Chapter Two

Public Finance in Ethiopia

2.1. Features of Ethiopian Fiscal Federalism

What is Federalism?

Federalism also referred to as federal government, a national or international political system in which two levels of government control the same territory and citizens. The word *federal* comes from the Latin term *fidere*, meaning "to trust." In federal system of government, government functions and political power are divided between two sets of authorities – central government and state governments – such that each government within its own area is independent of each other. The federal system of government refers to a government made up of many levels, and what we refer to as the federal government is the top level of government in the federal system. Under the federal government are: the state governments containing city, district, municipal, and other types of governments. In so, member states of a federation have the central government for the whole country and state governments for the parts of the country.

In a federal system, laws are made both by state, provincial, or territorial governments and by a central government. Federal political systems divide power and resources between central and regional governments. The balance of power between the two levels of government varies from country to country, but most federal systems grant substantial autonomy to state or provincial governments. Central governments decide issues that concern the whole country, such as organizing an army, building major roads, and making treaties with other countries. Federalism varies in practice, however, and in some countries with federal systems, the central government plays a large role in community planning, schools, and other local issues.

2.2. Federal Finance

Fiscal decentralization as one aspect of intergovernmental fiscal relations comprises the financial aspects of devolution to regional and local government. It is the currently fashionable term; the alternative descriptions *"central-local financial relations", "fiscal federalism"* and *"federal finance"* are often used. Federal finance refers to the system of assigning spending responsibilities and source of revenue to the central as well as state governments for the efficient discharge of their respective functions. It involves a clear-cut assignment of expenditure responsibilities and allocation of sources of revenue between the central and state authorities.

Intergovernmental financial relation covers two interrelated issues. The first is the division of spending responsibilities and revenue sources between levels of government (national, regional, local etc). The second is the amount of discretion given to regional and local governments to determine their expenditures and revenues (both in aggregate and detail). These combined dimensions have a significant impact on the reality of decentralization in its broader political and administrative sense. How much power and responsibility regional and local governments actually exercise depends substantially on:

- The range of public services they finance
- Whether their revenues are commensurate with these responsibilities
- How much real choice they have in allocating their budget to individual services
- Whether they can determine the rates of their taxes and charges which involves both allowing regional and local governments to vary their level of spending and making them answerable to the payers

Furthermore, Richard (2000) outlines five issues that arise with respect to federal finance:

- The question of expenditure assignment (Who does what?)
- The question of revenue assignment (Who levies what taxes?)
- The question of vertical imbalance (How is any imbalance between the revenues and expenditures of sub-national governments that results from the answers to the first two questions to be resolved?)
- The question of horizontal imbalance, or equalization (To what extent should fiscal institutions attempt to adjust for the differences in needs and capacities between different governmental units at the same level of government?)
- What, if any, rules exist with respect to sub-national borrowing?

Apart from these issues, the sixth important question concerns how these questions are answered implying *institutional framework* within which the technical and political problems of fiscal federalism are resolved.

In principle, each of these questions has to be analyzed in the specific circumstances of each country in order to achieve to the extent possible the policy objectives relevant to that country. Such objectives may include not only the normal public finance core objectives of efficiency in resource allocation, equity in resource distribution, and stabilization but also economic growth and such vague but politically resonant goals as regional balance and maintaining national integrity and political stability.

2.3. Principles of Federal Finance

The first fundamental step in the design of a system of federal finance should be a *clear assignment of functional responsibilities* among different levels of government. A stable and meaningful decentralization requires an unambiguous and well-defined institutional framework in the assignment of expenditure responsibilities among the different levels of government together with the sufficient budgetary autonomy to carry out the assigned responsibilities at each level of government.

Designing the other important pieces of a system of decentralized finances, *revenue assignments and transfers,* in the absence of a clear expenditure assignment is to put the car before the horse. The focus on the revenue side of decentralization and the neglect of a clearer assignment of expenditure responsibilities has also been a common theme of the decentralization process in countries in transition.

The crucial concern in inter-governmental fiscal relations is the assignment of functions and finances to different levels of government. We could then see that the revenue and expenditure assignment to different levels of government gives rise to vertical and horizontal fiscal imbalances. A vertical imbalance occurs when the own revenues and expenditures of various levels of government within a federation are unequal; whereas, a horizontal imbalance occurs when the own fiscal capacities of various sub national governments of the same level differ.

If fiscal decentralization is to be a reality, sub-national governments must control their own sources of revenue. Sub-national governments that lack independent sources of revenue can never truly enjoy fiscal autonomy; they may be – and probably are – under the financial thumb of the central government. The question, then, is which revenue sources can and should be assigned to sub-national levels of government and how these assignments are to be effected. This group of questions is commonly called *"the tax assignment problem."* They are closely related to *"the expenditure problem,"* because of the importance of benefit taxation in the finance of sub-national government and the need to assure that sub-national governments have revenues that are adequate to finance the expenditures assigned to them. The design of fiscal finance system, demands the consideration of four pillars: expenditures, revenues, intergovernmental transfers and sub-national borrowing or debt.

