead to illegal trade or a shift to other crops. In both cases, the tax-induced effects would affect the allocation of resources and the growth of the economy.

On the other hand, high government expenditure on hospitals and university education, disregarding basic health care and primary education will affect the distribution of income and ultimately the growth prospect of the economy. Therefore, the rate and structure of taxation, the size, purpose and source of financing government expenditure have impacts on economic growth, income distribution and stability of the economy.

Economic growth is the outcome of contributions made by many sectors in the economy. The government, the private sector (both domestic and foreign) and multilateral and bilateral donors play an important role. An efficient and sustainable growth, thus, dictates a defined role for the government, which must support rather than replace the contribution of the private sector to economic growth.

This paper examines the experience of fiscal policy in Ethiopia with respect to its allocation, distribution, growth and stabilization functions and proposes some reform measures related to the role of the government as well as its revenue and expenditures.

2. FUNCTIONS OF FISCAL POLICY

Eventhough different taxes and expenditure measures affect the economy in several ways and may be formulated to fulfill a variety of objectives the functions of fiscal policy are generally classified under the following four broad categories:

1) allocation of resources;
2) distribution of income;
3) promotion of economic growth; and
4) stabilization of the economy.

2.1 The Allocation Function

The allocation function, which deals with the process by which total resource use is divided between private and public goods and the means by which the mix of latter is chosen, is one of the oldest functions public finance. It has been recognized, at least since Adam Smith wrote the Wealth of Nations in 1776, that certain goods and services referred to as public goods, as distinct from private goods, cannot be provided for through the market system. This is because transactions between individual consumers and producers cannot take place mainly due to the technical characteristics of the goods: indivisibilities, cannot be priced, etc.

The above situations, thus, make private provision of public goods unprofitable. The allocation function of fiscal policy therefore emphasizes the need for the provision of such goods (defence, law and order, justice, health, education, roads, etc.) by the public sector.

In Ethiopia the allocation function of fiscal policy has lost its importance as one of the instruments of economic policy since the 1974 revolution. The wave of nationalization measures that accompanied the government's socialist outlook has blurred the difference between private and public goods, in as far as the provision of these goods is concerned. Such an extensive involvement of the government in areas that could have been better left to the private sector resulted in an ineffective use of public resources, crowded out the private sector and instead of correcting market failure has accelerated it.

As a result, school participation rates and health coverage have been low, the quality of social services has deteriorated drastically, the road network has dilapidated because of inadequate finance for repair and maintenance. The government's extensive involvement in commercial ventures has not been successful either. The number of loss-making public enterprises is increasing due to inadequate capital, bureaucratic government interference and administratively determined prices.

The allocation function of fiscal policy has, thus, been overwhelmed by the government's socialization policy. The New Economic Policy proclaimed towards the end of Mengistu's regime has a lot of positive measures that could encourage the participation of the private sector and rationalize the role of the government. It is hoped that the economic policy of the Transitional Government will count on these positive elements to bring the economy out of the present crisis.

2.2 The Distribution of Income

This aspect of the function of fiscal policy deals with equity, or reducing gross inequality of income and wealth, or at least checking the increase in inequality. It has been argued that while a perfectly functioning free market system can assure an efficient allocation of resources, it cannot guarantee that the resulting distribution of goods and services will be socially acceptable. The free market system has no built-in mechanism to correct any distributional imbalances that may initially exist in the economy.

Fiscal policy through the instruments of taxes and expenditures (for welfare purposes and consumption subsidies) has been used to mitigate the conditions of the disabled, the old, the young, the unemployed and other particular groups that, without government assistance, might end up with incomes below some poverty line. This aspect of fiscal policy, however, is more prevalent in the developed world and, as a result, public spending for transfer payments has grown at a very fast pace.

One method of using taxes as an instrument for redistribution is to design a progressive income tax, i.e., a tax which absorbs a larger fraction from higher levels of income than from lower ones. Likewise, while heavy sales taxes on luxury goods may be justified on equity grounds, it is not justified from the point of view of efficiency. Today, some countries pay more attention to the distribution of income than others, despite the belief that tax policy formulation should primarily focus on the efficiency objective only, leaving the distribution objective to be achieved through land reform, public transfer expenditures and other governmental policies.

In Ethiopia the distribution/equity function of fiscal policy can be traced from the design of certain taxes, expenditure allocations for subsidies, welfare programs and merit goods and the very low tariffs on urban bus transport and water supply.

With regard to taxes, the rates on employment and agricultural income as well as on unincorporated business are so progressive that the highest marginal rates reach 85 per cent, 89 per cent and 82 per cent[1] respectively. Certain heavy excises and surtaxes on domestically produced and imported goods may be justified on distributional grounds. However, such highly progressive taxes have stifled incentives to work and invest and have reduced compliances more than they have contributed to the equity objectives.

On the other hand, the consumption subsidy on bread for urban dwellers, the welfare programs run by the government for the old, the disabled and for orphanages, outlays on merit goods such as primary and secondary education, basic health care, low-cost housing and rural water supply are all examples of the distributional function of fiscal policy.

