UNIT 6

FISCAL POLICY AND PUBLIC DEVELOPMENT IN ETHIOPIA

Unit Objectives

After completing this unit, you will be able to:

- distinguish the different sources of government revenue;
- report how fiscal policy is applied in Ethiopia; and
- classify taxes and appreciate their significance to the development of the economy.

Main Contents

INTRODUCTION

This unit deals with the major fiscal policies and public developments in Ethiopia. Among them, the economic role of the government, structure and performance of revenue and expenditure, government budget and deficit financing and fiscal decentralization and public sector reform will be discussed.

In the first topic of this unit, you will learn about the economic role of the government. In the second topic historical background will be discussed. The third topic mainly emphasizes on the structure and performance of revenue and expenditure. The fourth topic will concentrate on evaluation and analysis of the structure and performance of government budget and deficit financing. The last topic in this unit deals with fiscal decentralization and public sector reform in Ethiopia and also taxes will be discussed in this section of the unit.

6.1 ECONOMIC ROLE OF THE GOVERNMENT

At the end of this section, you will be able to:

- explain the economic role of the government.

Key Terms and concepts

- Fiscal policy
- Taxes
- Revenue
- Expenditure
- Public goods

What do you think about the economic role of governments?

Discuss the role of good governance relative to economic development in a country.

The role of the government played in the sector is provision of goods and services which private firms are either unwilling or for some reason are not allowed to produce. Therefore, the government takes the responsibility of:

- *providing of public goods and social services;*
- *regulating the economy as its role.*

The other functions that the government serves are as follows:

- *Alteration of the structure of private production. In order to conform to some conception of the allocation of resources; this is considered 'better' than the resulting from private market transactions. This aim will be* *reflected in the choice of taxes levied on goods and services (example, taxes on expenditure), in corporation taxes and in current subsidies.*

- *Intervention in the distribution of income generated by private market transactions in order to conform to some acceptable criterion of equity; for example, a minimum income guarantee. This will be reflected in the national accounts principally in the choice of taxes and in the provision of transfer payments to households against which there is no counter flow of current services. For example, state pension payments are transfer payments, and though pensioners do not render current services in order to receive them, they may have contributed to their finance through compulsory levies on their past incomes. Transfer payments do not form a direct link between government and industry but major efforts by government to alter income distribution have considerable influence on the structure of household purchases and, therefore, on the pattern of demand for industrial products.*
- *Stabilization of the economy by attempting to reduce fluctuations in income and employment and to control movements in the general price level. The effects of this action can be seen in both the volume and the mix of transactions between the government and the rest of the economy.*

In general, government roles can be summarized as follows:

- *Promoting economic growth;*
- *Providing public goods and service, such as defence, judicial service highways, streetlight, education and health care service and others;*
- *Bring about equitable distribution of income;*
- *Stabilize the economy, through such measures as controlling inflation, reducing unemployment, avoidance of regional imbalance, fair or equitable distribution of income, and promoting economic growth;*
- *Regulating the externalities;*
- *Promoting efficiency;*
- *Maintenance of law and order; and*
- *Reduction of poverty.*

Activity 6.1

1 Outline the principal role of a government in an economy.
2 What is the difference between taxes and subsidies?
3 Discuss when a government intervenes in the economy of a country ______.

Content Check 6.1

1 What are the major economic role of government?
2 What should be the role of private firms in the economy of the country?
3 List down public goods and services provided by government?
4 What should be the government role to stabilize the economy of the country?

6.2 HISTORICAL BACKGROUND OF PUBLIC FINANCE IN ETHIOPIA

At the end of this section, you will be able to:

- review the historical background of the public finance in Ethiopia.

Key Terms and concepts

- Public sector
- Private sector

Start-up Activity

What do you know about the history of public finance in Ethiopia?

Public finance deals with the financial activities of the government such as collection of taxes from those who benefit from the provision of public goods by the government, and the use of those tax funds toward production and distribution of the public goods and social services.

Whereas, private finance deals with individual financial activities. Both Public and private finance are important, as both are the main determinant in the policy matters of any nations.

