

TRENDS IN GOVERNMENT FINANCE*

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ABSTRACT: *Recent developments in the Ethiopian budget system indicate a trend of increasing structural deficits, which are caused by independent developments both in the revenue and expenditure structures. The mode of expenditure finance pursued by the government also resulted in a further monetization of these deficits.*

1. INTRODUCTION

A most important post-1974 development in Ethiopia is the phenomenal growth of the public economy. The trend toward "larger government", started in earnest during 1974/75, did not take much time to attain the desired objective. Already, by the middle of 1976, much of the economic wealth of the country were in government hands and the major control and management responsibilities of the economy also lay with the government. The process of developing a large public economy involved complicated steps and had four main elements.

First, the newly established government that supplanted the monarchy, declared socialism as its ideology and the establishment of a strong "state economy" as the target of its economic policies and programmes. The framework for the realization and management of the socialist economy were provided in a number of government publications and proclamations issued around 1974 and 1975 (see, for example, Appendix I).

Second, by issuing and implementing a succession of proclamations it was possible to effect a large-scale transfer of economic resources from the private to the public sector (see Appendix II). The nationalization drive, zealously pursued by the government, was not confined to economic enterprises, urban and rural lands and extra urban houses but also included the services (e.g. wholesale trade, import and export business, etc.) as well as social sector institutions such as schools and cultural centres.

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Thirdly, to carry out this greatly expanded responsibilities of the government in the economic sphere, a new system of state machinery was established and the existing bureaucracy was greatly expanded [29]. This constitutes another aspect of the growth of the public economy. Many new ministries, institutes, corporations and departments were established which led to a dramatic expansion of public sector employment and an increase in government expenditures in wages and other benefits¹. The result of all these processes had been to expand the public sector economy considerably.

Finally, the launching of a series of sequenced "campaigns", which required the large-scale mobilization of human, material and financial resources had also contributed to the growth of the public economy (see Appendix III). In this connection mention may be made of the National Development Through Cooperation, Enlightenment and Work Campaigns (1974-1976) undertaken in order to agitate the peasantry and to implement the new land reform. The campaign was effected by closing all post-secondary institutions and engaging all their staff and students in campaign activities. During 1977 and 1978 about half a million-man militia was raised for another campaign, this time to "defend the mother land" from war of aggression by Somali "expansionists" and northern "secessionist forces". The literacy campaigns (since 1979) carried out over a ten year period and the *Eritrea Region Red-Star Multi-Faceted Campaign* (1982) also used up varying amounts of financial resources; in the latter case, in reconstruction activities and war effort. Following the persistent drought of the early 1980s a large-scale land resettlement campaign was launched which required sizable expenditures in rehabilitation work, transport and up-keep costs and establishment activities. The villagization drive was also extensive and covered nearly all the areas under government control. Later in 1978 another campaign was launched to rehabilitate economic infrastructure and activities destroyed by the "reactionary" wars and the persistent drought. A long run aim of this campaign, *the National Revolutionary Development Campaign* as it was called, had been to start economic development programmes on a stable and enduring basis.

It was attempted to manage these campaigns in a cost-effective and efficient manner by deploying students and peasants (during slack periods) in these campaigns and also by intensively using labour in public sector employment and by transferring underemployed workers to campaign operations. Campaign expenditures were also

trimmed down to approximate transport costs and other "necessary" operational costs only. Extensive use was also made of voluntary contributions and outside financial assistance and to limit as much as possible the financial burden on the public budget system. The initial steps in these campaign programmes may thus give the impression that they can be financed in ways that do not affect the regular government expenditure commitment. Nevertheless, these campaigns consumed a large amount of "transient cost" and also resulted in new activities and programmes requiring the establishment of permanent expenditure budget lines from the government.

Table 1: Total Government Expenditure to GDP Ratio
(Percentages)

Areas	1950	1970	1975	1980	1981	1985	1986	1988	1989	1990
World			27.3	27.8	28.6	30.0	30.1	28.8	---	---
Industrial Countries			28.9	28.7	29.6	31.4	31.4	30.1	29.9	---
Developing Countries			22.4	24.2	24.7	24.7	25.3	24.1	---	---
Africa			23.8	23.7	24.5	23.9	25.9	---	---	---
Ethiopia	5.3	14.3	21.7	28.4	32.3	42.1	40.1	49.2	46.4	45.2

SOURCE: The Ethiopian data is calculated from the Ministry of Finance, *Budgetary Revenue and Expenditures*, (various years) [6]; and the rest obtained from the International Monetary Fund (IMF), *Government Finance Statistics Yearbook*, (Various Years) [5].

The growth of the public sector economy is shown in Table 1. During the pre-1975 period the ratio of government expenditure to GDP was low, perhaps even lower than the world average or the average for the developing group of countries. Post-1974 developments show a marked increase in this ratio, reaching the staggering high rate of 45 percent by the latter half of the 1980s.

It appears that Wagner's thesis of the inevitable growth of the public economy is confirmed by the developments in Ethiopia except, perhaps, for the qualification that this growth in the Ethiopian case was more "revolutionary" rather than "evolutionary" [3, pp.44-46]. Peacock and Wiseman's thesis that government expenditures grow in step-like

fashion and that these expenditures are rigid downwards is also confirmed by the fiscal developments in Ethiopia. Every major expenditure up-thrust had raised public spending levels to a new high plateau which once achieved are apparently sustained by drawing regular expenditure budgets from the government [23].