These policies, however, are conducted in an uncoordinated and unsustainable way, as pointed out below:

1) The consumption subsidy and the low user charges on urban water supply and bus transport are not targeted.
2) The lion's share of the welfare expenditures are allocated to programs which are rather show-cases and therefore not sustainable.

3) The progressive taxes along with other government policies have stifled incentives to work and invest and have encouraged non-compliance.

An effective use of the distribution function of fiscal policy in Ethiopia requires a reassement of some of the tax and expenditure policies. Presently, some of the tax and expenditure measures which have equity objectives are being conducted haphazardly.

2.3 The Promotion of Economic Growth

In industrialized countries, the growth objective of fiscal policy might be directed almost entirely towards the maintenance of the appropriate level of aggregate demand. In other words, it is believed that growth is generally expected to follow automatically from the proper pursuit of the allocation, distribution and stabilization functions of fiscal policy. In developing countries, with income levels much below those of the industrial countries, it is believed that economic growth should be an explicit and important policy objective, for which fiscal policy is one of the important instruments.

It is argued that the government cannot passively accept the rate of growth that automatically results from the activities of the private sector but should actively formulate policies aimed at accelerating economic growth. The main task of fiscal policy for promoting growth is thus to increase saving and investment in the public and private sectors combined and to finance large and growing government expenditures in an orderly, efficient and sustainable manner, without interfering unduly with the growth of the private sector.

In Ethiopia the use of fiscal policy instruments to promote growth in a coordinated way started with the preparation and execution of development planning and programming. The first attempt began in 1944/45 with the preparation of the Ten-Year Investment Programme by the the United States Technical Project Mission. Following this, sectoral development programs for agriculture and forestry, transport and communications, foreign trade, education and urban development were prepared. These sectoral programs paved the way for the subsequent three five-year development plans (1957-61, 1963-67 and 1968-73), which were executed until the 1974 revolution.

To support the government's development efforts, domestic revenue collection increased substantially during these plan periods. As a result, the annual average revenue collection increased from Birr 148.2 and 293.9 million during the First and Second Five Year Plan periods respectively to Birr 465.4 million during the Third Five Year Plan period. In spite of the decreasing trend recorded from an average of 42.7 per cent during the First Five Year Plan period to 42.0 per cent and 33.6 per cent during the Second and Third Five Year Plan periods respectively, foreign trade taxes accounted for the lion's share of domestic revenue during these plan periods.

On the other hand, total government expenditure (recurrent and capital) grew, on the average, from Birr 181.1 and 397.8 million in the First and Second Five Year Plan periods respectively to Birr 626.9 million in the Third Five Year Plan period. The share of the capital expenditure during these plan periods was 22.1 per cent, 18 per cent and 19.5 per cent respectively.

The growth objective of fiscal policy has gained prominence with the government's socialist-oriented policy after the 1974 revolution. The successive annual development campaigns (1978-1985) and the Ten-Year Perspective Plan were the framework within which development activities were carried out. During this time, a remarkable domestic revenue performance (though not in an efficient way) has been achieved mainly as a result of continuous tax-rate increments and increased surplus from the state-owned enterprises. Total expenditure has also been increasing mainly as a result of increased expenditures on defence, wages and salaries, capital expenditures and debt service payments, which has been increasing at a fast rate due to the high domestic and external loans that were secured mainly to finance development programmes.

Eventhough the government's revenue mobilization effort was relatively high, the growth in total expenditure outstripped not only the growth of revenue but also that of the Gross Domestic Product (GDP). As a result, the government resorted to both internal and external borrowing to finance the deficit. The government's bank borrowing to finance its deficit, coupled with the requirements to finance public enterprises, significantly reduced the opportunity of the private sector to borrowing and have been contributing to the increasing inflationary pressures in the economy and the imbalance created in the trade account.

In Ethiopia, the growth objective of fiscal policy has not been encouraging:

- The high revenue performance has not been conducted in an efficient way.
- Emphasis is given to the size of the capital budget rather than to its efficient allocation.
- The extensive involvement of the government in nearly all economic activities has crowded out the private sector.
- The heavy dependence on internal borrowing to finance government expenditure has contributed to inflationary pressures and balance of payments disequilibrium, thus fiscal policy itself becoming a destabilizing factor.

With this financial crisis, therefore, it has become very difficult to promote a sustainable economic growth.

2.4 Stabilisation of the Economy

The function of fiscal policy in stabilisation came into prominence in the developed countries during the Great Depression of the 1930s. Later, the application of fiscal policy to inflationary conditions was elaborated particularly during World

War II. The general theoretical framework was that a depression is caused by a deficiency in effective demand. Thus, fiscal policy should remedy it by increasing public expenditure and by encouraging private expenditure. Similarly, during a boom there is a need to control demand partly through curtailing public expenditure and partly through curbing private expenditure.

The objective of a stabilising fiscal policy in the developed countries is thus to prevent short-term fluctuations in output and employment and the subsequent disturbances to internal and external stability.