The status of public finance in Ethiopia during Derg was directed towards expanding the public sector. The government adopted special tax increase policies in both direct and indirect taxes to discourage the private sector. In this period ,the rise in government expenditure on defense , strong involvement of government into the economy, overall expansion of the public sector, high degree of centralization and mismanagement of economic resources have led to considerable increase in government expenditure.

After the fall of the Derg EPRDF has been forced to take different measures. Most of these measures focused on the revenue and expenditure reform which increase government revenue and reduce government expenditure. The measures taken helped to remove the budget deficit.

Fiscal policy is a policy of government that guides the revenue and expenditure of a government. Fiscal policy instruments are tax and expenditure items.

The roles and functions of fiscal policy in the economy can be outlined in the following ways:

- *The allocation of resources into the production of public and private goods.*
- *The distribution of income in order to reduce inequality and poverty.*
- *The promotion of economic growth and the stabilization of the economy by reducing fluctuation in the level of prices, output and employment.*

Content Check 6.2

1. What is fiscal policy?
2. What kinds of economic problems can be solved by using fiscal policy instruments?

6.3 STRUCTURE AND PERFORMANCE OF REVENUE AND EXPENDITURE

At the end of this section, you will be able to:

- evaluate the structure and performance of revenue and expenditure.

Key Terms and Concepts

- Revenue
- Expenditure

6.3.1 Government Revenue

Start-up Activity

What do you understand about tax and non-tax revenue?

Sources of government revenue can be classified into tax and non-tax revenue. Though the revenue sources are numerous, those items which form the bulk of the total revenue are few. Taxes from wages and salaries, agricultural income tax, rural land-use fees and business profit tax are the major sources of revenue.

Tax Revenue

Table 6.1 **Government revenue in million Birr**

Year / Total	2006/07	2007/08	2008/09
Tax revenue	17353.0	23800.4	28997.4
Income and profit tax	4868.0	6626.0	9288.0
Rural land-use fee	130.0	149.0	239.0
Urban land-use fee	170.0	239.0	331.0
Domestic indirect taxes	3997.0	5093.0	7325.0
Import duties/taxes	8188.0	11693.4	11814.0
Export taxes	0	0	0
Total non-tax revenue	4444.1	7002.0	11647.0
Grand Total revenue	21797.1	30802.4	40644.0

Source: *Ministry of Finance, Central Accounting Department, 2008/09.*

The above Table 6.1 shows government revenue increased from 21,797,100 in 2006/07 to 30,802,400 in 2007/08 and 40,644,000 in 2008/09.

6.3.2 Government Expenditure

It is necessary to identify sectors to be included in the estimation of region's expenditure need. These sectors are determined by taking the biggest sectors that account for more than 90% of the region's total public expenditure. Using regional budget expenditure data obtained from the National Account Department of the (Ministry of Finance and Economic Development) MoFED, the following sectors were found to absorb more than 90% of the total expenditure in all regions.

- *General administration (organ of the state, public order and security, and justice);*
- *Primary and secondary education (including TVET);*
- *Public health;*
- *Agriculture and natural resources;*
- *Clean water supply; and*
- *Rural road construction and maintenance.*

Although they appear to have lower shares, the development of micro- and small-scale enterprises and urban development are crucial to addressing urban problems, particularly unemployment and poverty reduction. As of recently, these areas are getting more attention in government policy.

Table 6.2: **Recurrent government expenditure (in million Birr)**

Year / Expenditure type	2006/07	2007/08	2008/09
General service	7041.0	9129.0	11261.0
Economic service	2198.0	3110.0	3829.0
Social service	6193.0	8662.0	10250.0
Public debt	2429.8	1965.8	2046.7
Total Current Expenditure	18347.8	23626.8	27936.7

Source: *Ministry of Finance, Central Accounting Department, 2008/09.*

Table 6.3 **Capital government expenditure (in million Birr)**

Year / Capital expenditure	2006/07	2007/08	2008/09
Economic development	11367.0	17728.9	21812.1
Social development	5997.0	5426.1	7067.9
General service	1033.0	966.0	1718.7
Others	-	-	-
Total capital expenditure	18397.0	24121.0	30598.7

Source: *Ministry of Finance, Central Accounting Department, 2008/09.*

Table 6.2 below shows the government expenditure type from 2006/07 to 2008/09.

