GRADE 12
ECONOMICS
HANDOUT FOR SECOND SEMESTER LESSONS
OROMIAEDUCATION BUREAU

Unit 5

Trade in the Ethiopian Economy

5.1. Historical Background of Trade in Ethiopia

Ethiopian trade was started during the time of the Axumite Kingdom. During this time, the state obtained considerable income from both domestic and international trade. Trade took its modern shape under the regime of Emperor Menilik II. Trading activities that took place once a week in traditional markets were supplemented with the opening of small shops in towns. A particular impetus in domestic trade was attained with the construction of railway lines from Djibouit to Addis Ababa, thereby increasing the number and types of commodities available for sale. Due to cultural influence, and lack of adequate capital and knowledge, almost all of the modern shops were owned and run by foreign nationals (Armenians, Arabs, etc.).

International trade was facilitated through a network of trading routes from Adulis and other trading posts on the Red Sea coast. These trading routes were frequently used by both domestic and international traders and made the flow of goods and services to and from the country possible.

After the end of the Italian invasion, the modernization of domestic trade achieved a landmark. A responsible ministry, aware of its duties and responsibilities, backed by various rules and regulations for efficient operation, was set up. Institutions were also set up to provide training to Ethiopians who might enter the fields of trade and commerce. Above all, a commercial code was introduced in order to enforce laws governing business transactions. The business environment advanced greatly until the 1974 Revolution.

After the takeover of power by the Derg, the whole system of economic management, including domestic trade, changed greatly. Mass nationalization took place. Every activity of the national economy was guided under central planning: profit motives gave way to social objectives. Every measure to strengthen the socialization process was encouraged and, if necessary, subsidized.

The economy ultimately stagnated and demanded change. The reform measures that were started during the last years of the Military regime were not adequate enough to bring about the demanded change. And, as a necessity, a radical change in all spheres (economic, political and social) took place with the overthrow of the Derg in 1991. Since then, many important reform measures have been undertaken, based on the economic policies of the transitional period and on a number of most recent policy measures, rules, regulations and directives were issued to bring back a business environment governed by market law.

5.1.2 The Role and importance of Trade in Economic Development

Trade deals with business transactions that take place between households, firms, and governments. It can be divided into two: *domestic* and *international trade*. Domestic trade refers to pure exchange activities within a national boundary. Domestic trade encourages the diffusion of knowledge, culture, and religion. As such, domestic trade fosters specialization in which each locality or region specializes in the production of specific commodities, thereby creating interdependence among regions. The whole basis of domestic trade rests on the fact that localities or regions differ in their resource endowments and in their economic and social features and capacities for growth and development.

International trade, on the other hand, can be defined as the exchange of goods and services among citizens of independent or sovereign countries. People are better off when they have trade than when they are without trade. There are many factors accountable for the rise of international trade. Some of them are differences in resource endowment, demand, and economies of scale and specialization. For example, the differences in resource endowments lead to differences in relative costs in the production of goods and services among countries. Economies of scale provide additional cost incentives for specialization in production. That is, instead of manufacturing only a few units of each and every product that domestic consumers desire to purchase, a country specializes in the manufacture of large amounts of a limited number of goods and trades for the remaining goods. Specialization in a few products allows a manufacturing sub-sector to benefit from longer production runs, which leads to decreasing average costs.

International trade allows a country to specialize and export those goods and services that it can produce at relatively low cost and import those goods and services whose domestic production is relatively costly. As a consequence, international trade enables a country to consume and produce more than would be possible without trade. In other words, international trade enlarges the consumption choice of people by allowing them to consume those goods which they cannot produce. Unlike domestic trade, international trade provides foreign goods and services that cannot be produced within the domestic economy. International trade also encourages the diffusion of knowledge and culture because trade serves as a point of contact between people of different countries. International trade also encourages specialization, and creates interdependence among countries.