However, the application of stabilising fiscal policy in Ethiopia, like most other developing countries, must take account of the special structural characteristics affecting the economy and the budget. For instance, the problem of unemployment is not necessarily the result of deficient aggregate demand but of structural bottlenecks and impediments to the smooth functioning of markets. Hence, using a more expansionary fiscal policy to curb unemployment might simply worsen the rate of inflation and the balance of payments deficit with limited effects on employment.

Developing countries are more prone to economic instability than industrial countries, since they are exposed to a variety of external shocks that affect their economic performance.

The external shock may originate from:

- changes in export earnings, as many developing countries depend heavily on the export of one or more primary commodities for their foreign exchange earnings;
- changes in the price of major imports, for instance, oil;
- changes in the cost of borrowing, as was the case in the early 1980s when the real interest rate rose sharply;
- changes in the availability of foreign credit, as happened after the debt crises of the summer of 1982, when banks became much more reluctant to lend; and
- changes in the level of foreign grants.

In our case, eventhough the disbursement of some committed loans and grants were slowed down and the chances for new loans and grants became slim towards the end of Mengistu's regime, the major cause of the external shock is associated with the drastic fall in foreign exchange earnings. This had its origin in the low international coffee price due to the breakup of the international coffee agreement.

The impact of the fall in foreign exchange earnings has drastically affected the economic performance. Because of the lack of raw materials and spare parts, industries are forced to operate below capacity. This has seriously affected government revenue collection. It has also exacerbated the shortage of industrial products, creating inflationary pressures.

The economy is pushed further towards greater instability due to the drastic fall in revenue from the export of coffee. As a result, the government has resorted to the banking sector to finance its deficit, as no significant attempt was made to reduce expenditure. Such a financing scheme has further contributed to the growth of inflation exacerbated by the shortage of domestically produced and imported goods.

The shortage of foreign exchange has also resulted in increased foreign debt arrears, which could further be a major cause for reduced foreign financial inflow. Presently, debt rescheduling, cancellation and/or balance of payments support from multilateral or bilateral sources could only come if a country accepts a structural adjustment program, for which Ethiopia has not shown any genuine commitment so far.

Though fiscal policy is supposed to play an important role in stabilising an economy whose fiscal disequilibrium has originated in external shocks, it can itself become a major destabilising force as it can be the root cause of inflation and a deteriorating balance of payments.

In Ethiopia, the expansionary government budget has contributed to the inflationary pressure, as the excessive domestic government expenditure is being financed through domestic bank borrowing and foreign loans. Such financing arrangements have contributed to the destabilising factors originating either in supply shortfalls or external shocks. One can safely generalize that in Ethiopia fiscal policy has been adversely affecting both the budget and the balance of trade rather than serving as one of the stabilising instruments.

A fiscal policy that is consistent with growth and stability will depend on measures that bring government expenditures in line with the average level of revenue expected over time. This, however, has not been the norm in Ethiopia. The practice has been to increase government expenditures both during slack and boom periods. In order to bring about stability, a sizeable and sustainable reduction in the fiscal deficit must come mainly from a reduction in the level of government recurrent expenditure. At present, the opportunity of raising non-discretionary tax revenue is rather limited. There is also some room to trim the capital expenditure.

Using fiscal policy as one of the instruments to stabilise the economy seem to have a better chance with the existing government, as defence expenditure will dramatically be reduced and as the government will not have much commitment to the existing policies and establishments.

3. INSTRUMENTS OF FISCAL POLICY

In Ethiopia, fiscal policy instruments can broadly be classified into revenue and expenditure instruments. Among the revenue instruments direct, indirect and foreign trade taxes[2] play an important role. However, non-tax revenue[3] has gained prominence, especially after 1978, as a result of the policy which requires public enterprises to pay 5 per cent capital charge on their capital and reserve and surrender 90 per cent of their net profit (residual surplus) to the government.

The government expenditure is, in turn, broadly classified into recurrent and capital expenditures. Recurrent expenditure mainly consists of wages and salaries of central government employees, operating expenses of government ministries and agencies, pension and debt service payments, subsidies and other miscellaneous expenditures. On the other hand, capital expenditure, presumably considered as expenditure that contributes to growth unlike the recurrent one, includes expenditures on projects and programs such as studies and designs, building and other construction works, operating expenses and certain transfer expenditures.

Borrowing from both domestic and foreign sources has also become an important instrument of fiscal policy, because part of the expenditure not covered by ordinary revenue is being financed through such means. Other financing sources include foreign grants, special public contributions, and building-up arrears to domestic and foreign creditors. Presently, the scope for non-inflationary financing through the voluntary placement of bonds in the market is non-existent because of economic and ideological factors, consequently the banking system is the sole domestic source to finance the budget deficit .

Eventhough government revenue and expenditure are the major instruments of fiscal policy, increasing government regulations have now become important instruments. Such direct regulations that encourage domestic production include, among others, the restriction of imports of competing items instead of subsidising domestic products from the budget, and restricting the importation of vehicles rather than devising very high customs duties or sales tax.