The total government recurrent expenditure shows an increment by 28.8% in 2007/08 and 18.24% in the year 2008/09. While table 6.3 shows, government capital expenditure from 2006/07 to 2008/09.

As compared to 2006/07, the total government capital expenditure increased by 31.1% in 2007/08 and 26.9% in 2008/09.

Activity 6.2

1 What is the function of fiscal policy in the economy?

2 What is public finance?

6.4 ANALYSIS OF GOVERNMENT BUDGET AND DEFICIT FINANCING

At the end of this section, you will be able to:

- analyze government budget and deficit financing.

Key Terms and concepts

- Deficit
- Surplus

What do you think about government revenue sources?

6.4.1 Structure of Government Budget

Government budget is a financial plan of government revenue and expenditure for a specific period, usually for one fiscal year. Ethiopia's fiscal year starts on Hamle 1, and ends on Sene 30, based on the Ethiopian calendar.

The usual objectives of the government budget include relating expenditure decision to policies, to current and future resources and to efficiently implement programs.

Most of the time government budget is divided into two major areas such as, revenue and expenditure budget. Revenue budget consists of the annual forecast of government budget from tax, non-tax, external assistance and capital source of revenue.

Tax-Source of Government Revenue

A Ordinary revenue

i **Direct tax:** The term direct tax means a tax paid directly to the government by the persons on whom it is imposed. Examples include income taxes, such as the following.

- ***Personal income tax:*** *Every person deriving income from employment in any government or other private organization or non-governmental organization and income from employment including any payments or gain in cash or in kind which he/she received from employees.*
- ***Business Income Tax:*** *Is a tax imposed on business enterprises, professional or vocational activity or any other activity recognized as trade pays tax based on their profit.*
- ***Corporate tax:*** *refers to a direct tax levied on the profits made by companies or associations and often includes capital gains of a company.*
- ***An inheritance tax (also known as an estate tax):*** *is a tax which arises on the death of an individual. It is a tax on the estate, or total value of the money and property, of a person who has died.*
- ***Transfer tax:*** *a tax on the passing of title of property from one person (or entity) to another.*

- ***Tax on dividends:*** *is an income tax on dividend payments to the stockholders (shareholders) of a company.*
- ***Income from games of chance:*** *Every person deriving income from winning at games of chance – for example, lotteries, tombolas, and other similar activities, are subject to tax at the rate of fifteen percent /15%/ except for winnings of less than 100 Birr.*
- ***Rental income tax:*** *Rental income is any payment you receive for the use or occupation of property.*
- ***Interest Income on Deposits:*** *Every person deriving income from interest on deposits shall pay tax at the rate of five percent.*

ii ***Indirect tax:*** a tax levied indirectly, as one levied on commodities before they reach the consumer but ultimately paid by the consumer as part of the market price. Examples includes sales tax or value added tax (VAT).

- ***Value added tax (VAT):*** *is a sales tax based on the increase in value or price of product at each stage in its manufacture and distribution and the cost of the tax in added at the final price and eventually paid by consumer on the purchase price of 15%.*
- ***Sales tax:*** *a consumption tax charged at the point of purchase for certain goods and services. The tax amount is usually calculated by applying a percentage rate to the taxable price of a sale.*
- ***Turnover tax (TOT):*** *It is an indirect tax which is similar to a sales tax or VAT, with the different that (TOT) tax imposed on those who are not register for VAT which their annual taxable transaction is under the total value of 500,000 birr.*
- ***Withholding tax:*** *is a government requirement for the payer of an item of income to withhold or deduct tax from the payment, and pay that tax to the government.*
- ***Stamp duty:*** *is a tax that is levied on documents. This include the majority of legal documents such as cheques, receipts, marriage licenses and land transactions. A physical stamp (a tax stamp) had to be attached to or impressed upon the document to denote that stamp duty had been paid before the document was legally effective.*
- ***Excise duties:*** *This tax is imposed on selected goods, such as luxury goods and basic goods which are demand-inelastic.* Tax on gasoline and other fuel and tax on tobacco and alcohol.

iii ***Foreign trade tax:*** It comprises both import and export taxes.