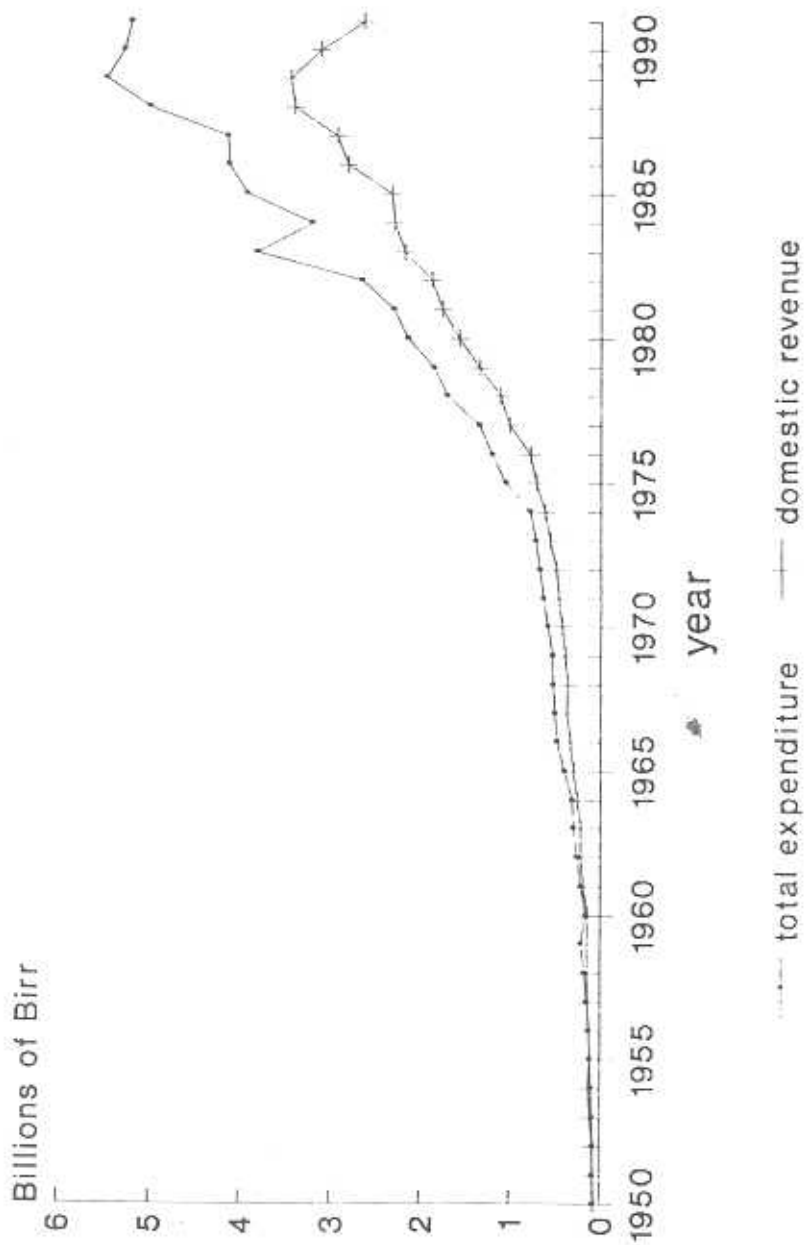
2. BUDGETARY DEFICITS

A major consequence of the fast growth of the public sector economy is the introduction of persistent structural deficits in the economic system. The management of government expenditures is made increasingly difficult because government revenues and expenditures are not properly aligned. Both revenues and expenditures are subject to wild fluctuations. This is not necessarily a manifestation of cyclical deficits, since the fluctuations lack periodicity and pattern. Also, cyclical budgets contribute little to the analysis of budgetary deficits because of limited role of automatic stabilizers in the Ethiopian fiscal system (automatic changes in tax receipts, following business cycles, are small; and so are transfer payments). Rather, the large and growing deficits are results of independent developments in both revenue and expenditure sources and indicate a vulnerable budgeting system operating with erratic fiscal behaviour: heavy and unsustainable financial injections here, large expenditure jumps there and with shocks and crises throughout the period since 1974. Such a budgeting practice is not untypical for an underdeveloped economy where a small financial assistance from a relatively rich source transforms the revenue picture and where, at another time, a small rise in the demand for public resources overtaxes its capacity to finance expenditures [see 31].

Figure 1 shows that budgetary deficits were increasing over the longer term. During the period 1950-1955 budgetary surpluses were recorded. During the following decade balanced budgets were maintained, more or less, and during the period 1965-1974, the practice of "fiscal conservatism" kept the deficits small. It was during the period 1975-1991 that large budgetary deficits are sustained.

Once in that state, all the precepts of classical fiscal management are violated. By deliberate act of government, deficits are increased and the call for "small government" is substituted by the outcry for "larger government". Balanced budget is no

Budget Deficit From 1950 to 1991



longer the guiding principle for the management of the "fisc", and as for fiscal neutrality, the workings of the invisible hand in the market is substituted by administration and administered prices. In general prudent budget policies are not followed: Public sector investments are not necessarily guided by social rate of return calculus, government expenditures may not be planned always and may reflect the needs to cover "emergency costs", there is a trend toward increased government reliance on ad hoc and unstable revenue sources and the role of fiscal policy in the alleviation of mass poverty and in bringing about economic structural adjustment is not played [see, 31].

3. THE GROWTH OF GOVERNMENT EXPENDITURE

A major factor behind the trend of increasing government deficits has been the relatively higher growth of expenditures than revenues. The ratio of total domestic revenue to total government expenditure averaged 108.88 percent per annum during the period 1950-1955, 82.63 percent per annum during 1956-1964, 73.08 percent during 1965-1974 and 66.59 percent per annum during the period 1975-1991².

The trend of increasing government deficits is indicated by the continuing decline in the above ratio. The relatively high growth rate of government expenditures is also shown in Table 2.

Table 2: Average Annual Growth Rates of (Real) Expenditures³
(percent)

Period	Recurrent Expenditure	Capital Expenditure	Total Government Expenditure
1950-1960 ^(a)	7.35 (16.07)	^(b) 12.40 (38.94)	9.17 (15.47)
1961-1974	9.80 (12.84)	17.48 (31.79)	10.25 (11.08)
1975-1990	7.97 (12.87)	11.33 (22.42)	8.38 (13.13)

^(a)The growth rates of monetary values are calculated (since appropriate deflators are not provided for this period).