Such excessive reliance on regulations has resulted in a situation where the economy has become over-regulated and highly inefficient with widespread abuses, undermining the proper role of fiscal policy.

4. FISCAL PERFORMANCE

4.1 Government Revenue

As Table 1 below reveals, between 1968 and 1988, Ethiopia's tax effort, the ratio of revenue to GDP, continuously increased from 9.5 per cent to 30.1 per cent, before it drastically declined to 20.9 per cent in 1991. According to the World Development Report 1991 of the World Bank, Ethiopia's 25.2 per cent total current revenue as a percentage of GNP for 1989 was the second highest among the 23 low-income economies, excelled only by Togo whose record was 30.2 per cent.

This remarkable revenue-generating achievement did not come about as a result of any significant increase in the growth of the traditional tax bases or an increase in real GDP per capita. But it is mainly the outcome of continuous increases in tax rates, high collection from public enterprises by way of capital charge and residual surplus and favorable coffee revenue performance as a result of high international coffee prices, as for instance, from 1978 to 1980, in 1984 and 1986. Therefore, discretionary measures, highly influenced by increasing government expenditures, have reduced the chance of designing a tax structure that helps to raise sufficient revenue and at the same time minimizes distortions.

Table 1: Central Government Revenue Structure, 1968-1991
(in million Birr)

Types of Revenue	1968	1974	1979	1983	1988	1991 provis.
Total Revenue	363.5	622.6	1,382.4	2,174.5	3,467.2	2,666.4
Tax Revenue	309.8	536.8	1,150.0	1,558.1	2,317.7	2,065.7
Direct	76.5	151.9	315.6	604.3	1,012.4	789.0
Indirect	104.1	167.7	271.6	447.7	720.4	754.0
Foreign Trade	129.2	217.2	562.8	506.1	584.9	522.7
- Import	102.7	166.4	333.7	302.4	437.8	498.1
- Export	26.5	50.8	229.1	203.7	147.1	24.6
Non-tax Revenue	53.7	85.8	232.4	616.4	1,149.4	600.7
- Capital charge & Residual Surplus	20.3	29.5	99.4	387.7	840.1	349.0
- Others	33.4	56.3	133.0	228.7	309.3	251.7
Total Revenue as per cent of GDP	9.5	11.2	16.6	21.7	30.1	20.9
- Of which tax	8.1	9.6	14.3	15.5	20.6	16.2

Source: 1) Ministry of Finance, *Budgetary Revenue and Expenditure* for the Ethiopian Fiscal Years 1960, 1966, 1971, 1975 and 1980 Ethiopian Calendar (EC).
2) Ministry of Finance, *1991 Central Government Fiscal Plan Implementation*, August 1991, Addis Ababa (Unpublished, Amharic).

4.1.1 Tax Revenue

Of the total domestic revenue tax revenue accounts for the largest share. On average, for the period from 1984 to 1988, the share of tax revenue was about 70.6 per cent. During this period, of the total government revenue the average share of direct taxes was only about 29.2 per cent, depicting (like most sub-Saharan African countries) the importance of domestic taxes on goods and services and taxes on foreign trade. However, the share of taxes on foreign trade has been decreasing mainly as a result of the fall in international coffee prices.

4.1.1.1 Direct Taxes

Among the direct taxes, income tax on unincorporated business and profit taxes, mainly on public enterprises, contributes the largest share. Revenue from this source depends on the availability of foreign exchange to purchase raw materials and spare parts. As a result, revenue collection dropped from Birr 684.7 million in 1989 to Birr 554.8 million in 1990 and Birr 459.2 million in 1991. The marginal tax rate for unincorporated income was very progressive, with the maximum set at 82 per cent for annual taxable income above Birr 36,000. Such a high rate had a negative impact on investment, encouraged evasion and increased the cost of tax administration without fulfilling the revenue objective. As a result, it was revised in 1990 with the maximum rate reduced to 59 per cent on taxable income over Birr 24,000.

The other direct tax component, which contributes a significant share, is employment income tax. The rate on employment income was revised in 1979. Employment income tax more than doubled in the eight-year period between 1980 and 1988, increasing from Birr 119.0 million to Birr 244.3 million. According to provisional figures, the 1991 collection is estimated at Birr 275.0 million. The growth in the employment income tax is attributable mainly to the government's guaranteed employment policy for university and junior college graduates. Graduates from teacher training institutes and other specialized training institutes have as well contributed to its growth.

Like the income tax rate for unincorporated income, the tax rate for employment is so high that for a monthly taxable income over Birr 3,750, one has to pay 85 per cent on the additional income. This is contrary to recent income tax reforms which recommend that marginal tax rates should be low to minimize distortions, encourage work effort, savings, and promote compliance. Recent tax reform measures in Columbia, Indonesia, Jamaica and Malawi testify to this. In Jamica, for instance, the reformed personal income tax has only a single rate, 35 per cent.