In summary the following fundamental principles should maintained in any federal structure

- There should be clear assignments of functional responsibilities between the levels of governments
- There should be proper decentralization of revenues to sub governments in such a way that allows them to control their own resources and other sources of revenue
- Tax collection and other revenue raising responsibilities should be assigned in such a way that considers:
  a. Efficiency of the internal common market (such as free movement of labor and capital among sub-national governments, free movements of goods and services from one sub-nationals to the other, etc…)
  b. The overall national equity where fair distribution of wealth and income is maintained
  c. Administration and compliance costs(issues such as capacity of states to tackle tax evasion, auditing and financial administration capacities of states, etc…) has to be taken in to account
  d. Fiscal accountability has to carefully considered (i.e access to revenue sources should matched as close as possible to revenue needs)

2.4. Fiscal Federalism in Ethiopia

2.4.1. Assignment of Expenditure Responsibilities between Central and Regional Governments

The present federal fiscal system in Ethiopia is of a recent origin. The distribution of expenditure responsibilities (called powers and duties) between the centre and states is followed based on Constitution of FDRE and Proclamation No. 33/1992. Ethiopian constitution adopted the model of "residual approach" where the powers and duties of the central or federal government are

exhaustively listed and all other remaining government activities are left as the discretionary power of states. It is clearly proclaimed in Article 45, to 49 of the constitution that Ethiopia is the federal government with parliamentary forms and having constituents named regions, who have their own duties and powers and responsibilities. With the possibility of delegating the power and functions between themselves, ***Articles 51 and 52*** of the constitutions provide for the powers and functions of the Federal government and regional governments as follows:

Central List

The federal government's roles are;

- To formulate the country's policies in respect to overall economic and social development; draw up and implement plans and strategies of development.
- Establish national standards and basic criteria for the evaluation of policies in public health, education, science, technology, culture as well as for the protection and preservation of historical legends.
- Formulate and execute the country's financial, monetary and foreign investment policies.
- Enact laws for the utilization and protection of land and other natural resources, historical sites and objects.
- Establish and administer national defense and public security forces as well as a federal police force.
- Administer the National Bank, print and borrow money, mint coins, regulate foreign exchange and money in circulation. It shall determine by law the conditions and terms under which States can borrow money from internal sources.
- Formulate and implement foreign policy. It shall negotiate and ratify international agreements.
- Engage in the development, administration and regulation of air, rail, waterways and sea transport and major roads linking two or more States, as well as for postal and telecommunications.
- Determine and administer the utilization of the water of lakes linking two or more States or of rivers crossing the boundaries of two or more states.
- Regulate inter-State and foreign commerce.
- Administer and expand all federally funded institutions and programs that provide services to two or more States.
- Deploy, at the request of State authorities, Federal defense forces to arrest a deteriorating security situation within the requesting State when its authorities are unable to control it.
- Enact, in order to give practical effect to political rights provided for in this Constitution, all necessary laws governing political parties and elections.
- It has the power to proclaim and to lift national states of emergency and states of emergencies limited to certain parts of the country.
- Determine and administer matters relating to nationality and citizenship.

- Determine and administer all matter s relating to immigration, the granting of passports, entry into and exit from the country, refugees, and asylum.
- It grants patent inventions and protects copyrights and establishes uniform standards of measurement, and calendar. .

Some of Regional Lists

The state governments' power and functions

- All powers not given separately to the Federal Government, or powers not given expressly and concurrently to the States and the Federal State, are reserved to the States.
- The states establish a State administration that best advances self-rule, a democratic order on the supremacy of the law, and the protection and the defense of the Federal Constitution.
- Enact and execute their own constitution and other laws.
- Formulate and execute policies, strategies and plans for their economic and social development.
- To administer land and the use of other natural resource in accordance with Federal laws.
- Enact laws on administrative matters and on conditions of services of state employees. In the implementation of this responsibility it shall ensure that educational, training and experience requirements for any administrative position.
- Establish and administer a state police force, and to maintain public order and peace within the State.

2.4.2. Distribution of Revenue generation Powers between Central and Regional Governments

As noted above, federalism involves the transfer of political, fiscal and administrative powers form central government to sub national units of government. The notion of fiscal decentralization in Ethiopia is pursued as associated with the federal government structure launched relatively recently in the country. The distribution of revenues between the center and states is followed based on "Constitution of Ethiopia" and Proclamation No. 33/1992- Proclamation "To Define sharing of Revenue between the Central Government and the National/Regional Self Governments." The Articles 96, 97, 98, 99 and 100 of the Constitution of Ethiopia make a clear demarcation of areas where the Central alone or State alone have authority to impose taxes. It contains a detailed list of the functions and financial resources of the center and states. The objectives of revenue sharing are explained as:

- To enable the central government and national/regional governments efficiently carry out their respective duties and responsibilities
- To assist national/regional governments develop their regions on their own initiatives,
- To narrow the existing gap in development and economic growth between regions, and
- To encourage activities that have common interest to regions

Categorization of Revenue

According to Constitution of FDRE and Proclamation No. 33/1992, revenues shall be categorized as Central, Regional and Joint. That is there are three lists of revenue. These are the central list, the regional list, and the joint/concurrent list. Important sources of revenue identified thereon are supplied here below.