^(b)The extremely high growth rate for 1955/56 is substituted by the average of the two encompassing growth rates.

SOURCE: Computed from Ministry of Finance, *Budgetary Revenue and Expenditures*.

Total expenditures, measured in real terms, had a growth rate of about 9 percent per annum during the period 1950-1960, and during the period 1961-1974 the average growth rate increased to about 10 percent per annum. During the era of socialist management of the economy (1975-1991), it was also possible to sustain a high rate of growth of government expenditure, averaging 8 percent per annum. In fact, the average annual rate of growth for the period 1975-1985 was 10.6 percent, and it is due to the relatively steeper drop of growth rate in subsequent years that the decline for the longer period, 1975-1991, to 8 percent is recorded. Both recurrent and capital expenditures increased, contributing to the dramatic rise in the level of total government expenditures.

Regarding the changes in the structure of expenditures and the impact these had on the nature and magnitude of government deficits several developments are indicated. Government expenditure allocations between capital and recurrent expenditures are shown in Table 3.

While recurrent expenditures were 13 times the level of capital expenditures during the 1950-1960 period, 6 times for the period 1961-1974, they were only 3 times as large during the period 1975-1991.

Table 3: Government Recurrent/Capital Expenditure Ratios
(Yearly Averages)

Period	Recurrent/Capital Expenditure Ratios (yearly averages)
1950-1960	12.54 (9.84)
1961-1974	4.52 (1.46)
1975-1991	2.95 (0.78)

NOTES: The figures in parentheses are the standard deviations of the yearly ratios.

SOURCE: Calculated from data in the Ministry of Finance, *Budgetary Revenues and Expenditures*.

The rise in the Capital/Recurrent expenditure ratio need not necessarily imply that a significant change in the overall investment level in the economy had occurred. That the rate of investment growth has in fact decelerated during the post-1974 period

is indicated by national income account statistics. These show that the average annual rate of growth of real fixed capital formation, estimated at 3.03 percent per annum during the period 1961-1974, had decreased to the level of 2.54 percent per annum for the 1975-1991 period⁴.

What is indicated by the rise in the capital/recurrent expenditure ratio is merely the changes in the government shares of total investment. The socialist management of the economy has shifted investment responsibilities from the private toward the public economy. Government share of the total fixed capital formation, which averaged a mere 20 percent per annum during the period 1961-1974, increased to 71 percent per year during 1975-1989⁵.

The increases in the rate of government capital expenditures (growing structural deficits) had a significant "crowding-out effect" on private investment. Normally, the mechanism through which this effect is transmitted is indirect and involves the reactions of the money market. Structural deficit growth leads to an increase in the rate of interest (government expenditure growth raises the level of gross national income which, in turn, increases the demand for money and thus increases the rate of interest) and, therefore, a decrease in the level of private investment [27, pp.368-689]. However, in the Ethiopian case the crowding-out effect is carried through a more direct route: private entry into specific investment lines are barred (by law), credit rationing practice gives priority to government investment projects, licensing and permit procedures are cumbersome and frequent changes in investment laws and administrative red-tapes are discouraging to prospective private investors. The inefficient and not-so-cost-effective government operations in the investment field deny society the economic benefits from private investment projects, perhaps, with relatively higher yield and greater social utility. As a result, the possible increase in the gross national income (caused by government expenditure growth) is offset by the decline of (or, crowding-out effect on) private investment.

Table 4: Sources of Government Capital Expenditure Finance - Actual
(Percentage Shares)

Period	Central Treasury	Foreign Loans	Foreign Assistance
1973-1974	56.9 (1.8)	27.4 (1.3)	15.7 (3.2)
1975-1988	56.9 (4.7)	30.1 (4.9)	13.0 (3.7)
1975-1991*	55.0 (6.5)	32.0 (6.2)	13.0 (3.8)

*The figures for 1989-1991 are "budget" estimates and not "actual". Note also the figures in parentheses are the standard deviations of the annual shares.

SOURCE: Computed from Ministry of Planning and Development, *Government Capital Expenditures*.

Furthermore, there has also been little change in the relative importance of government sources of capital finance. The Central Treasury allocations cover about 55 percent of the government capital expenditures. In recent years there have been slight increases in the share of foreign loans and a decrease in the share of foreign assistance as sources of government capital expenditure finance. But these small changes do not seem to have affected the general picture: the system of capital expenditures depends, to a high degree, on foreign finance (see, Table 4).

With regard to the allocational effects of government recurrent expenditures three points may be made. First, while the bulk of the expenditures are made in "general services", "defence" forms the single most important category of that group. The annual rate of growth of real expenditure on defence averaged 6.3 percent per annum during the period 1961-1974 and rose to the growth rate of 19.8 percent per annum during the 1975-1991 period⁶. The distortion this high growth rate introduces into the structure of government expenditures is pretty obvious. Ever increasing shares of government expenditures were pumped into destructive activities with adverse consequences on economic growth. The share of defence expenditures (in the total government expenditure), which averaged 26 percent per year during the period 1950-1960, rose to the rate of 42 percent per annum during the period 1975-1991 (see Table 5).

Table 5: Functional Distribution of Recurrent Expenditures (percentages)

Period	General services/Total Recurrent Expenditures		Economic development/Total Recurrent Expenditures	Social Services/Total Recurrent Expenditures
	Defence Exp./Total Recurrent Expend.	General Serv./Total Recurrent Expenditures.		
1950-1960	26.35 (2.39)	62.87 (2.15)	16.44 (2.73)	17.25 (1.84)
1961-1974	22.10 (4.32)	52.12 (8.91)	10.73 (2.87)	21.13 (2.85)
1975-1991	41.66 (6.02)	55.19 (6.01)	6.16 (1.18)	17.90 (2.44)

Note the row additions do not yield 100 percent because of "unallocated" expenditures. The figures in parentheses are standard deviations of the yearly ratios.