Taxes that are being collected from the agricultural sector directly by way of the agricultural income tax and rural land use fee increased from Birr 96.7 million in 1984 to Birr 104.4 million in 1988. The average annual collection from this source was Birr 94.2 million for the period 1984-88. The present procedure is that tax on incomes lower than Birr 600 per annum is collected by peasant associations, while farmers with higher incomes per annum must have their incomes assessed by the tax office, which will also collect the tax. The tax rate for incomes above Birr 600, like the other forms of income taxes, is very progressive with the marginal tax rate for incomes exceeding Birr 36,000 being 89 per cent.

Despite the progressive nature of the tax rate, in practice, nearly every peasant household pays Birr 10 as his tax on agricultural income on the assumption that the annual income of every farmer is less than Birr 600. For rural land use, the fee was Birr 5 for those who were members of agricultural producers cooperatives and Birr 10 for non-members, an indication showing the use of fiscal policy to promote the government's socialization policy.

Because of the low revenue collection from agricultural income tax and rural land use fee, the direct contribution of the agricultural sector to government revenue is insignificant. However, if one adds to this the forced delivery of grains by every peasant to the Agricultural Marketing Corporation at prices far below what the market used to offer and the numerous contributions that the farmer used to pay, the burden was really heavy.

4.1.1.2 Indirect Taxes

As a result of discretionary tax rate increases and the newly established factories, indirect taxes have become a fast growing sources of government revenue. As shown in Table 1, over the 14 years between 1974 and 1988, revenue from these taxes increased continuously, growing from Birr 167.7 million in 1974 to Birr 720.4 million in 1988. The growth continued through 1989, when record collection was registered at Birr 784.9 million and, from then on, decreased to Birr 764.9 and 754.0 million in 1990 and 1991 respectively, mainly because industries were operating below capacity due to the shortages of foreign exchange to purchase the necessary inputs.

Until 1990, the major indirect tax sources were excise, transaction and sales taxes. However, these taxes were amalgamated in 1990 to form the sales tax on domestically produced goods applied at the manufacturing level. In addition, a sales tax on some services (telecommunications, garages, etc.) has been introduced. The sales tax on domestically produced goods could be considered as an embryonic consumption tax, which is considered as the most desirable means of raising revenue from commodity transactions, since they do not affect the efficiency of domestic production. According to the provisional estimates for 1991, revenue from sales taxes on domestically produced goods and services was put at Birr 689.9 million and about Birr 28.0 million respectively.

4.1.1.3 Foreign Trade Taxes

Foreign trade taxes, which comprise both import and export taxes, contribute a major share to tax revenue. From 1968 to 1988 (except for 1985, 1987 and 1988), the contribution of these taxes to total tax revenue was higher than domestic indirect taxes. The lower contribution in 1985, 1987 and 1988 was the result of the combined effect of lower international coffee prices and smaller quantity of coffee exported in those years.

Like taxes on domestically produced goods, excise and transaction taxes on imports were amalgamated to form the sales tax on imported goods. Thus, the present taxes on imports consist of costoms duties and sales taxes applied at the point of import.

This pauses an additional means for the implementation of a consumption tax which requires the integration of import tax rates with those levied on domestically produced goods; the rationalisation of taxes on inputs and to some degree on exports, thus providing no protection, and the elimination of discrimination against exports in favor of import substitutes.

Revenue from export taxes depends on one primary commodity, coffee, whose performance depends, by and large, on exogenous factors: the level of international coffee price and the weather condition. Domestic measures like taxes and exchange rate policies also play an important role for the performance of revenue generation from taxes on coffee.

It was very hard to justify the relatively high marginal tax rates[4] levied on the export of coffee, eventhough such taxes could be said to be used as a means of capturing windfall gains from exogenous factors. The monopolistic tendency of the Coffee Marketing Corporation also affected the incomes of the farmers since it used to pay a less competitive price. The Draft Economic Policy of the Transitional Government, which designates the government as the sole exporter of coffee, is even more discouraging. At times when strict control measures on illegal coffee trade was strengthened, in addition to the high coffee surtax, a significant shift to the production of other crops (mainly *chat*) was observed, supporting the view that smallholders respond significantly to price changes.

The contribution of export taxes on coffee to total revenue was as high as 20.7 per cent in 1977 and 25.2 per cent in 1978. In 1988, its contribution drastically dropped to 4 per cent and, according to the provisional estimates for 1990 and 1991, it dwindled down to 1.6 per cent and 0.9 per cent respectively. In fact, if one considers the direct budgetary subsidy that went to coffee farmers during these two years, the contributions were rather negative.

Because of the strong links between the foreign trade sector, on the one hand, and economic growth and stability, on the other, the formulation of an appropriate fiscal policy has an important role to play in promoting the latter two objectives. Thus, there is a need to review further the present surtax on coffee so as to encourage the production and export of coffee by the private sector. Streamlining the size of government expenditure to the average revenue collection over years would also help to avoid financial instability.