- ***Import tax:*** *An import tax collected on imported goods. Such as a tariff is a tax levied on imports or exports.*
- ***Export tax:*** *An export tax is a tax collected on exported goods.*

iv *Non-tax source of government revenue*: are government revenue not generated from taxes. Examples include:

- *charges and fees*
- *sales of government goods and service*
- *government investment income*
- *privatization proceeds*

B *External Assistance*

It comprises of grants, loans and technical assistance from bilateral or multilateral agencies.

C *Capital revenue:*

Domestic source collection of loans and sales of government asset.

6.4.2 Government Expenditure Budget

Government expenditure is divided into two principal headings: *Recurrent* and *Capital expenditure*. The recurrent budget is mostly financed from domestic revenue sources, i.e., from tax and non-tax revenue. The capital budget is usually financed by external loans and grants.

Recurrent budget expenditure consists of expenses that repeated in nature like salaries of civil servants. The recurrent budget in Ethiopia is structured under four functional catagories.

Recurrent Budget Category

Functional classification:

- *Administration and general service*
- *Economic service*
- *Social and other services.*

Sub-functional classification:

- *Administration and general service*
  - *Organ of state*
  - *Justice*
  - *Defence*
  - *Public order*
  - *General service.*

- *Economic*
  - *agriculture and natural resource*
  - *trade and industry*
  - *mining and energy*
  - *tourism*
  - *transportation and communication*
  - *construction*
- *Social*
  - *education and health*
  - *culture and sport*
  - *labor and social affairs*
  - *prevention and rehabilitation*
- *Others*
  - *transfer payment*
  - *repayment of public debt*
  - *contingency*
  - *miscellaneous*

Capital Budget Category

- *Economic development*
  - *The economic development includes production activities in all sectors of the economy.*
- *Social development*
  - *It constitutes activities like education, health and social welfare.*
- *General development*
  - *services in statistics*
  - *cartography*
  - *public and administrative buildings*

6.4.3 Budgetary Deficit Financing

A government budgetary deficit occurs when governmental expenditure is greater than government revenue, whereas government budgetary surplus occurs when government revenue exceeds government expenditure.

- *Domestic borrowing*
- *External borrowing*
- *Issuing currency (money printing)*

Trends in Fiscal Deficit to GDP Ratio and Financing

The overall fiscal deficit improved to –2.9 percent of GDP in 2007/08 from –3.6 percent in the previous fiscal year (see Table 6.4). The deficit was financed by domestic and foreign loans. In the next few years, expenditure management is expected to remain prudent, with cuts in recurrent expenditure and priority given to key social sectors such as health, education, agriculture, as well as support for infrastructure development.

In the past years, fiscal deficit has shown a declining trend with a –7.2 percent of GDP in 2001/02 to –2.9 percent of GDP in 2007/08.

Table 6.4 **Public Finances (percentage of GDP)**

Item / Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Total Revenue and Grant	19.3	21.4	20.7	18.9	17.7	17.1	16.2
Domestic Revenue	15.6	15.2	16.1	14.6	14.8	12.7	12.1
Tax Revenue	11.9	11.2	12.6	11.6	10.8	10.1	9.7
External Grant	3.6	6.2	4.6	4.3	2.8	4.4	4.0
Total Expenditure	26.5	27.9	23.7	23.3	22.3	20.7	19.1
Fiscal Deficit Including Grants	-7.2	-6.5	-3.0	-4.4	-4.6	-3.6	-2.9

Source: *Ministry of Finance and Economic Development (MoFED), year*.

Fiscal Deficit Financing

Table 6.5 **Fiscal Deficit Financing (In Percent of GDP)**

Item / Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	Average
Financing	7.2	6.5	3.0	4.4	4.6	3.6	2.9	4.6
External (net)	7.4	5.3	2.8	2.2	1.1	1.1	1.0	3.0
Domestic (net)	7.2	6.6	2.5	3.3	2.1	3.5	2.7	4.0

Source: *Ministry of Finance and Economic Development (MoFED), year*.

There are three main ways the government can finance a deficit.