The second feature of recurrent expenditure allocation is that while "social service" expenditure shares during the 1975-1991 period were maintained at their 1950-1960 period levels, the expenditure allocations for "economic services" have in fact declined in recent years. Low rates of social service expenditure allocations are reflected in declining health and educational standards. The problems in this regard are accentuated by population growth and by the declining rate of private participation in the delivery of social services.

Government recurrent expenditure allocations for economic services were 16 percent of the total per year during 1950-1960, 11 percent during 1961-1974 and only 6 percent per year during the period 1975-1991. Nevertheless, the range of social goods produced in the public sector were both diversified and increasing. In other words, although the relative expenditure shares (on economic services) were declining, the actual levels of government sectoral expenditure allocations were rising. But, with declining shares of sectoral expenditure allocations, declining rates of private sector participation, poor economic performance overall and a high rate of population growth, the economic wellbeing of the population had not improved.

Thirdly, the rapid growth of government expenditure has created a situation where the ordinary revenue system not only fails to contribute to capital finance, but also fails to cover all recurrent expenditures of government. The expansion of the public sector,

it is argued, led to public sector employment growth, the rapid expansion of the bureaucracy and hence the establishment of a permanent budget line in the government expenditure budget system. The rapid expansion of government investment also had a "snowball effect" on the levels of recurrent and total expenditures. Through expenditure linkages and investment multipliers a given level of government investment led to multiples of these in regularized wage bills, running costs and maintenance expenditures.

The overall impact of government expenditure growth had been to create a condition, perhaps inappropriately called and otherwise known as the "recurrent cost problem": excess capacities are created in the productive economic enterprises, projects are abandoned after only some phases of the project cycle are completed, other projects take longer running-in periods, depreciation and maintenance reserves are consumed, etc. and in general, regular government revenues fail to cover even recurrent expenditures, let alone pay for economic expansion and new investment.

4. RECENT DEVELOPMENTS IN GOVERNMENT EXPENDITURE FINANCE

The growing government deficits (or the gaps between domestic revenue and government expenditures), as shown in Figure 1, are bridged by external assistance, external loans and domestic bank borrowing. The last factor, government borrowing from the national banking system, is examined in some detail later.

External assistance and foreign loans constituted an important element in government expenditure finance. Over the years the level of external assistance and loans had increased, although the relative share of these in the total government finance has not changed significantly (see Table 6).

Regarding external assistance, there is no recorded evidence that the Ethiopian government received any prior to 1963. During the period 1964-1974, the annual share of external assistance in the total government finance averaged 16 percent and declined to the level of 9 percent for the period 1975-1991.

Table 6: Sources of Deficit Finance

Period	External Assistance	External Loans	External Assistance and Loans	Domestic Bank Borrowing	Total Government Finance
A. Average Annual Levels (million Birr)					
1950-1963	0	13.76 (17.43)	13.76 (17.43)	3.12 (20.93)	149.66 (72.52)
1964-1974	86.12 (19.01)	40.42 (18.71)	126.56 (31.14)	14.93 (14.61)	556.78 (138.20)
1975-1991	291.00 (219.19)	334.32 (195.07)	625.32 (366.27)	475.71 (452.40)	3198.12 (1536.32)
B. Average Annual Share of Total Finance (percent)					
1950-1963	0	7.36 (5.59)	7.36 (5.59)	-2.01 (16.57)	100.00
1964-1974	15.73 (3.63)	7.05 (2.26)	22.77 (2.83)	2.63 (2.78)	100.00
1975-1991	8.72 (3.62)	10.15 (3.09)	18.87 (5.03)	13.75 (8.07)	100.00

Note the total finance (equals total expenditures) is arrived at by adding to the above "domestic revenue". The figures in parentheses are the standard deviations of the annual values.

On the other hand, the level and share of external loans have been increasing. External loans were about 7 percent of the total yearly finance (on the average) during the pre-1974 period but account for an average of 10 percent share per year of total finance during the period 1974-1991.

While external assistance went mainly to finance consumption (pay for food, labour services, etc), loans constitute a most important source of capital (investment) finance. During the period 1974-1991 assistance and loans were flowing from Eastern Europe, the country's main trading partners, but following the recent setback in both Eastern Europe and Ethiopia, these are now reduced to a trickle and stopped altogether in most cases. Presently, the major sources of relief aid are Western donors and the UN system and the bulk of investment finance is expected from the World Bank and the International Monetary Fund (IMF). However, the negotiations with these institutions under their structural adjustment programme are on-going; and the early monetary disbursement within the framework of the so-called "Economic Restructuring and Reconstruction Programme (ERRP)" do not have a sizable investment component.

External assistance and loans form a rather unstable financial base for government expenditure programmes. As is clearly shown in Ethiopia, international politics rather than the economic needs of the country influence the flow of these

resources. Nevertheless, these sources account for about 20 percent of the annual government finance in recent years, which indicates a high dependency ratio.

4.1 Domestic Financing of Government Expenditures

4.1.1 Tax Financing of Government Expenditure

An important element in the domestic revenue system is taxation. Although over the longer term tax yields had a high growth rate, there has been a marked decline in the rate of growth of tax revenues in recent years. The recent declines in tax collections have resulted in the main from an erosion of the tax base and marked deterioration in tax administration. This trend is indicated in Table 7.

Real tax revenues had an average annual growth rate of about 7 percent during the period 1950-1960. By breaking down the 1975-1991 period into smaller time intervals, the declines in the rate of growth of tax revenues in most recent years can be shown. Although the rate of growth of tax revenue is less than the rate of growth of government expenditure, it is much higher than corresponding growth rates for such macro-variables as gross national income, exports, per capita income or the rate of growth of labour productivity.