Central List

The sources of revenue are given under Federal/Central List, are:

a. Duties, tax and other charges levied on the importation and exportation of goods
b. Personal income tax collected from the employees of the central Government and international organizations
c. Profit tax, Personal income tax and sales tax collected from enterprises owned by the Central Government. (Now sales tax is replaced with VAT and Turnover taxes)
d. Taxes collected from National Lotteries and other chance winning prizes
e. Taxes collected on income from air, train and marine transport activities
f. Taxes collected from rent of houses and properties owned by the central government
g. Charges and fees on licenses and services issued or rented by the central government

Regional List

The following shall be Revenues for the Regions:

a. Personal income tax collected from the employees of the Regional Government and employees other than those covered under the sources of central government
b. Rural land use fee
c. Agricultural income tax collected from farmers not incorporated in an organization
d. Profit and sales tax collected individual traders
e. Tax on income from inland water transportation
f. Taxes collected from rent of houses and properties owned by the Regional governments
g. Profit tax, personal income tax and sales tax collected from enterprises owned by the regional government
h. Without prejudice to joint revenue sources, income tax, royalty and rent of land collected from mining activities
i. Charges and fees on licenses and services issued or rented by the regional government

Joint/Concurrent List

The following shall be joint revenues of the central and regional governments:

a. Profit tax, personal income tax and sales tax collected from enterprises jointly owned by the central and regional governments
b. Profit tax, dividend tax and sales tax collected from organizations
c. Profit tax, royalty and rent of land collected from large scale mining, any petroleum and gas operations
d. Forest royalty

2.4.3. Inter-Governmental Fiscal Transfer in Ethiopia/Correcting Imbalances

National/Regional Governments, where deemed appropriate, shall receive subsidies from the Central Government. National/Regional Governments shall before the approval of their budget, submit to the Ministry of Finance and to the Ministry of Planning and Economic Development ,their subsidy request, together with the total expenditure required for the fulfillment of objectives given in the Proclamation.

The issues of intergovernmental fiscal transfers are designed to address the vertical fiscal imbalance and horizontal fiscal imbalance. It also takes into consideration inter jurisdictional spillover effect. The working principles of intergovernmental budget grants in Ethiopia are provided as:

1. The rendering of proportional distribution of public services for residents of different states. This again is very crucial. This is considered as the objective of equity.
2. Making the grant effort neutral. This means, the grant will not take in to consideration the revenue added by a region using cost effective administrations and the increase in tax revenue. This may geared to encourage states by giving incentives. However, the disregard of difference in tax bases may have effect of equity consideration.
3. Those regions prone to expenses beyond the standard expenditure are considered in the allocation of the budget grant.

The Ministry of Finance and the Ministry of Planning and Economic Development shall review the subsidy request submitted to them from the various regions based on the objectives and in relation to the central government revenue collection. The amount of subsidy to be granted shall be based on *Budget Formula* specified by the Ministry of Economic Development and endorsed by the house of federation and councils of people's representative

Article 7 of the proclamation 33/1992 entitles regional governments to receive subsidies from the central or federal government. Thus, Proclamation No. 33/1992 has set the legal framework for making grants as revenues for regional governments. All regional governments, including, Dire Dawa administrative council, but with the exception of Addis Ababa administration, are unable to fully cover their recurrent budget needs or implement their development programs and projects from their own revenue sources. Addressing financial disparities between governments through fiscal transfers is sought for equity reasons and for promoting an economic union

To sum up, to address financial disparities between governments the Government of Ethiopia has developed '*a budget grant formula.*' This then expected to help the realization of a common minimum standard of public service. Consequently, the percentage share of each region in the grant pool will be attained. For better understanding, let us briefly describe the assessments made in the determination of the grant formula.

A. Expenditure Need Assessment

In the assessment of expenditure need, expenditure responsibilities of states enshrined in the constitution will be considered. The assessment takes in to account the recurrent and capital expenditure of the preceding five years is categorized in to six major sectors. These are expenditure for education, agricultural sector expenditures, rural safe drinking water expenditures, expenditure for rural load construction, health sector expenditure and recurrent expenditures. These sectors are indicated as having constituted over 90% of the share of expenditure responsibilities. This is an important consideration in that the formula takes in to account the need of regions as regards to investment finance.

B. Revenue Capacity Assessment

In order to determine the revenue capacity of regions, revenue capacity assessment is carried out. In doing so, revenue base assessment and tax rate are consulted. However, as we have already said tax rate is not considered in the grant formula. The reason as indicated is that the grant formula is effort neutral.

In the revenue capacity assessment, tax bases which cover over 90% of the revenue are taken. In such cases, the data available for the preceding five years are considered. Besides, to reiterate what is already said, in the assessment, equalization of revenue capacity is taken instead of equalization of tax collection effort. The variables included in the grant formula are population and disability factors in both revenue rising and expenditure needs. The question of performance incentives is ignored from the grant formula. The case is that if an incentive is to be granted, it shall not be part of the grant share; rather part of conditional or specific purpose grant. Moreover, budget grant will not be given for failure or success of the financial policies of the respective.