- *Firstly, the government can borrow funds from the other sources of the economy. When the government borrows from domestic sources it competes with the private sector and creates what is referred to as "crowding out effect". A shortage of funds in the domestic market can result in the rise of cost of credit and hence discourages private investment.*

- *The second possible method used to finance a budget deficit is to borrow funds from international financial markets .But it widens the balance of payments in current account deficit.*
- *The third possible method of financing a deficit is issuing currency; this form of financing basically means that the government prints money to finance the deficit. But this method is not advisable. It is because it is highly inflationary: when the government increases money supply, if the economy is near full employment, demand pull inflation occurs rapidly, as there is too much money chasing a limited supply of goods.*

Activity 6.4

1. Identify tax and non-tax sources of government revenue.
2. How the recurrent and capital budget financed?
3. Mention the means of budgetary deficit financing.
4. When does government budgetary deficit occur?

6.5 FISCAL DECENTRALIZATION AND PUBLIC SECTOR REFORM IN ETHIOPIA

At the end of this section, you will be able to:

- describe fiscal decentralization and public sector reform in Ethiopia.
- distinguish the different types of taxes and state their characteristics.
- evaluate foreign trade taxes by taking into account the comparison between import taxes and export taxes.

Key Terms and concepts

- Decentralization
- Export tax
- Import tax

What do you understand about import and export taxes? And what are the reasons that government levied them?

Decentralization

Decentralization is a systematic delegation of authority at all levels of management and in all of the organizations. In a decentralization concern, authority retained by the top management for taking major decisions and formulating policies and the rest of the authority may be delegated to the middle and lower levels of management.

Decentralization is not the same as delegation. In fact, decentralization is an extension of delegation. Decentralization is wider in scope and the authorities are diffused to the lowest levels of management. Delegation of authority is a complete process and takes place from one person to another, while decentralization is complete only when fullest possible delegation has taken place.

Fiscal decentralization, which involves the sharing of revenue between regions and central governments, and introduced transfers and subsidies, is part of the decentralization process.

Fiscal decentralization is intended to assist regional governments by boosting their capacity for developing their localities through self-initiative. It is also meant to narrow the existing gaps in economic growth and development among regions. Despite this, fiscal imbalances between regions and heavy dependence of the regional governments on the federal government's transfer and subsidies have persisted.

Fiscal decentralization in Ethiopia emanates from federal and regional governments' constitutions. It has the objectives of devolving fiscal decision-making power to lower governments, and narrowing the vertical fiscal gap as well as ensuring horizontal equalization. Accordingly, the regional governments are empowered to the extent of levying taxes, and preparing and administering their own budgets. They are also entitled to collect their defined revenues, draw budget subsidies from the federal government and borrow from domestic sources.

As the devolution process was initiated prior to the adoption of the constitution, the transitional government issued Proclamation 33/92 which defined the nature of fiscal relations between the federal and regional governments.

The proclamation has had the objectives of enabling both levels of governments to carry out their respective duties and responsibilities effectively, assist regional governments to develop their regions on their own initiatives, narrow the gap in development and economic growth between regions and encourage their common interest.

Moreover, Proclamation 7/92 which affirmed the rights of Federal and Regional Governments and the Constitution of the Federal Democratic Republic of Ethiopia ratified powers and responsibilities of all levels of governments.

The major driving factor for assigning expenditure responsibilities and decision-making powers to the lower level governments is to improve their ability of efficiently identifying and addressing their citizens' needs. Being closer to the beneficiary population, sub-national levels of governments have informational advantage over the federal government as they can better see their constituents' needs. In line with these assumptions, regional governments have greater incentive to improve service delivery on the one hand, and on the other, beneficiaries and citizens can easily monitor their actions and evaluate them constantly and timely.

In Ethiopia, the federal government's powers and functions are more clearly defined in the constitution and generally encompass all national public goods such as:

- *defence,*
- *foreign policy,*
- *fiscal and money policy,*
- *designing of economic and social policies, and,*
- *building major infrastructure such as those of air, railway, shipping, postal, telecommunication and electric power.*

Regional governments, therefore, are responsible for duties related to basic service delivery, such as primary and secondary education, health, water and sanitation, rural roads, agriculture and natural resources.