Table 7: The Growth of Tax Revenue (percent)

Period	Average Annual Rate of Growth of Real Tax Revenue	Tax Revenue/GDP at Current Factor Cost	Tax Revenue/Total Expenditures	Tax Revenue/Domestic Revenue
1950-1960	8.45 (11.95)*	5.91 (1.02)	86.46 (17.63)	88.10 (1.74)
1961-1974	7.52 (7.60)	8.73 (1.09)	66.84 (9.79)	86.27 (1.82)
1975-1989	7.22 (9.23)	---	---	---
1975-1990	5.96 (10.15)	---	---	---
1975-1991	4.90 (10.67)	17.25 (3.12)	50.68 (8.19)	76.26 (6.37)

*money values (appropriate deflators are not available for the pre-1960 period). The figures in parentheses are standard deviations of the annual figures.

SOURCE: Based on data in Ministry of Finance, *Budgetary Revenue and Expenditures*, and Ministry of Planning and Development, *National Income Accounts*.

Thus, the ratio of tax revenue to GDP at current factor cost increased over time. Tax revenues per annum were about 6 percent of GDP during the period 1950-1960, 9 percent during the period 1961-1974 and 17 percent per annum during 1975-1991. On the other hand, the tax revenue/total expenditure ratio shows a declining trend, indicating a widening gap between government expenditures and tax revenues. Likewise, the ratio of tax revenue to domestic revenues declined, indicating a faster growth of non-tax revenues in recent years.

Table 8: Tax Revenue Structure (percentages)

Period	Direct Tax/Total Tax	Indirect Tax/Total Tax	Foreign Trade Tax/Total Tax Revenue
1950-1960	29.18 (7.80)	22.94 (9.05)	47.88 (4.94)
1961-1974	26.32 (3.09)	29.81 (2.47)	43.87 (4.89)
1975-1991	35.84 (7.00)	29.08 (4.35)	35.08 (10.54)

SOURCE: Ministry of Finance [6].

There has been little change in the structure of tax revenues, using broad classifications (see Table 8). Direct and indirect taxes together accounted for about 50 percent of the tax revenue, and foreign trade taxes for the remaining 50 percent during the period 1950-1960. During the period 1961-1974 the average annual share of direct taxes and foreign trade taxes decreased slightly and that of indirect taxes increased. The average annual share of direct taxes in the total tax revenue increased, that of indirect taxes remained constant and the share of foreign trade tax revenue declined during 1975-1991. During this period foreign trade performance was poor and this is reflected in the relatively low tax returns from that source.

A main factor behind the rising trend of tax revenues has been the discretionary changes introduced around 1964 and 1974. Tax reforms were introduced during the mid-1960s and include the *Income Tax Proclamation 173/1961* and the amendment *Proclamation 242/1966* and *Proclamation 255/1967*, as well as *The Public Servant*

Pensions Contribution Proclamation 199/1963, *Transaction Taxes Proclamation 205/1963* and the *Transaction Tax Regulations, Legal Notice 282/1964*. The amendments to the *Customs Revised Import and Export Regulations, Legal Notice 153/1959* (including the *Customs Temporary Importation Regulations, Legal Notice 310/1965*), *Coffee Surtax Regulations (Legal Notice 280/1964)*, *Excise Tax Proclamation 204/1963*, *Excise Tax (Amendment) Proclamation 220/1965* and *Alcohol Excise Tax Proclamation 217/1965* are also among the important tax laws revised and introduced during the mid-1960s.

The tax reforms made during the mid-1970s, which are thought to have contributed to a considerable increase in tax yield, include the *Rural Land Use Fee and Agricultural Activities Income Tax Proclamation 77/1976* and its amendment, the *Rural Land Use Fee and Agricultural Activities Income Tax Amendment Proclamation 152/1978*. The introduction of these reforms not only replaced the archaic and complicated system of agricultural taxation of previous years, but also increased the agricultural tax yield considerably. Agricultural tax reforms are estimated to have raised the average yearly level of agricultural tax revenues during the post-1976 period to twice the level of the pre-1976 period [30, p.39]. Other tax reforms introduced around mid-1970s and causing a significant increase in tax yields include *The Customs Tariffs Regulations, Legal Notice 42/1976* and the *Income Tax Proclamation 155/1978*. The overall effect of these tax reforms had been to raise the taxation rate, broaden the tax base and thus, increase the tax yield.

There were also tax administration reforms contributing to the growth of government tax revenues. Attempts were made to make the operations of the Ministry of finance departments relatively efficient and cost-effective. The land reform of 1975 introduced a new system of land administration (peasant associations and cooperatives) with responsibilities in tax collections, a factor behind the high increase in agricultural tax yields during the post-1976 period.

4.1.2 The Growth of Domestic Nontax Revenue

Charges and fees, government sales of goods and services, miscellaneous revenues (e.g. fines on government employees), employees pensions contributions and revenues from government property and investment constitute the important nontax revenues in

the system of domestic finance. Of these the revenue source with the highest yield is "revenues from government property and investments". Presently, the yield from this source is at least twice as much as the other nontax revenues put together and includes revenue from state mines, sale of movable property, profits and dividends from capital investment, various rents, surplus from national lottery, and interest on loans and dividends. Since the introduction of *Proclamation 163/1979*, over 95 percent of the revenue from "government property and investments" is contributed by another revenue category: "capital charges and residual surplus". In effect this category can replace the former nomenclature since it is a good approximation of "revenues from government property and investment".

The bases of government extraction of capital charges and residual surpluses is the *Regulation and Coordination of Public Financial Operations Proclamation 163/1979*. According to this Proclamation, each public enterprise pays to the government an annual capital charge of five percent of (the value of) "state capital plus general reserve fund". The General Reserve Fund is 10 percent of the surplus of an enterprise (and to be collected and kept by the enterprise up to a ceiling of 30 percent of the state capital) and 30 percent of the surplus of a financial agency (also collected and kept by the agency for a maximum of 60 percent of the state capital) to be used by the enterprise or financial agency for expansion activities and to pay debts. The capital charge is paid to the government as interest on loan capital, the thinking being that had the government not provided the capital itself, the enterprise or financial agency would have to obtain it from the capital market and pay the debt and the interest on it. In addition to the "Capital charge", a public enterprise or financial agency pays to the government the residual surplus defined as "the sum remaining after the deduction of the general reserve fund from the surplus".