2.5. Public Budgeting in Ethiopia

2.5.1. Meaning and Functions of Budget in Ethiopia

Historically, t he word budget derives from the medieval English or French word bougette, diminutive of bouge, a leather bag. In English parliamentary terminology, it meant the leather bag in which the Chancellor of the Exchequer brought proposals for national revenues and expenditures for the coming period to parliament and thus it is used for the plan of revenue and expenditure in a given period of time. A national budget is a public finance management instrument; reflect government policy, priority, planning and implementation process for the delivery of public goods and services:

The word now means, “Plans of government finances submitted for the approval of the legislature.” The budget reflects what the government intends to do. The budget has become the powerful instrument for fulfilling the basic objectives of government. The budget covers all the transactions of the central government. Budget is a time bound financial program systematically worked out and ready for execution in the ensuing fiscal year. It is a comprehensive plan of action, which brings together in one consolidated statement all financial requirements of the government. The budget goes into operation only after it is approved by the parliament. A

rational decision regarding allocation of resources to satisfy different social wants requires considerable thinking and planning. Thus, budget is an annual statement of receipts and payments of a government.

The functions of budget include the following:

- It reflects government stated policies and set national priorities
- Evaluate public programs and review the activities of government departments
- A system of accountability and controls over government officials, ministries and departments, setting expenditure limits and safeguard against abuse of public funds
- A tool for development management and economic growth
    - As a political tool, budget is value ridden signaling the government's ideological commitment, political philosophy and policy plat form
    - As an economic tool, budget shapes economic priorities and accelerates economic growth (development)
    - Influence the direction of investment
    - Promotes employment
    - Influence the redistribution of income (can be pro poor or non-caring)

In addition to the above points budget has also the following functions:

i. *Proper allocation of resources: - to relate expenditure decisions to specified policy objectives and to existing and future resources to relate all major decisions to the state of the national economy*
ii. *Long-term economic growth: to ensure efficiency and effectiveness in the implementation of government programs*
iii. *To facilitate legislative control over the various phases of the budgetary process*
iv. *Equitable distribution of income and wealth and Securing economic stability and full employment*

2.5.2. Budget Structure in Ethiopia

The government budget represents a plan/forecast by government of its expenditures and revenues for a specified period. Commonly government budget is prepared for a year, known as *a financial year* or *fiscal year*. In Ethiopia, the fiscal year is from July 7 of this year to July 6 of the coming year (Hamle 1- Sene 30 in Ethiopian calendar). Basically, as it can clearly understandable from the nature of federal government operation, both federal government and regional governments prepare their own budgets independently. Federal government’s budget is organized and presented by Ministry of Finance and Economic Development and finally approved by Parliament. Regional Finance Bureaus prepares and present the regional governments’ budget for approval by the Regional Councils. For consistency purpose the framework and procedures of budget preparation and the structures of budgets of regional governments may resemble that of federal government.

Budget structures are the formats that organize budget data. Budget data could be classified in different ways and for different purposes. In addition to providing information on what the government proposed to do; the budget structures indicate the full responsibility of the spending agency. To this end the budget head or nomenclature of the budget are mostly mapped to each spending agency. This should not, however, imply unnecessarily extended and detailed structure (or mapping). Perhaps, due consideration must be taken to make the structure manageable and appropriate. The first classification of the budget is between revenue and expenditure.

Revenue Budget

It represents the annual forecast of revenues to be raised by government through taxation and other discretionary measures, the amount of revenues raised this way differ from country to country both in magnitude and structure, mainly due to the level of economic development and the type of the economy. In Ethiopia, the revenue budget is usually structured into three major headings: ordinary revenue, external assistance, and capital revenue. Hence, the funds expected from these three sources are proclaimed as the annual revenue budget for the country. The revenue budget is prepared by the Ministry of Finance (MoF) for the federal government and by Finance Bureaus for regional governments.

Ordinary revenues include both tax and non-tax revenues. The tax revenues categorize direct taxes such as personal income tax, rental income tax, business income tax, agricultural income tax, tax on dividend and chance wining, land use fee and lease on one side. On the other side, there are indirect taxes including excise tax on locally manufactured goods, sales tax on locally manufactured goods, service sales tax, stamps and duty and taxes on foreign trade customs duty on imported goods, duty and tax on coffee export. Non-tax revenues include charges and fees, investment revenue, miscellaneous revenue (e.g. gains) and pension contribution. The second major item in revenue budget is external assistance. It includes cash grants; these are grants from multilateral and bilateral donors for different structural adjustment programs; and technical assistance in cash and material form. The third item is capital revenue. This could be from domestic (sales of movable properties and collection of loans), external loan from multilateral and bilateral creditors mostly for capital projects, and grants in the form of counterpart fund.

Expenditures Budget

Government expenditures for administration and developmental activities are handled through the expenditures budget. These expenditures are categorized into recurrent and capital expenditures. The recurrent budget which covers the current expenditures is financed in principle by taxation (more broadly by domestic revenue from tax and non tax sources), and the capital budget which covers the acquisition of newly produced assets in the economy is financed through external borrowing and grants. In Ethiopia the definition of recurrent and capital budgets, follow some combination of these criteria. That is:

i. Recurrent budget is to be covered by domestic revenue from tax and non-tax sources. But the economy could borrow to meet its capital budget.

ii. The financial Proclamation 57/1996 and financial Regulations 17/1997 defined capital budget based on the object of expenditure. Accordingly, capital budget equals capital expenditure which equals fixed assets and consultancy services.

iii. Short-term activities that are project in nature are included in capital budget while those activities that are recurring and continuous in nature are put in the recurrent budget. In some instances activities with a very long life period have been entertained in the capital budget. Since fiscal year 1994/95 efforts have been exerted to identify many such projects that have been categorized under recurrent budget (projects in education, health and agriculture sectors). The exercise does not seem complete, as there are projects with recurring nature (e.g. Agricultural Research) though attempts have been made to isolate the investment components.