5.1.3 Restrictions and Modes of Payment in Foreign Trade

Because of its special features, foreign trade has been a serious area of debate. Since it involves trade among nations of different levels of economic development, capacity, currency, economic policy, etc., there are some issues which arise from international trade. Among these issues, trade restrictions and modes of payment are the two important ones.

A . *Restrictions on International Trade*

Trade restrictions have a long history in world economy. Trade restrictions are basically designed to protect a local economy from foreign competition, and they also serve as an important source of government revenue. There are different types of restrictions used by governments. Some of them are:

Quotas

These are some of the oldest trade restrictions used. Quotas are a strong and very serious kind of restriction. Aquota places a limit on the amount of a product that can enter into a country. Quotas usually have a limit, so that the entrance of the goods into a country is stopped when the quota is met.

Tariffs

These are duties or taxes imposed by the government of a nation on goods entering that country. Tariffs may take different forms, but in general they raise the prices of the imported goods. Tariffs serve for two general purposes: they generate revenue for the government, and they protect local products from foreign competition. Unlike quotas, tariffs can be overcome by reducing prices. There are three forms of tariffs:

- ✓ ***Specific tariff:*** *specific tariffs are tariffs imposed on each unit imported or based on physical quantities.*
- ✓ ***Advalorem tariff:*** *this is imposed on the basis of the monetar of the product.*
- ✓ ***Compounded tariff:*** *this is a combination of the specific and ad v duties. That is, some products are taxed on both quantity and va*
  Example: Birr 5 per quintal and 5% on the value of the good.

Exchange Controls

Restrictions on the amount of a certain currency that can be bought or sold are called exchange controls. The government can use exchange control to limit or avoid the import of some goods by not giving the foreign currency that the importers of these goods need.

B *Modes of Payment in International Trade*

Payments in domestic trade are quite simple. In international trade, payment is an important area of concern. Payments in international trade can be made in one of the following ways:*Banker's transfer,Bill of exchange, or Letter of credit (LC).*

A ***Banker's transfer:***This is a simple transfer of money from the bank account of the buyer (importer) in his/her own country to the bank account of the seller in the seller'scountry.

B ***Bill of exchange:*** This is an order in written form addressed by a creditor to a debtor and signed by the creditor, requiring the person to whom it is addressed (the debtor or buyer) to pay either on demand, or at a fixed date, or at a determinable future time, a certain sum of money to the person named on the bill or to his order. The bill is drawn by the creditor on the debtor and is sent to the debtor (or his agent) for the latter to pay or accept. The debtor accepts by signing his name on the face (front) of the bill together with the date, at which point the bill now becomes legally binding, and the accepter must meet it on or before the due date.

C ***Letter of Credit (LC):*** This is the most common mode of payment for imports in Ethiopia today. A letter of credit is a letter addressed by a banker to an exporter, undertaking to make a payment to him against documents relating to the dispatch of goods. The letter of credit includes different documents that specify the nature, unit price, and total price of the good and the shipment of the good, insurance, and other supplementary documents.

5.2.1 Domestic Trade Policies and Strategies

The domestic trade policy of Ethiopia has different components which determine the trade environment and its development. Some of the components of the domestic trade policies are given below.

Ownership Policy

During the Imperial Period, most of the trading activities were controlled by the private sector. But, motivated by socialistic ideology, the Dreg nationalized both the wholesale and retail trading enterprises, which were mainly owned and run by foreign nationals, and restructured those which were not nationalized in order to meet the socialist-oriented objectives of the government. In other words, the dominance of the government in manufacturing, distribution, transportation and finance was the order of the day. This measure of nationalization stifled the rising participation of national entrepreneurs in all sectors. After nationalizing and restructuring trade organizations, the government reorganized them into wholesale and retail trading corporations and enterprises under the supervision of the then Ministry of Domestic Trade.