Table 9 shows the growth of government revenue from "capital charges and residual surplus". The average annual rate of growth of "revenue from government property and investments" was 5.7 percent during the period 1967-1977. The average rate of growth of revenue from "capital charge and residual surplus" was a high 21.8 percent per annum during the period 1978-1990 (note the effective date for the introduction of *Proclamation 163/1979* was 30 June 1978). "Revenues from government

property and investment" accounted for only 7 percent of the annual total domestic revenue and 44 percent of the annual nontax revenue during the period 1967-1977. On the other hand, "residual surplus and capital charge" constituted, on the average, 17 percent of the annual total domestic revenue and 65 percent of the annual nontax revenue during 1978-1990.

Table 9: The Growth of "Capital Charge and Residual Surplus"

Period	Average Annual Rate of Growth (percent)	Capital Charge and Residual Surplus-Average annual (million Birr)	Capital Charge and Residual Surplus/Total Domestic Revenue (percent)	Residual Surplus and Capital Charge/Nontax Revenue (percent)
1967-1977*	5.74 (23.26)	45.19 (28.02)	6.80 (2.27)	44.19 (6.45)
1978-1990	21.82 (41.41)	433.93 (223.09)	16.84 (4.98)	64.62 (10.49)

*The row figures refer to "Revenue from Government Property and Investments". The growth rate of 5.74 is obtained when the annual rate of growth for the year 1974/75 is substituted by the average of the growth rates for 1973/74 and 1975/76. As before, the figures in parentheses are the standard deviations of the actual annual values.

For most public enterprises and financial agencies the extraction rate (taken away by the government in the form of capital charge and residual surplus) is considered high. Many of these enterprises and agencies could not produce "surplus", and were kept, for varying periods of time under the "relief" provisions of the Proclamation. Other than narrowing the scope for independent action, the extraction formula leaves the public enterprises and financial institutions with very little resource for expansion and new investment. Furthermore, every time the government is hard-pressed for cash, it tends to syphon off the revenues of the public enterprises and financial agencies by applying the full provisions of the law. During the years 1988, 1989 and 1990 for example, (when the structural deficits reached their peak) the average yearly take of the government on the bases of Proclamation 163/1979 amounted to 74 percent of nontax revenues or 22 percent of the total domestic revenue.

4.2 Domestic Bank Borrowing

Government borrowing from the domestic banking system constitutes a most important means of financing government deficit in recent years. Although the *Monetary and Banking Proclamation 206/1963* permitted the government to use the borrowing facility, it did not make an extensive use of it during the pre-1974 years. This was because of, among other reasons, the relative smallness of government deficits and the greater possibilities of using less inflationary means of deficit financing (including foreign borrowing) in those years. However, since 1974 the government was hard pressed for cash to cover its ever growing levels of deficits and resorted to an extensive use of the borrowing provisions of the banking laws.

The practice of government bank borrowing shows the application of diverse borrowing instruments. Short-term loans are financed by means of treasury bills, which are issued by the government and purchased and held as security by the banks and other financial institutions. Although the 1963 Monetary and Banking Proclamation (*Proclamation 206/1963*) allowed the National Bank to purchase in the open market freely negotiable treasury bills, it was *Proclamation 263/1969* which first initiated the practical application of this borrowing instrument. *Proclamation 263/1969* authorized the Minister of Finance to issue and redeem treasury bills from time to time. In the original proclamation the treasury bills were issued in 50,000 Birr denominations and had a maturity period "not exceeding 93 days". Direct advances constitute the other important, and in recent years indeed a most important, instrument for short-term borrowing from the banking system. First introduced to overcome fluctuations in the ordinary revenues of government in 1963 (*Proclamation 206/1963*), the government used direct advances to finance the bulk of its bulging expenditures in recent years.

On the other hand, government bonds are used to finance long-term borrowing, and they came into the picture a bit earlier, in 1961. By *Proclamation 172/1961* the Minister of Finance was authorized to issue bonds ("with a total principal value not exceeding 30 million Birr" and) with a maturity period of "not more than 10 years". As the financial needs of government to finance long-term investments expanded considerably, various types of bonds were issued over the years. Some were specific: e.g. there was a 1963 government borrowing against a treasury obligation, later converted

into bond, of 87 million Birr; there was a government issue of an investment bond valued at 46.3 million Birr to save the Agro-Industrial Development Bank from bankruptcy, etc. There were two bonds issued by the government and bought by the National Bank: Pension Commission Bond and the National Bank Bond with a combined value of 1.3 billion Birr. Other bonds issued by the Government were more general, including many saving bonds, premium bonds and, in most recent years, special bonds. With regard to the last type, in 1988 the Government issued a Decree for the purchase of Special Government Bonds by the Bank with a total ceiling value of 1.5 billion Birr and bearing a 2 percent per annum interest payment obligation to contribute to its debt finances.

Two related developments are apparent from this trend of debt financing. First, the government is seen moving in the direction of "soft financial management" by loosening the tight borrowing procedures, raising the loan ceiling, reducing the interest payment obligation, expanding the loan base and introducing special government bonds. This process eroded the "financial discipline" that was there during the pre-1974 years. For example, according to the *Monetary and Banking Proclamation 206/1963*, the ceiling for "direct advances" made by the Bank to the government, was 15 percent of the ordinary revenue of government in the previous fiscal year. This ceiling was raised to 25 percent in the *Monetary and Banking Proclamation 99/1976*, to 50 percent in the *Monetary and Banking (Amendment) Proclamation 289/1985*, to 70 percent in the *Council of State Special Decree 3/1988* and to the high level of 145 percent of the actual ordinary revenue collected during the previous fiscal year in the *Council of State Special Decree No. 22/1990*.