4.1.2. Non-tax Revenue

Non-tax revenue has become an important source of government revenue, especially since 1979, as a result of the government's policy compelling public enterprises to pay 5 per cent capital charge on their capital and reserve, and to surrender 90 per cent of their net profit to the government. In 1988, revenue collected from this source was Birr 840.1 million while the figures for 1989, 1990 and 1991 were Birr 790.6, 630.4 and 349.0 million respectively. The continuous decline from this source shows the weak financial performance of the public enterprises.

Except for the ideological justification on the basis of which they were devised, these sources of government revenue will only contribute to inefficient allocation of resources. Revenue from this source is used to finance government recurrent expenditure. If enterprises fail to meet their obligation due to liquidity problems, they are forced to borrow from banks in order to meet their obligation. From the point of view of economic efficiency and growth, this is an important area that needs to be reformed.

Table 2: Central Government Recurrent Expenditure, 1968 - 1991
(in million Birr)

Expenditure	1968	1974	1979	1983	1988	1991 Provisi.
Total Expenditure	363.9	533.4	1,324.2	2,403.4	3,132.0	3,486.1
General Services	207.3	263.0	839.8	1,346.3	1,714.9	2,078.3
Economic Services	40.3	60.4	86.6	150.0	190.9	202.7
Social Services	75.2	147.5	256.3	415.7	601.8	628.2
Unallocated Expenditure	41.1	62.5	141.5	491.4	624.4	576.9
- Pension	7.1	28.6	66.0	92.2	129.5	154.2
- Debt	33.8	33.6	73.5	112.9	421.2	331.5
- Internal		8.4	45.7	70.5	196.2	227.0
- External		25.2	27.8	42.4	225.0	104.5
- Others	0.2	0.3	2.0	286.3	73.7	91.2
Total Expenditure as per cent of GDP	9.5	9.6	16.5	24.0	27.9	27.3

Source: 1) Ministry of Finance, *Budgetary Revenue and Expenditure,* for the Ethiopian Fiscal Year 1960, 1966, 1971, 1975 and 1980 (EC).

2) Ministry of Finance, *1991 Central Government Fiscal Plan Implementation,* August, 1991, Addis Ababa. (Unpublished, Amharic).

4.2 Government Expenditure

Government expenditure is at times classified as real expenditures and transfers. But on the assumption that the expenditures on capital contribute to growth while other forms of expenditures do not, the most adhered to form of classification, including in Ethiopia, is the one that classifies it as recurrent and capital expenditure.

4.2.1 Recurrent Expenditure

Central government recurrent expenditure has been increasing since 1968, except in 1978, 1984 and 1991 when declines were recorded, mainly as a result of reduced expenditures on defence and subsidy. Recurrent expenditure increased from Birr 533.4 million in 1974 to Birr 3,831.4 million in 1990 before it declined to Birr 3,486.1 million in 1991. The highest share of these expenses goes to general services, the major ones being defence and internal order and security. Defence expenditure grew from Birr 105.8 million in 1974 to Birr 2,025.8 million in 1990, with its share in total recurrent expenditure growing from 19.8 per cent to 52.9 per cent.

In 1990, defence expenditure consumed 65.2 per cent of the revenue collection while the share for 1991 was 65.6 per cent. With this high level of defence expenditure, it would obviously be impossible to promote a sustainable economic development.

Economic classification of the recurrent expenditure reveals the increasing tendency of the wage bill. The wage bill increased from Birr 329.0 million in 1974 to Birr 1,354.7 million in 1988, which is about a fourfold increase. This is mainly due to the increased defence budget and the government's guaranteed employment policy. The increasing wage and salary expenditure of the government as a result of its employment policy for graduates without the necessary increase in operating expenditure and the observed wage freeze have created a large, less motivated, and inefficient civil service.

The other recurrent expenditure item which has been continuously growing is public debt repayment, both internal and external. Total public debt repayment which was Birr 33.6 million in 1974, increased to Birr 112.9 million in 1983 and Birr 421.2 million in 1988. In 1990 and 1991, external debt repayment started to decline due to a drastic fall in external debt repayment as a result of shortages in foreign exchange.

The government's pension expenditure is also another item that has been growing fast over the years. It has more than doubled in the ten-year period from 1978 to 1988, growing from Birr 57.2 million to Birr 129.5 million. Presently, employees' pension contribution is considered as one source of revenue; however, the inefficient policy of pay-as-you-go financing will create a heavy future budgetary constraint.

4.2.2 Capital Expenditure

Unlike the government's recurrent expenditure, the performance of the capital expenditure (budget implementation) has not been encouraging. Shortages of domestic finance, foreign exchange, construction materials and poor budgeting and security problems are some of the reasons for this low performance. The average annual implementation for the years 1989, 1990 and 1991 was 74.8 per cent, 48.5 per cent and 57.9 per cent for the domestic source, foreign assistance and foreign loans respectively. The high level recurrent expenditure, mainly due to increased expenditures on defence, wages and salaries, and repayment of debt and pension has affected the performance of the capital budget. Mostly, budgetary revisions affect the capital budget more than the recurrent budget, as most of the expenditures in the recurrent budget are government commitments.