It is apparent that regional and wereda administrations (the lowest level of administration) have significant responsibility for the provision of basic services targeted to reduce poverty, by way of generating income and empowering the local people.

The economic system in the Military Government was characterized by a high degree of centralization the decision-making and responsibility, and economic power was concentrated in the hands of few government officials. The new government, on the other hand, is based on the principle of decentralization. We have now federal and regional governments and each of them have their own duties and responsibilities. Regional states exercise their power over their jurisdictions by using their own plans and budgets. This way of administration gives economic freedom to properly manage and efficiently use resources at the disposal of the regional state. And there are other measures taken by the government sine 1992/93, such as,

- *rationalization of tax structure;*
- *broadening of tax base;*
- *reduction of government expenditure by narrowing public sector, selling loss-making public enterprises to generate revenue from the sale as well as to reduce expenditure; and*
- *reduction of the marginal tax rate. A marginal tax rate is the tax rate that applies to the last dollar of the tax base (taxable income or spending).*

6.5.1 Personal Income Tax

Every person deriving income from employment in any government or other private organizations or non-governmental organizations pays tax.

Personal income tax is the component of direct tax which is levied on income of a person. According to proclamation No. 286/2002 G.C the first 150 birr from employment shall be exempted from payment of income tax in all cases with the highest marginal tax rate on income to be 35%.

Table 6.6: **Percentage change of personal income tax based on the income level in Ethiopia**

No	Monthly income (Birr)	Percentage of Income tax (%)
1	1 - 150	No charge
2	151 – 650	10
3	651 - 1400	15
4	1401 – 2350	20
5	2351 – 3550	25
6	3551 – 5000	30
7	Above 5000	35

As shown in Table 6.6 above, the percentage of the personal income tax increases as personal earnings increase. An individual who earns 1 – 150 Birr is not required to pay an income tax.

Based on the above Table 6.6, parsonal income tax of Ms Hana would be computed as follows:

Ms Hana monthly salary = Birr 3000

The first 150 birr shall be exempted from payment of income tax.

- $(150 - 0) \times 0\% = 150 \times 0\% = 0$
- $(150 - 650) \times 10\% = 500 \times 10\% = 50$
- $(650 - 1400) \times 15\% = 750 \times 15\% = 112.5$
- $(1400 - 2350) \times 20\% = 950 \times 20\% = 190$
- $(2350 - 3000) \times 25\% = 650 \times 25\% = 162.5$

Total income tax = 0 + 50 + 112.5 + 190 + 162.5 = 515

Total income = 3000

Income after income tax = 3000 - 515 = 2485 birr

Income taxes are of three types in nature:

- ***Progressive:*** *is a tax by which the tax rate increases as the taxable amount increases.*

This type of income tax hurts more those people with relatively high income brackets. This is employed to collect more tax revenue from the people who are in high income brackets.

- ***Regressive income tax:*** *is a tax imposed in such a manner that the tax rate decreases as the amount subject to taxation increases.*

  It hurts more those people in low income brackets, and it affects their purchasing power significantly and hence reduces aggregate demand.

- ***Proportional income tax:*** *is a tax rate which levies certain fixed percentages on income received, or the amount of the tax is fixed in proportion to the amount subjected to taxation.*

6.5.2 Business Income Tax

According to Proclamation 286/2002, a tax is imposed on commercial, professional or vocational activities or any other activity recognized as trade by the commercial code of Ethiopia and carried on by any person for profit.

6.5.3 Indirect Taxes

A tax, such as a sales tax or value-added tax, that is levied on goods or services rather than individuals and is ultimately paid by consumers in the form of higher prices is referred to as an indirect tax.

6.5.4 Foreign Trade Taxes

Import tax: is the type of tax imposed on imported goods on specific values or ad. volarum or on a compounded basis.

Export tax: an export duty, or export tax, is a tax imposed on commodities leaving a customs area.

Strengthening Institutional Framework

The administrative capacity of the existing institutions should be improved in order to enforce tax compliance so that tax collection can be facilitated and strengthened.

In 2007/08, total revenue and grants as the share of GDP has reached to 16.2 percent (Table 6.7). Tax collection remained weak, with tax revenue declining marginally from 10.8 percent of GDP in 2005/06 to 9.7 percent in 2007/08. This calls for further strengthening of revenue collection institutions.