The ceiling for government cash borrowing from the Bank in exchange of Treasury Bills was "50 percent of the capital (and general reserve fund) of the Bank according to *Proclamation 206/1963*. According to *Proclamation 99/1976* the value of treasury bills surrendered to the Bank "must not exceed 20 percent of the ordinary revenue of government in the previous (i.e previous to the borrowing) fiscal year". The ceiling for government borrowing using treasury bills rises to "25 percent of the ordinary revenue of the government of the previous fiscal year" in the *Special Decree 3/1988* and to the level of 35 percent of the ordinary revenue according to the *Council of State Special Decree 22/1990*.

Similarly, for bonds the loan base became "the ordinary revenue of government in a previous fiscal year" rather than the "Bank capital and general reserve fund of the Bank" in *Proclamation 99/1976*, which also set the loan ceiling at 50 percent of the ordinary revenue of government in the year preceding the borrowing year. The ceiling was raised to 55 percent of ordinary revenue in the *Special Decree 3/1988* and to 70 percent of ordinary revenue in the *Council of State Special Decree 22/1990*. It is also obvious that the issuance of the *Special Decrees 3/1988, 4/1988 and 22/1990* removed some of the other barriers to government borrowing practice and increased the ceiling of such borrowing significantly.

The second development points to the trend of increasing use of more inflationary instruments of bank borrowing. As tax revenue sources and revenues from government property and investment failed to generate the required finances to offset deficits, the government resorted to bank borrowing. The borrowing instruments vary in their respective safeguards (some impose relatively more financial discipline than others, for example), loan maturity, mode of repayment and the amount of the loan. Long-term loan instruments have relatively better "safety valves" and impose better financial discipline than the instruments used for short term financing of government expenditures. In the Ethiopian case the instrument with the least safety provisions - "direct advances" - is most frequently used in government borrowing practice. As such it constitutes a most "inflationary" instrument in debt financing. The result of this government debt financing practice had been the monetization of deficits.

The growth of government borrowing from the banking system are also shown in Table 10. The rather high growth rate (averaging 19 percent per annum) of the cash loans to the government by the banking system during the post-1974 period are indicated in the last column. During the pre-1974 period the government deposited with the bank more than it withdrew from it. Because data on breakdowns of government borrowing by type of instruments used are not given, it is not possible to confirm or deny the allegation that the government was exceeding the ceiling set in the banking regulations in its borrowing practice. However, it is known most loans are based on "direct advance" the bank makes to the government and the years when relatively large cash withdrawals are reported are shown in the Table.

Table 10: The Growth of Government Bank Borrowing - Averages Per Year (percent)

Period	Domestic Bank Borrowing (year t)/Ordinary Revenue (year t-1)	Domestic Bank Borrowing/Total Expenditures	Average Annual Rate of Growth of (Real) Bank Borrowing*
1950-1960	-2.52 (21.48)	-3.62 (18.45)	
1950-1974	1.47 (14.18)	0.05 (12.53)	
1961-1974	4.31 (3.96)	2.93 (2.76)	-1.78 (146.42)
1975-1991	22.92 (13.91)	13.75 (8.07)	18.75 (86.28)
1975/76	30.71	18.35	
1977/78	34.49	20.52	
1982/83	49.55	24.42	
1984/85	25.85	15.11	
1989/90	50.72	33.13	
1990/91	40.00	23.91	

The figures in parentheses are standard deviations of the annual values

*The exceptionally high growth rates for 1974/75 and 1982/83 are left out.

Although comprehensive "inflation indices" are not computed by any authority in Ethiopia, the Central Statistical Authority's *Retail Price Index for Addis Ababa* may be used as an approximation (see Appendix IV). The rate of inflation increase has been particularly high in recent years. For example, during the period 1963-1974 the increase in the inflation rate had been by only 47 points while between 1983 and 1991 the rate of inflation doubled. These inflationary trends are associated with the growth of government deficits which result in large scale bank borrowing. The related expansion of money supply unaccompanied by growth of productivity causes inflation. It is that trend that is captured by the Addis Ababa Retail price General Index.

5. CONCLUSION

The socialist economic policies followed by the last government, the private property nationalization drive zealously pursued during 1975 and 1976, the establishment of an expanded bureaucracy and state administration and the conduct of endless

"campaigns" had resulted in a large public economy within a short span of time. The management of the finances of the public economy had been problematic from the start.

A vulnerable fiscal system characterized by erratic behaviour is borne out of these developments. The vulnerability is evident in the "smallness" of the budget and in the great difference to the deficit situation a small financial injection (or its denial) from outside can make. The erratic behaviour is also shown by the high revenue growth in some years and by an even larger expenditure jumps in others.

The structural deficits have continued to grow and this trend had serious economic implications. A large crowding-out effect of government deficit on private investment is noted. The allocation effects of government expenditures also leave negative impressions. Increasing levels of government expenditures have been made in "defence" with noticeable neglect of the social and economic sector development. As a result health and educational standards have deteriorated and the rate of economic growth decelerated considerably.

The large and growing deficits also led to gross fiscal mismanagement. The revenues not only failed to contribute to the finances of capital expenditures, they also failed to cover even the recurrent expenditures of government. As a result projects, mostly unplanned, were abandoned without completing the project cycle, and others were retained with ever extended running-in periods. Excess capacities in most public enterprises showed an increasing trend, plants were not properly maintained and depreciation allowances and reserve funds were consumed. The so-called "recurrent cost problem" characterized these fiscal developments in Ethiopia.