Table 3: Structures of Central Government Capital Expenditure, 1968-1991 (in million Birr)

Expenditure	1968	1974	1979	1983	1988	1991 Provisi.
Total Expenditure	80.9	178.5	368.8	1,245.3	1,459.2	1,167.1
Economic Dev't.	--	139.7	320.7	1,144.1	1,321.0	1,061.9
Agricultural and Natural Resorces	--	47.2	197.9	587.6	596.7	--
Mining and Energy	--	6.0	22.0	187.3	308.4	--
Transport Construction	--	39.7	70.8	120.1	114.6	--
Others	--	46.8	30.0	249.1	301.3	--
Social Development	--	35.6	45.2	84.3	106.7	87.2
Education	--	24.3	27.3	42.9	41.8	--
Health	--	8 7	11.9	21.7	37.0	--
Others	--	2.6	6.0	19.7	27.9	--
General Services	--	3.2	2.8	16.9	31.5	18.0
Percentage share in GDP	2.1	3.2	4.6	12.4	13.0	9.1

Source: 1) Ministry of Finance, *Budgetary Revenue and Expenditure*, for the Ethiopian Fiscal Year 1960, 1966, 1971, 1975 and 1980 (EC).

2) Ministry of Finance, *1991 Central Government Fiscal Plan Implementation*, August, 1991, Addis Ababa. (Unpublished, Amharic).

As shown in Table 3, total capital expenditure increased from Birr 178.5 million in 1974 to Birr 1,245.3 million in 1983 and Birr 1,459.2 million in 1988, before it dramatically decreased to 1,176.1 million birr in 1991. Eventhough the main emphasis of fiscal policy is to achieve growth through a more efficient allocation of resources, the Ethiopian reality does not attest to this fact.

Some projects were included in the budget before they were even appraised economically, financially, technically, etc. Examples of such projects include Muger Cement Factory, Nazreth Tractor Factory, Bahar Dar Edible Oil, etc. The number of projects in each sector that are included in the budget in each fiscal year are so many (738 for fiscal year 1990/1991) that the budget is over-stretched without any significant impact on growth. There has been a tendency to favor new projects at the cost of existing ones. However, emphasis on adequate spending on operation and maintenance of capital projects will increase the productivity and longevity of the

Table 4: Financing of Central Government Expenditure, 1968-1991 (in million Birr)

Financing	1968	1974	1979	1983	1988	1991 Provi.
Revenue	363.5	622.6	1,382.4	2,174.5	3,467.2	2,666.4
Recurrent Expenditure	363.5	533.4	1,324.2	2,403.4	3,132.0	3,486.1
Surplus/Deficit (-)		89.2	58.2	-228.9	335.2	-819.7
Capital Expenditure	80.9	178.5	368.8	1,245.3	1,459.2	1,167.0
Financing of Capital Expenditure						
Revenue	--	89.2	58.2	--	335.2	--
External Assistance	9.5	32.1	41.5	98.8	154.7	150.0
External Loans	26.1	47.1	123.3	299.3	539.2	400.6
Domestic Bank Borrowing	45.3	--	83.6	847.2	430.1	410.8
Others	--	10.1	62.2	--	--	205.7
Total Borrowing	71.4	--	83.6	929.8	430.1	1,230.5
Total Borrowing as per cent of GDP	1.9	0.8	2.6	12.3	8.6	12.8

Source: 1) Ministry of Finance, *Budgetary Revenue and Expenditure*. for the Ethiopian Fiscal Year 1960, 1966, 1971, 1975 and 1980 (EC).

2) Ministry of Finance, *1991 Central Government Fiscal Plan Implementation*, August, 1991, Addis Ababa. (Unpublished, Amharic).

existing stock. Presently, the road network has deteriorated, the quality of education is falling fast due to lack of textbooks, motivated teachers, laboratory facilities, etc. Health facilities have also deteriorated beyond imagination.

4.3 Financing of Government Expenditure

As depicted in Table 1, the revenue performance of the government, especially since 1974, has been remarkable. It increased from 11.2 per cent of GDP in 1974 to 31.0 per cent in 1989, before it dramatically decreased to 20.9 per cent in 1991. During the same period, total government expenditure increased from 12.8 per cent to a peak of 42.4 per cent in 1989 and then declined to 36.4 per cent in 1991.

The shortfall in revenue has been financed by borrowing, both external and domestic, and external assistance. Apart from its possible political cost, external assistance is the most attractive source of financing as it does not increase the foreign monetary indebtedness of the country. As shown in Table 4, external assistance grew from Birr 32.1 million in 1974 to Birr 154.7 million in 1988, financing 18.0 per cent and 10.6 per cent of the capital expenditure respectively.

The proportionally high revenue shortfall, in addition to the external assistance, is being financed by domestic and external borrowing. As a result, the central government's overall deficit as a percentage of GDP increased from 0.8 per cent in 1974 to 14.0 per cent in 1990, before it slightly decreased to 12.8 per cent in 1991. According to the World Development Report 1991, Ethiopia's deficit to GDP ratio, recorded at 6.8 per cent, was the third highest in sub-Saharan Africa, next to Zimbabwe (9.1 per cent) and Nigeria (10.1 per cent).