The Expenditure Budget includes the recurrent and capital budget.

Recurrent Budget

Financial Proclamation 57/1996 and Financial Regulation 17/1997 defined only the capital budget, implicitly defining the recurrent one as a ***residua****l*. The common practice, however, is to include in the recurrent budget expenditures of recurrent nature (like salaries of civil servants) and fixed assets with a multi-year life.

The recurrent budget is structured by implementing agencies (public bodies) under four functional categories: administrative and general services, economic services, social services, and other expenditures. All public bodies then fall under one of these functional categories. The budget hierarchy will then be down to sub agencies.

Capital Budget

Capital budget is budget for capital expenditures. Financial Proclamation 57/1996 defined capital expenditure as "an outlay for the acquisition of and improvements to fixed assets, and includes expenditures made for consultancy services." Financial Regulations 17/1997 further provided a detailed definition of capital expenditures to mean:

1. *The acquisition, reclamation, enhancement as laying out of land exclusive of roads, buildings or other structures;*
2. *The acquisition, construction, preparation enhancement or replacement of roads, buildings and other structures;*
3. *The acquisition, installation or replacement of movable plant, machinery and apparatus, vehicles and vessels;*
4. *The making of advances, grants or other financial assistance to any person towards him/her on the matters mentioned in (a) to (c) above or in the acquisition of investments; and*
5. *The acquisition of share of capital or loan capital in any body corporate;*
6. *Any associated consultancy costs of the above.*

Capital budget could thus broadly be described as an outlay on projects that result in the acquisition of fixed assets and the provision of development services (Ministry of Planning and Economic Development, 1993:4). It should therefore be need that, capital budget as a wider coverage than simple outlays in fixed investments, since it includes expenditure on development services like agricultural research and transfer payments related to a project.

The capital budget is presented in three functional groups viz., economic development, social development, and general development. Economic development includes production activities (agriculture, industry, etc.), economic infrastructure facilities (mining, energy, road etc.), commerce, communication, and so on. Social development includes education, health, urban development, welfare and so on. General development include services like cartography, statistics, public and administrative buildings, and the like.

2.5.3. Ethiopian Budgetary Process

Budgeting from the initial stage of forecasting the annual revenues and expenditures, to the final stage of approval of the annual budget by the Council of Peoples Representatives, passes through a sequential and an iterative process.

The budget process thus includes all these stages, which obviously are sequential (one after the other) and iterative. Peterson summarized the budget process into three phases: analyzing, fitting, and implementing. The analysis phase is the assembly and integration of financial data which might include processes from the formulation of macro-economic and fiscal framework to the allocation of expenditure budget between Federal and Regional governments the fitting phase is the process of prioritizing activities to fit with policy and reducing a budget to a ceiling.

Referring to the budgeting processes outlined above this might range from the processes of allocation of Federal government expenditures budget between recurrent and capital budget down to the submission of the budget to the Council of Peoples' Representatives. The final phase, implementing, is distributing and using the allocation, i.e. the notification and publication of the budget, allotment and the monitoring processes.

Budget being a one-year plan prepared for the coming fiscal year it requires a time schedule (deadlines) for each and every processes that should strictly be adhered to. The time schedule is usually handled through the budget calendar. In effect, the budget calendar is the major instrument to manage the budgetary process. Thus far we do not have an authoritative and binding budget calendar that could force all public bodies involved in the process of budgeting. The only dates proclaimed by law are the final approval and notification dates of the budget.

Financial Proclamation 57/1996 states that "the budget appropriation shall be approved by the Council of Peoples Representatives by Sene 30th (July 6) and all public bodies shall be notified by Hamle 7 (July 13)." The other deadlines in the process of budgeting will be set by the MoF and MEDaC who are responsible for the preparation of the recurrent and capital budgets, respectively. The MoF and MEDaC will notify the spending public bodies well ahead of time about the important deadlines, the budget ceiling and other information through the budget