In order to achieve fiscal sustainability, fiscal policy has been targeted at reducing the fiscal deficit in percentage of GDP, while focusing on expanding the provision of socio-economic services and expansion of critical infrastructure.

To this end, several measures including rationalizing public expenditure, adjusting public sector salaries, limiting the number of zero-tariff related items and import exemptions, broadening the tax base such as the introduction of new tax bases, for example value added tax (VAT), introducing rental income tax and other similar measures have been taken.

Table 6.7 **Fiscal revenue/GDP (%)**

Year / Revenues	1998/99	2003/04	2004/05	2005/06	2006/07	2007/08
Total revenue and grants	18.1	20.78	18.9	17.7	17.1	16.2
Tax revenue	9.7	12.6	11.6	10.8	10.1	9.7
Grants	2.8	4.6	4.6	2.8	4.4	4.0

Content Check 6.3

1. What do you understand from the information given in Table 6.7?
2. What is marginal tax?
3. List the three types of income tax and which one is more hurt low income brackets?

UNIT REVIEW

UNIT SUMMARY

- Government provides public goods and social services.
- Government involvement in the economy in Ethiopia was high during the Military Regime due to the command economy system it followed.
- Sources of government revenue can be divided into two: tax and non-tax.
- Tax revenue consists of direct, indirect, and foreign trade tax, whereas non-tax revenue consists of charges, fees, fines and sales of government assets or properties.
- Government expenditures are classified as recurrent and capital
- Recurrent expenditures involve repeated types of expense occurring frequently, for example, payments of wages and salaries of government employees and public debt.
- Capital expenditure involves expenses incurred for the purpose of adding to the capital stock by way of investment in social and economic development.
- Government budget is an instrument and financial plan of revenue and expenditure for a specified period of time.
- Revenue budget is decomposed into ordinary, external assistance and capital revenue.
- Expenditure budget is decomposed into recurrent and capital budget.
- Budget deficit occurs when government expenditure exceeds revenue.
- Deficit financing can take different forms: borrowing from domestic as well as foreign sources, and issuing currency.
- Fiscal decentralization refers to sharing government power with local and regional governments in decision-making regarding their revenue and expenditure.
- The recent reform measures taken have the objective of increasing revenue and reducing government expenditure.

REVIEW EXERCISE FOR UNIT 6

I Choose the correct answer from the given alternatives.

1 Which of the following is not an indirect tax?

A Sales tax
B VAT
C Excise tax
D None

2 Which of the following is not a component of fiscal policy?

A the way the government mobilizes its revenue
B the way the government sets exchange and interest rates
C determination of tax burden
D the policy of the government employed to raise revenue
E none

3 The Ethiopian income tax system is based on ____________.

A regressive
B progressive
C proportional
D none

II Label the following questions as True or False.

4 Deficit can be financed by borrowing from external sources but not domestic sources.

5 Capital budget expenditure is usually made on the acquisition and improvement to fixed assets.

6 The direct tax of ordinary revenue consists of business income tax and personal income tax.

7 Recurrent budget expenditure consists of expenses that are repeated in nature like salaries of civil servants.

8 Tax free income is Birr 120 per month, and the highest marginal tax rate on income is 35%.

III Answer the following briefly.

9 Discuss the major economic role of government.

10 Distinguish between progressive, regressive and proportional taxes.

11 List the components of capital expenditure.

12 Discuss the macroeconomic and other consequences of the different deficit financing methods.

IV *Workout*

13 Given the following hypothetical data for a country, answer the questions that follows (*the numbers are in millions of dollar*).

- *Import tax = 1725*
- *Business profit tax = 1400*
- *Personal income tax = 225*
- *Value Added Tax(VAT) = 2000*
- *Excise tax = 800*
- *Recurrent expenditure = 5500*
- *Capital expenditure = 4000*
- *Taxes on export = 1725*
- *Non-tax revenue = 3000*

i Now Calculate:

a the total amount of indirect tax,

b the total direct tax revenue,

c the foreign trade tax,

d the total government revenue for the year, and

e the total government expenditure,

ii Is there a surplus or deficit? How large is it?