On the revenue side, although the rate of growth of government finance had been rather high, it was offset by an even higher rate of growth of government expenditures. Tax reforms made during the mid-1960s and mid-1970s together with reforms in tax administration improved the yield from this source. It was possible to exploit tax revenue sources by raising the taxation rate, broadening the tax base and introducing cost-effective and efficient measures in tax administration. But the gap between the tax yield and government expenditure needs continued to widen.

Of the nontax sources of domestic revenue, the revenues from "residual surplus and capital charge" make the most contribution to government expenditure finance.

Unfortunately, and in spite of the high growth rate of the revenue yield from this source, public enterprises and financial agencies consider the government extraction rate "excessive". The evidence for this is borne by the fact that many enterprises were kept for extended periods of time under the "relief" provisions of the tax law, others could not manage maintenance of plants, carry out expansion programmes or make investment. The extraction formula also denied public enterprise managers the freedom to make independent decisions.

With foreign sources of finance outside the range of influence of the Ethiopian government, it had to resort to domestic bank borrowing to finance its ever growing deficits. Two important developments are noted in this regard. First, there had been a marked move toward "looser" budget management. Borrowing ceilings are continuously raised, the base on which ceiling calculations are made are broadened, the effective rate of interest on loans and payable to the National Bank are lowered and special government bonds (which allow the government to borrow even larger amounts of cash from the domestic banking system) are introduced. These depreciate the "financial discipline" in budget management and make the government ever more dependent on this easy mode of deficit financing.

The second development indicates greater dependency on the most inflationary borrowing instrument to finance deficits - direct advances. The result of this development had been the "monetization of deficits" and the accentuation of the inflationary state of the economy.

NOTES

¹Between 1975 and 1990, no less than 116 enterprise establishment proclamations and regulations were issued.

²Government Domestic Revenue/Total Government Expenditure (percentages)

Period	Ratios (percent)
1950-1955	108.88 (19.04)
1956-1964	82.63 (9.19)
1965-1974	73.08 (3.54)
1975-1991	66.59 (7.30)

NOTE: The figures in parentheses are the standard deviations of the yearly ratios

SOURCE: Calculated from the Ministry of Finance, *Budgetary Revenue and Expenditure*. (various years)

³The deflator used to calculate real expenditures is the implicit GDP index which is defined as the ratio of GDP at current Factor cost by the GDP at constant factor cost of 1980/81 prices.

⁴Computations using data from the Ministry of Planning and Development, *National Income Accounts*, yields the following result:

Average Annual Rate of Growth of Real Fixed Capital Formation (percent)

Period	Average Growth Rates
1961-1974	3.03 (9.19)
1975-1989	2.54 (12.81)

NOTE: The figures in parentheses are the standard deviations of the yearly growth rates:

⁵Government Capital Expenditure/Gross Fixed Capital Formation (percent)

Period	Average Shares
1961-1974	19.56 (6.55)
1975-1989	20.83 (21.06)

NOTES: The figures in parentheses are the standard deviations of the annual shares.

SOURCES: Computed from data obtained in [6,7]

⁶Average Annual Rate of Increase of Real Expenditures on "Defence" (percent)

Period	Average Growth Rates
1960-1974	6.29 (18.30)
1975-1991	19.83 (31.53)

NOTES: The figures in parentheses are standard deviations of the annual growth rates.

SOURCE: Calculated from data in the Ministry of Finance, *Budgetary Revenue and Expenditures*. (various years)

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APPENDIX I

The Policy Framework for a Socialist Economy

- Proclamation 1/1974: Provisional Military Government Establishment Proclamation*
PMAC: Declaration on the Economic Policy of Ethiopia, February 1974
PMAC: Programme of the National Democratic Revolution of Ethiopia
Proclamation 19/1975: Ministry of National Resources Development Establishment Proclamation
Proclamation 20/1975: Public Enterprises Proclamation
Proclamation 26/1975: Government Ownership and Control of the Means of Production Proclamation
Proclamation 64/1975: Labour Proclamation
Proclamation 71/1975: Peasant Associations Organization and Consolidation Proclamation
Proclamation 76/1975: Proclamation Relating to Commercial Activities Undertaken by the Private Sector
Proclamation 138/1978: Cooperatives Societies Establishment Proclamation

APPENDIX II

Nationalization Programme

- Proclamation 3/1975: Public Ownership of Rural Lands Proclamation*
Proclamation 19/1975: Ministry of National Resources Development Establishment Proclamation
Proclamation 20/1975: Public Enterprises Proclamation
Proclamation 47/1975: Proclamation to Provide for Government Ownership of Urban Lands and Extra-Urban Houses
Proclamation 39/1975: Government Control of Mineral Prospecting, Exploration and Mining Activities Procl.
Proclamation 54/1975: Public Ownership of Private Schools Proclamation

APPENDIX III

Campaign Proclamations

- Proclamation 11/1974: Development Through Cooperation, Enlightenment and Work Campaign Proclamation*
Proclamation 97/1976: Eritrea Region Affairs Special Commission Establishment Proclamations
Proclamation 129/1977: National Revolutionary Operations Command Proclamation
Proclamation 156/1978: National Revolutionary Development Campaign and Central Planning Supreme Council Establishment
Proclamation 174/1979: Commission for Organizing the Party of the Working People of Ethiopia Establishment
Proclamation 237/1983: National Defence and Security Council Establishment Proclamation
Proclamation 238/1983: National Military Service Proclamation
Proclamation 239/1983: Establishment of the Military Commissariat and the Territorial People's Militia
Council of State Special Decree 25/1990: National Revolutionary Campaign Command Establishment

APPENDIX IV

Retail Price Index for Addis Ababa 1963 = 100

<i>Year/month</i>	<i>General Index</i>
1973	147.0
1975	170.1
1980	353.5
1981	375.2
1982	396.1
1983	394.5
1984	427.8
1985	509.4
1986	459.4
1987	448.3
1988	480.0
1989	517.6
1990	544.2
1991	738.7
March 1992	781.2