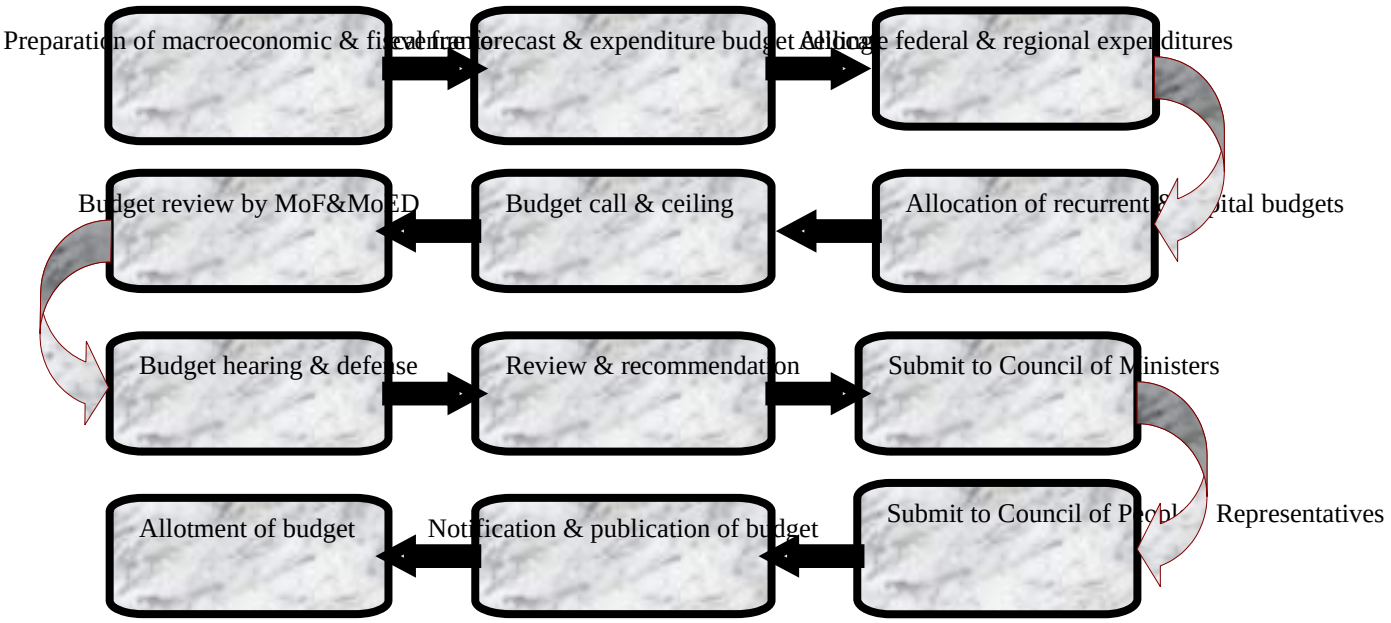
circular. The budgeting process usually took between six to eight months, and the MoF and MoED will release the budget circular around November to December.

The Budgetary Process at the Federal Level

The budget processes at the Federal level follows sequential and iterative steps. These steps can be explained with the help of the following figure. Let us briefly explain these steps one by one hereunder.

Step I: Macro-Economic and Fiscal Framework

The preparation of the macro-economic and fiscal framework is basically a component of the recently initiated public investment program (PIP). It is a planning practice and as stated in Ministry of Economic Development, the macro-economic and fiscal framework determines the overall level of government expenditures based on policies related to the role of government in the economy, government deficits, and priorities for resource allocation between regions and sectors. For the Federal government the framework is a three years forecast and will be updated each year.



The framework is composed of macro-economic forecast and fiscal forecast. The macro-economic forecast gives the forecast of Gross Domestic Product based on past performance and estimates for future years, and provides baseline information in preparing the fiscal forecast. Financial Regulation 17/1997 gave the responsibility of preparing this framework to the Ministry of Economic Development (MoED). Whereas, the later establish the level of total resources available for expenditure. It provides a more detailed forecast of revenue (both Federal and Regional), end projection of expenditure. Given the policy of no borrowing from domestic banks

to finance budget deficit the level of expenditure mainly depend on the amount of resources to be raised in the form of domestic revenues and external fund that include counterpart funds. Once prepared by the concerned coordinating ministries, i.e. MoF and MoED, it will be reviewed and approved by the Prime Minister's Office (PMO).

Step II: Determination of Federal Government Expenditure and Subsidy to Regional Governments

After the revenue and expenditure of the government are estimated through the fiscal framework, the PMO will decide on the shares of Federal government expenditures and subsidies to Regional governments. It is known that, following the decentralization policy, Regional governments took grants from the Federal government in the form of subsidy.

Once the amount of subsidy is known, the allocation among regions is determined based on a formula. Initially the formula was composed of five parameters (population, level of development, revenue generating capacity, utilization capacity, and land area). At present, however, the formula takes account of three parameters: population, the level of development, and revenue generating capacity of each region which are given a relative weight of 60%, 25% and 15% respectively. This allocation will first be prepared by MoED, then reviewed by the PMO and finally approved by the Council of Peoples' Representatives.

Step III: Allocation of Federal Expenditure between Recurrent and Capital Budget

The practice in the allocation of recurrent and capital budget is to consider the latter as a residual. That is, first the amount of budget necessary to cover such recurrent expenditures like pensions, debt servicing, wages and non-wage operating costs will be determined. The balance will then be allotted to capital expenditures. This will be performed by the PMO in consultation with MoF and MoED.

Step IV: Budget Call and Ceiling Notification

This includes two items.

1. *Recurrent budget:*MoF will release the budget ceiling to the line ministries in a budget call. The budget call provides each ministry such information as the macro-economic environment, an aggregate recurrent budget ceiling, and priorities to budget.
2. *Capital Budget:*MoED issues detailed capital budget preparation guidelines to spending public bodies along with the ceilings provided to each line institution. MoED will set the ceiling for each sector.

Step V: Budget Review by MoF and MoED

This includes two items.