The heavy dependence on external financing has resulted in increased external debt service burden, with the total debt service as a percentage of exports of goods and services rising from 2.6 per cent in 1980 to 17.3 per cent in 1988. Presently, the ratio is even higher, as the size of arrears has increased due to the shortage of foreign exchange.

On the other hand, heavy reliance on domestic bank borrowing has been one of the major causes for the extremely high domestic bank credit, money supply and increased domestic debt service. Of the total outstanding bank credit of Birr 8,930.8 million in June 1991, claims on central government was Birr 6,045.8 million or 67.7 per cent. The consequence of such mode of financing has contributed to the present economic instability, reflected in inflationary pressures, deteriorating balance of payments and overvalued currency.

5. CONCLUSION

Like other economic policy instruments (monetary, trade, exchange rate, etc.), fiscal policy plays an important role in promoting economic growth, distributing income and wealth, and stabilizing the economy. To fulfill these functions it has to be designed appropriately. In Ethiopia, eventhough fiscal policy has been an important and traditional policy instrument, its implementation with respect to these major functions has not been conducted efficiently, especially since 1974. In some cases, its functions has been replaced by regulations, resulting in an economy which is over-regulated and inefficient.

The government's socialist policy has disregarded the allocation function of fiscal policy. As a result, inefficient provision of both public and private goods and services prevail. The attempt to fulfill the distribution function by mobilizing higher revenue through progressive taxes has been one of the causes for disincentives to investment and evasion of tax payments. Other expenditure and revenue measures have not been targeted to the low-income group, nor carried out in a coordinated and sustainable way.

With regard to stabilization, fiscal policy has, in fact, been one of the destabilizing factors. Despite the discretionary revenue measures, revenue shortfall (due to negative external shocks and the government's expansionary policy) is mainly financed by resort to banks, thus, exacerbating the inflationary pressure.

An assessment of the fiscal performance over the last 17 years reveals these factors. The relatively high tax effort was not achieved as a result of revenue productivity and built-in elasticity. The observed high expenditure to GDP ratio was not the outcome of only growing defence expenditure; the proliferation of organizations, the government's guaranteed employment policy for graduates and the increasing debt service payments have also contributed to its growth. The capital expenditure has been stretched over too many projects and programs, some of them implemented without being studied or appraised, thus, affecting its contribution to growth.

If fiscal policy in Ethiopia is to play its allocative, distributional, growth and stabilization functions properly, it has to be reformulated along with other policies. However, since recommendations on other policies are beyond the scope of this paper, reform measures on fiscal policy are briefly pointed out below.

1. The Role of the Government

The achievement of a sustainable economic growth requires the efficient mobilization and allocation of resources in both the public and private sectors. To this end, the government has to concentrate on:

- the provision of public and merit goods -- defence, law and order, justice, economic and social infrastructure, extension services to promote peasant agriculture, etc.;
- encouraging the private sector (domestic and foreign) through fiscal incentives, competition and streamlining the administrative, legal and property rights;

- restructuring public enterprises through the sale and lease of assets, management contract, joint ownership and closure; and
- granting financial and management autonomy for those which will remain under government ownership because of their nature, i.e., being natural monopolies.

2. Government Revenue

In order to enhance incentives to work, save, invest and thereby advance economic growth and equity, reform measures include:

- reducing the maximum tax rate and the progressivity (fewer brackets) on employment and agriculture;
- further revising the surtax on the export of coffee and harmonizing import taxes; and
- increasing the exemption level on personal income tax.

3. Government Expenditure

Growth and stabilization functions of fiscal policy requires a reformulation of the government's expenditure policy including:

- restructuring the government's organizational structure;
- revising the guaranteed employment policy for graduates;
- managing pension contribution through a pension fund;
- targeting subsidy expenditures to reach the low-income group;
- avoiding the inclusion of projects into the budget before they are studied and appraised;
- giving priority to the maintenance and operation of existing capital projects;
- reducing the size of the deficit to a manageable level; and
- linking the budget to the macroeconomic framework.

There is no doubt that conflicts exist between the different functions of fiscal policy. However, successful implementation of these objectives necessitates trade-offs or compromises. Further, fiscal policy is only one of the policies used to enhance growth, distribution/equity and stabilization. In order to fulfill these objectives in a sustainable and efficient way, fiscal policy has to be harmonized with other macroeconomic and adjustment policies.

NOTES

1. This has been reduced to 59 per cent since 1990.

2. Direct taxes include taxes on personal income, agricultural income, business income and profit as well as rural land use fee and taxes on dividends and lottery.

Indirect taxes include sales taxes on domestically produced goods and services and stamp duty.

Foreign trade taxes include customs duties and sales taxes on imported goods, and customs duties, surtax, excise and transaction taxes on exported goods.

3. Non-tax revenue includde charges and other fees, sales of goods and services, residual surplus and capital charge, employees pension contribution and other miscellaneous revenue.

4. The coffee surtax was revised in 1989.

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