The participation of private organizations in domestic wholesale trading activities was very limited. For instance, in food grain marketing, merchants in Arssi, Bale and Gojam were banned altogether. In Gondar and Wollega, grain merchants had to surrender all their purchases to the government-owned Agricultural Marketing Corporation (AMC), while in other surplus-producing areas, such as Shoa, they surrendered 50 percent of their annual purchases to the corporation. In the domestic wholesale trade of manufactured products, the Ethiopian Domestic Distribution Corporation (EDDC) had a monopoly, and private traders were forced to take part in the trading of items with slow rates of turnover allocated to them by the corporation.

Distribution Policy

The distribution policy followed during the Derg was mainly a direct reflection of its ownership policy. As the ownership policy was based on socialist ideology, the distribution policy was in favor of socialized sectors. Those sectors under public ownership and cooperatives were given priority in the distribution of goods and services. The private sector, on the other hand, was only entitled to the residual. For instance, from 1985/86 to 1991/92, EDDC sold, on the average, 31 percent of its sales to private traders, while the rest went to socialized sectors. Moreover, all of AMC sales were directed to government institutions and urbandweller associations.

The most important strategies employed in the distribution of basic or essential goods for which shortage was common were quota allocation and rationing. Basic commodities such as sugar, wheat flour, salt, etc. were under strict quota allocation. The then existing administrative regions received their quotas by EDDC, depending on supply. After the quota allocation, rationing was implemented,

mainly through urban-dweller associations and service cooperatives, to final consumers, depending again on supply and on family size. But urban dwellers who were not registered in kebele associations were not entitled even to rationing and, as a result, they were forced to buy those basic commodities at very high prices from private shops. Likewise, the movement of food grains from region to region by private traders was strictly forbidden. Only AMC had the mandate to move grains between regions, although other public organizations got permission to do so when a need arose. Restriction on the movement of food grains by private traders had the following impacts:

 It adversely affected the consumers in deficit areas by pushing up grain prices.

It eroded incentives for producers in surplus areas by depressing prices.

It hindered both the expansion of marketed supplies and the development of an integrated national market, which were very important for the country's economic development.

In January 1988, the government announced that private traders would be issued permits to move grain as long as they agreed to sell half of their purchases to AMC at AMC buying prices. As of late 1988, there were reports of some private traders moving grain in some areas. However, there was a disincentive to trade in cases where the official prices at which traders had to sell to AMC were lower than the local prices at which they purchased the grains.

Pricing Policy

During the Derg Regime, price determination through the free functioning of market forces of demand and supply was disturbed by the government's intervention. There were, by and large, administratively managed pricing practices. However, there were no uniform pricing policies or procedures across ectors or commodities. In this section, the pricing policies followed with regard to manufacturing and agricultural commodities will be reviewed.

The prices of manufactured products, which were considered very basic and in short supply were determined by the Ministry of Domestic Trade and announced to consumers through public notices. These commodities could be imported and/ or domestically produced. After price determination, price control was the next step. The prices of other manufactured products were determined on a cost-plus basis. However, this mechanism of price determination had its own limitation as it allowed inefficiencies of manufacturing and trading enterprises to be transmitted to consumers in the form of additional costs.

More problems were observed in the pricing mechanism of agricultural commodities or food grains. Based on the cost-of-production study undertaken by the Ministry of Agriculture, national farm-gate and wholesale prices of food grains were introduced in 1980/81. These fixed prices continued to be operational in the purchasing activity of AMC until 1987/88, when a minor increase in price modification was introduced. The upward price revision ranged from 6 to 10 present, depending on the type of crop. Official marketing of food grains with fixed prices ended with the introduction of the mixed economic policy in March 1989/90.