1. *Recurrent Budget:* Prior to a formal budget hearing, spending public bodies will submit their budget proposals to the MoF Budget Department. In consultation with spending public bodies, MoF will prepare an issue paper on major issues at each head level in the proposed

budget. Here, spending public bodies can submit above the ceiling but need to have a compelling justification

2. *Capital Budget:* The sector departments of MoED review the capital budget requests from different public bodies. At this stage, projects will be screened. If there exist a discrepancy between the respective sector department and the public body, a series of discussions will be held to reach agreement. After such a process, the various sector departments of MoEDwill submit their first round recommendation to the Development Finance and Budget Department of MoED. Then it will be consolidated and prepared for the capital budget hearing and defense.

Step VI: Budget Hearing and Defense

This includes two items.

1. *Recurrent Budget:* Spending public bodies defend their budget submission in a formal hearing with the MoF. The issue paper will be the basis of the hearing. The hearing focuses on policies, programs and cost issues, when necessary it might involve discussion down to line item. Spending public bodies could also challenge the ceiling. Presenting the hearing will be ministers and/or vice ministers, heads of public bodies and the MoF.

2. *Capital Budget:* Spending public bodies will be called to defend their projects to a budget hearing convened by the PMO which will be chaired by the Prime Minister or the Deputy Prime Minister or the their economic advisers. The hearing customarily includes a review of status of the project, implementation capacity of the institution, compatibility with the countries development strategy and policy, cost structure, and regional distribution. A project description will be presented which includes objectives of the project, main activities of the project, status of the project, total cost, past performance of the project, source of finance, and whether the project is accepted or rejected by MoED. Based on the discussion the respective sector departments of MoED in consultations with the spending public body will further refine the capital projects.

Step VII: Review and Recommendation:

This includes two items.

1. *Recurrent budget*: After the hearing is over, the budget committee of the MoF will review the discussion and make a recommendation. If there is an increase (over ceiling) this will go to the PMO for approval.

2. *Capital budget*: After the hearing and defense with the PMO and MoED, sector departments of MoED will give a final recommendation to the development finance and budget department of MoED. This will then be compiled and put in appropriate formats for submission to the council of ministers.

Step VIII: Submission to the Council of Ministers

At this stage the two budgets (recurrent and capital) will be consolidated, and MoF will prepare a brief analysis of the total budget.

1. *Recurrent budget*: The recommended budget will be submitted to the deputy Prime Minister for economic affairs. This will first be reviewed by ministers and vise ministers in economic affairs, and then presented to the Prime Minister along with a brief. The Prime Minister may or may not make amendments and then the budget will be sent to the council of Ministers for discussion.
2. *Capital Budget*: A brief analysis of the capital budget will be prepared by MoED on the final recommended budget and, along with the consolidated capital budget, will be submitted to the council of ministers. MoED will defend the budget in the council. The council of ministers may make some adjustment and the draft capital budget will pass the first stage of approval.

Step IX: Submission to the Council of Peoples' Representatives

Once approved by the council of ministers, the Prime Minister will present both the recurrent and capital budget to the council of peoples' representatives. The budget will then be debated based on the recommendation of the budget of the committee.

Step X: Notification and Publication

The approved budget will then get the legal status through the publication in the 'NegaretGazeta.' Spending public bodies will then formally be notified of their approved budget by line items from MoF and MoED for recurrent and capital budgets, respectively. MoF will notify spending public bodies through Form 3/1. Likewise, MoED will inform through Form 3/2. Both Forms will be copied to the Treasury Department of the MoF which disburse funds to spending public bodies. Until Form 3/1 is released spending public bodies are authorized to spend one-twelfth of the previous year's budget with no provision for new expenditures (e.g. new staff posts) in the case of recurrent budget. For capital budget spending public bodies are authorized to use approved budget for on going projects even when Form 3/2 is not released.

The final stage of the budgetary process is to request spending public bodies to prepare adjusted work plan and cash flow for the approved budget. The adjusted work plan and cash flow will be verified by MoF-for the recurrent budget-and by MoED-for the capital budget, and then will be sent to the treasury Department of the MoF.

STEP XI: Supplementary Budget

In the course of the budget year supplementary (additional) budget will be proclaimed when necessary, following almost the same process as the initial budget preparation. Likewise budget reallocation will be made mainly based on performance.

Budgetary Process at the Regional Level

It is quite difficult to present the budget process at the Regional level in the way discussed for Federal Budgeting. At present the budget process followed by regions is not uniform. Hence, let us discuss the process of budgeting in a more general terms without referring to a particular region.

The process is more or less a mirror image of the Federal budget process. In place of MoF the Regional Finance Bureau (RFB) is responsible for the preparation of the recurrent budget. While the Regional planning and Economic Development bureau (RPEDb) is responsible for the capital budget. At the higher level the Regional council is the one responsible for the appropriation of the region's budget. One significant deviation is, the regional budget process starts at the woreda level and goes up to Zone and Region levels.

1. Pre-ceiling Budgeting

Pre-ceiling budgeting is the budgeting practice at the woreda and zone levels before the region receives its subsidy/grant from the Federal government. The process is as follows: the woreda prepares a budget with no indicative or final ceiling from the Zone or the Region. The Finance Office will consolidate the budget of the sectoral offices and submit to the woreda council. The woreda executive committee will then form a budget committee to review the budget. This budget will be sent to the zone through two channels: one, the woreda counsel submit the budget to the zone executive committee,: second, the woredasectoral offices send to the zone sectoral departments. The zone executive committee will then form a budget committee that will be chaired by the head of the Finance Department, to review the woredas' and zones' budget proposal.