Licensing Policy

Domestic trade licensing involves the issuance of licenses to wholesale, retail and service trading activities. The licensing policy during the Derg regime aimed at limiting the participation of private traders as depicted in Proclamation No. 76/1976. According to the proclamation:

- *Trading activity was allowed only to proprietorships;*
- *There was no licensing to government employees; Wholesaling was limited to the capital ceiling of Birr 300,000 and retailing to Birr 200,000;*
- *An individual could get licensed only in the region in which he/she resided;*
- *Only one business license and one business undertaking were permitted to an individual. Branch establishment was prohibited; and*
- *License provision was tied to supply conditions.*

These restrictive licensing conditions for private traders were relaxed with the introduction of mixed economy policies during the dying hours of the Derg Regime. Following the relaxation of restrictive licensing conditions, a great many new wholesale, retail, and service licenses were issued to individuals and business associations. For instance, new licenses issued in 1988/89 before the relaxation of licensing restrictions were 3,163, and this number went up to 30,729 in 1990/91— that is, after the relaxation of those restrictive licensing conditions. With the overthrow of the Derg by the EPRDF and the establishment of the Transitional Government of Ethiopia (TGE) in mid-1991, changes took place in the political, economic, and social conditions of the country. Rules that encouraged the functioning of the market were institutionalized, with some government intervention when necessary.

The importance and constructive role of the private sector in the national economy was better appreciated and an enabling environment for its operation was created. The foundation for the changes observed was laid down with the adoption of the country's new economic policies during the transitional period. Subsequently, various proclamations, regulations, and directives, as well as reform measures, were introduced so as to create a favorable legal framework for the implementation of the adopted policies.

Liberalization Measures: Trade liberalization, particularly that for food grain marketing, was started during the Derg regime as part of the reform measures envisaged in the polices of mixed economy. However, there was public doubt regarding the continuity of the system because there was still a heavy government hand in all sectors of the economy.
The first most important step taken after the Derg was the removal of restrictions on traders. Private traders were allowed to operate side-by-side with government parastatals. Controls on inter-regional grain movement were also removed and, as a result, price differentials between surplus and deficit areas narrowed. The quota system for grain purchases was abolished.

The adoption of the new economic policy and the subsequent measures taken under the New Economic Reform Program further consolidated the reform measures started in 1990 and introduced additional ones. This time, the reform measures were well rounded, ranging from macroeconomic to sectoral policies, and they were radical enough to bring structural change to the whole economy. As a result of the liberalization measures undertaken so far in domestic trade:

- ✓ *New entrants as well as established traders can move food grains freely from market to market;*
- ✓ * Obtaining licenses and legal recognition are relatively easy;*
- ✓ *The activities of parastatals a shrinkage in their purchase and distribution network;the traditional private marketing system has revived;*
  * types of markets and market channels in both rural and urban areas are diversified;*
- ✓ *private trade appears to be deficient in making goods available in time and place, compared with public sector trade;*
- ✓ *better quality grains are shipped to the central markets as prices are permitted to reflect widely accepted perceptions of quality differences;*
- ✓ *the producer-consumer price margin has narrowed, due to a sharp increase in producer prices, without change in the already inflated consumer prices;*
- ✓ *markets have started to experience price fluctuations related to supply and demand; and*
- ✓ *as can be observed from the trend in the number of new domestic trade licenses issued, (for both wholesale and retail trade) the volume of*

commodities handled and the number of participants in private trade have increased since the launching of the reform.

Privatization Measures: Nationalization and socialization were the basic economic principles of the Derg government. In the new economic policies adopted by the then TGE and the now FDRE government agencies have had only limited participation in wholesale trade and their complete withdrawal from retail trade activities has been well expressed. The role of the private sector in running wholesale and retail trading more efficiently is well-appreciated.

The Ethiopian Privatization Agency started privatizing public enterprises in February 1995 by selling retail trade shops and stores as well as small and medium-size hotels through tenders. So far, a total of 126 retail trade shops and stores have been offered for privatization, out of which 108 have been sold. Of these, 69 sold. On tender basis, while 39 sold directly to employees organized under safety-net programs.

In addition, the private sector has been investing in wholesale and retail trade activities. This indicates significant changes in the attitudes of the business communities that had been accustomed to “air to air” trading practices for almost two decades. In general, the participation of the private sector in domestic trade, in particular, and in the national economy at large has been encouraging. The following table depicts the profile of private sector participation in wholesale trade for the period July 1992 - April 1997.

5.2.2 Foreign Trade Policy

The foreign trade policy of the Derg had four major objectives.

 Mobilizing government revenue by imposing taxes on imports and exports,

 Protecting domestic economy participants from foreign competition,

 Maintaining a favourable balance of payments at a sustainable level, and

 The gradual prevention of the private sector from foreign trade participation.

Consistent with the last objective, the government discouraged private importers and exporters from exporting traditional export items, such as coffee, pulses, oil seeds, and the like. Public enterprises were established to run such activities.During this regime:

- ✓ *Exporters were not allowed to export commodities at prices less than the reference prices provided by the government.*
- ✓ *Exporters were also forced to surrender 100 percent of the foreign exchange they obtained to the government.*
- ✓ *There was a restrictive foreign exchange licensing system for private use.*
- ✓ *The exchange rate was fixed at Birr 2.07 for a dollar for quite a long period of time.*
- ✓ *The government provided marketing channels for all imports and major exports of the country.*

However, after the overthrow of the Derg, the TGE started taking a number of foreign trade policy measures in 1992. The government

changed the fixed exchange rate regime to that of a managed floating exchange rate regime (that is, a rate determined by the market). introduced a bi-weekly foreign exchange auction market in May 1993.

Currently, this auction system is changed on a daily basis. The marginal rate (the market clearing rate) established at the auction used to be used as a secondary rate applicable to all current and capital account transactions until the next auction, with the exception of a limited number of payments for which the foregoing exchange rate was made available at the official rate. However, the two rates were unified on July 25, 1995, and a weekly foreign exchange auction was introduced a year later.

In August 1998, the government replaced the retail auction market with wholesale auctioning in which commercial banks, the foreign exchange bureau, and investors in need of large amounts of foreign exchange (above USD 500,000 per auction) could participate. An inter-bank market for foreign exchange has also been introduced and is still practiced.

The other main external trade reform measure was the suspension of taxes and duties levied on exports, except on coffee. It was introduced in January 1993. But the tax on coffee was also removed after the recent historic coffee price decline in order to reduce the adverse effects of this price decline on coffee growers and other citizens participating in the coffee market. This tax removal on export of all commodities together with the devaluation, provides a strong incentive to exporters because it allows them to receive the equivalent of world prices for exports. Government subsidies to exporters were also terminated when export taxes were lifted.

Complementary to this measure, the government introduced an export duty drawback scheme in August 1993 to further encourage investment in the production of exportable item. There were two versions in this incentive scheme.

i.The first was the duty draw-back scheme. It provided persons or enterprises that were wholly, partially, or occasionally engaged in exporting their products, refunds of the duty paid on raw materials (whether imported or locally produced) used in the production of the exportable item. The duty draw-back scheme has had two term of condition.

- *The first term states that when the raw material or commodity on which duty is to be drawn-back is re-exported in the same condition, 95% of the duty will be refunded.*
- *The second term stipulates that if the raw material or commodity on which duty is to be drawn-back is exported after being processed or used for packing or containing, 100% of the duty will be refunded.*
- *However, this scheme is applicable only if the commodity produced using the raw material is exported within one year from the date on which such raw material has been imported or purchased locally.*

ii The second version of the scheme is known as the duty-free importation scheme. This scheme authorizes organizations and persons wholly engaged in supplying their products to foreign markets to import or locally purchase raw materials they use in production of such commodities free of duty. Similar to the earlier scheme, this scheme requires exporters to export their commodities within one year from the date on which the raw materials used have been imported or locally purchased. Furthermore, within the framework of promoting exports, the following measures were undertaken:

- ✓ *Reducing license fees for coffee exporters and simplifying the procedure for getting licenses.*
- ✓ *An action program for the liberalization of the coffee sector has also been developed.*
- ✓ *Since 1996/97, the government has reduced the 100 percent foreign exchange surrender requirement on exporters to the National Bank of Ethiopia to 50 percent and allowed the exporters to open foreign exchange saving accounts at commercial banks and save 10 percent*

of their proceeds for a given transaction. The remaining 40 percent of their earnings is to be exchanged for Birr within three weeks at a rate they find favorable. This saving is to be used for investment and other expenditures related to the development of the export sector.