In passing the budget to the region it will again be through two channels. The zone executive committee submits to the Region executive committee and the zone sectoral departments will submit to the region sectoral bureaus. The sectoral bureaus then prepare a budget submission to the Region Finance Bureau.

2. Post-ceiling Budgeting

Following the notification of the subsidy from the Federal government, the regional public expenditure envelope will be determined based on the Federal subsidy, local revenue and local borrowing. Once the expenditure envelope is set, then it will be split up between recurrent and capital expenditures. The practice is similar to the Federal government, i.e. the allocation begins with recurrent expenditures and the balance of the envelope will be reserved for capital expenditures. After this stage, different regions follow different approaches to allocate recurrent expenditure between salary and organization and management, and to allocate capital expenditure among the different sectors. In some regions, the budget will be prepared up to line items at the region level, whereas in some regions a lump sum will be allotted to zones that will be in turn allocated to woredas. At last, the budget will be published in the region's 'NegaritGazeta'.

2.6. Budget Deficit

A budget is considered as surplus or deficit according to the position of the revenue accounts of the government. Thus, a surplus budget is one in which revenue receipts exceed expenditure charged to revenue account regardless of the gap in capital accounts; while a deficit budget is one in which expenditure is greater than current revenue receipts. Budget deficit is the excess of total expenditure over total revenue of the government.

The deficit financing denotes the direct addition to gross national expenditure through budget deficits whether the deficits are on revenue or capital accounts". It implies that the expenditure of the government over and above the aggregate receipt of revenue account and capital account is treated as budget deficit of the government.

The meaning of deficit financing is different in different countries. In western countries, the budget gap, that is covered by loans is called deficit financing because, if the government borrows from the banks rather than from individuals the idle funds will be activated and there will be an increase in the total public expenditure and thus there will automatically be a deficit financing has been used in a different sense,. Here it is used to denote the direct addition to gross national expenditure because of budget deficit. Thus deficit financing can be defined as "*the financing of a deliberately created gap between public revenue and public expenditure.*" The government of Ethiopia has used deficit financing for acquiring funds to finance economic development. When the government cannot raise enough financial resources through taxation, it finances its developmental expenditure through borrowing from the market or from other sources.

2.6.1. Methods of Financing Deficit

There are four important techniques through which the Government may finance its budgetary deficits. They are as follows:

1. Borrowing from central bank
2. The running down of accumulated cash balances
3. The government may issue new currency
4. Borrowing from market or from external sources

Under the first method, government borrows from central bank as per budgetary policy. In the second source, government spends from available cash balance. In the third measure, government issues new currency for financing deficit. The last method is that government borrows from internal and external sources to finance its deficit.

2.6.2. Objectives of Deficit Financing

1. Deficit financing has generally been used as a method of meeting the financial needs of the government in times of war, when it is considered difficult to mobilize adequate resources.

2. Keynes advocated deficit financing as an instrument of economic policy to overcome conditions of depression and to raise the level of output and employment.
3. The use of deficit financing has also been considered essential for financing economic development especially in under developed countries.
4. Deficit financing is also advocated for the mobilization of surplus idle and unutilized resources in the economy.

2.6.3. Effects of Deficit Financing

Deficit financing has both positive and negative effects in the economy as under:

1. **Inflationary rise in prices:** The most serious disadvantage of deficit finance is the inflationary rise of prices. Deficit financing increases the total volume of money supply. Unless there is proportional increase in production this can lead to inflation. When deficit financing goes too far it becomes self-defeating. There was inflationary pressure during the decade due to deficit financing.
2. **Effects on distribution of wealth and income:** The real income of wage earners gets reduced and that of entrepreneurs/ businessmen increased, leading to distribution of wealth in favor of business class
3. **Faster growth:** Country is able to implement the developmental plans through deficit financing thereby attaining faster growth.
4. **Change in pattern of Investment:** Deficit financing leads to encouragement for investment in certain fields like construction, luxury consumption inventory holding and speculation. This may lead to investment in undesirable fields.
5. **Credit creation in banks:** Inflationary forces created by deficit financing are reinforced by increase credit creation by banks.

Among various fiscal measures, deficit financing has been assigned an important place in financing developmental plan and various developing countries including Ethiopia resort to deficit financing to meet budgetary gaps.

2.6.4. Deficit Financing in Ethiopia

Deficit financing in Ethiopia is mainly resorted to enable the government to obtain necessary resources for the plans. The levels of outlay laid down are of an order, which could not be met only by taxation or through a revenue surplus. The gap in resources is made up partly through external assistance. But when external assistance is not enough to fill the gap, deficit financing has to be undertaken. The targets of production and employment in the plans are fixed primarily with reference to what is considered as the desirable rate of growth for the economy. When these targets cannot be achieved through resources obtained from taxation and external borrowing, additional resources have to be found. Deficit financing is the easier option. It is important to emphasis the fact that deficit financing cannot create real resources which do not exist in the economy.