With respect to import trade liberalization, the government has been introducing policies step-by-step or gradually. For example,

- ✓ *Maximum import duties were lowered from 280 percent to 80 percent during the first move of import liberalization and currently stands at 50 percent.*
- ✓ *In addition, efforts are being made to correct legal and administrative impediments to import liberalization through a simplification of the system of granting import licenses and permits.*

In line with the government's policy to build a market-based economy, the external sector has also benefited from the abolition of monopolistic operations of public enterprises, which used to dominate the export and import sector alike. Since then, the private sector has been encouraged (including by the simplification of entry to market) to participate in the external sector.

5.3.1 The Structure of Domestic Trade

The concept of 'structure' here refers to the relative magnitude of wholesale trade activities under public and private enterprises, including retail trade in domestic trade activities.

Wholesale Trade under Public Enterprises

Wholesale trade in manufactured and agricultural products was more or less under government monopoly during the Derg Regime. Both imported and domestically produced manufactured products could be distributed only under the sole monopoly of EDDC, and agricultural products mainly through AMC. Even though there were licensed private wholesale traders, they were forced to take commodities that were less in demanded from EDDC.

A ***Wholesale trade in manufactured products:*** EDDC was established by merging together nationalized trading organizations under Regulation Number 13/1975 with authorized and paid-up capital of Birr 10 and 5 million, respectively. The main objective of the corporation was to strengthen the arm of government in the socialization of wholesale trade in manufactured products. At the time of its establishment, it had a storage capacity of 28,000 square meters, 8 cargo vehicles, 18 branches, 338 workers and an annual sales turnover of Birr 40 million. The position of the corporation was further strengthened by Regulation Number 104/1987, which reflected the intention of the government to fully socialize wholesale trade in industrial products. This time, its authorized capital was raised to Birr 90 million and its paid-up capital to Birr 20 million.

After the downfall of the Derg, the corporation was restructured as Merchandise Wholesale and Import Trade Enterprise, and its paid-up capital has risen to Birr 50 Million through Regulation Number 103/1992. The enterprise has had no monopoly power and has been left to operate under a competitive environment. Stabilizing consumer markets and becoming profitable have been the two main objectives of the enterprise.

B ***Wholesale Trade in Agricultural Products:*** AMC was established with Proclamation No. 105/1976 with the principal objective of executing government policy in the field of wholesale food grain marketing, procurement, and distribution of inputs and maintaining national grain reserves. At the time of its establishment, its authorized and paid up capital stood at Birr 100 million and 21.1 million, respectively. With Regulation No. 103/1987, its authorized capital was raised to Birr 130 million and its paid-up capital to Birr 90 million. The intention behind this regulation was to fully socialize the wholesale trade in food grains and coordinate wholesale trade in manufactured products with wholesale trade in food grains.

After the downfall of the Derg Regime, AMC was restructured as the Ethiopian Grain Trade Enterprise (EGTE) in 1992. At this time its authorized and paid-up capitals remained the same as in 1987. However, major changes in its form of management and objectives were effected. The management was made autonomous and its objectives mainly became stabilizing grain markets.

Wholesale Trade Under Private Enterprises

Private traders have the flexibility and efficiency to move goods more easily than government parastatals where and when they are needed. Besides, they can efficiently supply consumers at lower costs. However, the extent to which they are able to compete effectively in the market is dictated by the capacity they have in terms of access to capital, storage, and transportation as well as in terms of the various laws governing the economy.

Before the 1974 revolution, trade was predominantly in the hands of the private sector, and the role of the government was limited to the regulation and promotion of the private sector. After the revolution, however, the nature of trade completely changed and the economic environment as a whole became hostile to private sector participation. Private businesses were made owner-operated, and were limited to only one type of business with no branches, and the government set a capital ceiling to limit their expansion.

After the downfall of the Derg, the Transitional Government of Ethiopia adopted a new economic policy during the second quarter of the 1991/92 fiscal year. The new economic policy brought about fundamental changes in economic outlook, management, and structure. In May 1992, the TGE undertook another big step: It legalized and broadened the scope of private-sector participation by issuing Proclamation No. 15/1992 — a proclamation issued to provide encouragement, expansion, and coordination of investment. These measures are believed to have caused attitudinal changes in business people who thought trade was the only area of participation. They therefore decided to take part in other economic sectors.

Retail Trade

In addition to controlling whole sale trade, the Derg Regime wanted to control retail trading. To this end, it organized publicly-owned retail trade enterprises like the Ethiopian Retail Trade Corporation (ERTC) and the Ethiopian Households and Office Furniture Enterprise (ETHOF) and by giving priority to commodity distribution to organized consumers such as urban-dweller associations in urban areas and service cooperatives in rural areas.

With the regime change in the 1990s, the government withdrew from retail trade activities. Accordingly, measures have been taken since 1994/95 to privatize government-owned retail trade organizations. Due to this and other conditions created by the TGE, the number of new retail trade licenses issued reached as high as 43,911 in 1991/92, an average growth rate of 264.5 percent compared to the preceding year. The new economic policy recognized the participation of voluntarily organized cooperatives in retail trading, but they are not being given any special privileges now.

5.3.2 Structure and Performance of Foreign Trade

In this section we will examine the performance and the relative share of commodities in Ethiopia’s foreign trade activities. We will also discuss the trade partners of Ethiopia.

Exports

Because Ethiopia's economy is underdeveloped heavily depends on agriculture, the structure of Ethiopia's exports is dominated by agricultural products, which alone accounted for more than 90% of the export proceeds of the country. As shown in Table 5.2, among the agricultural products, coffee accounted for the lion's share — about 70% — of agricultural exports and for 60% of total export earnings. Hides and skins and chat distantly follow second and third, and they account, on average, for 12% and 7% of total exports, respectively. Coffee was the dominant export item as far back as the 1960's, constituting, on average, 55-60% of total exports. From 1994/95 – 1996/97, coffee alone accounted for 66% of total exports on average. Hides and skins were the secondmost important export items, and they showed a general trend of improvement until their share peaked at 21% of total exports in 1991/92. From this year onwards, the available evidence indicates that hides and skins (as a proportion of total exports) exhibited consistently declining trends. Pulses and oil seed were important export items of Ethiopia.

When we look at the 2008/09 figures, we find that the same commodities dominated in the export activities of Ethiopia, as in the 1990's but with different shares. For instance, in 2008/09, coffee contributed only 26% of the total value of exports. This was due to a very large decline both in the price of coffee and in the volume of export, which resulted from the huge increase in the supply of coffee in the international coffee market offered by some new and old suppliers. However, coffee was the single most important contributor to the foreign exchange earnings of Ethiopia in 2008/09. The second and the third places were occupied by oil seeds and chat, with 24.6% and 9.6% shares, respectively (see Table 5.2).

able 5.2 **Value of Exports, by Major Commodity Group (in millions of USD)**

Coffee	424.2	35.8	524.5	35.8
Oil seeds	187.4	15.8	218.8	14.9
Leather and leather products *	89.6	7.6	99.2	6.8
Pulses	70.3	5.9	143.6	9.8
Meat and meat products	15.5	1.3	20.9	1.4
Fruits and vegetables	16.2	1.4	12.8	0.9
Live animals	36.8	3.1	40.9	2.8
Chat	92.8	7.8	108.3	7.4
Gold	97.0	8.2	78.8	5.4
Flower	63.6	5.4	111.8	7.6
Others	91.8	7.7	106.3	7.2
Total Export	1185.1	100.0	1465.7	100.0

* *Previously known as hides and skin*

Source: *NBE, 2008/09*

The dominance of agricultural commodities makes the country's external sector susceptible to adverse shocks that affect both the agricultural and the industrial sectors. The shock experienced in the beginning of the 21st century by coffeeexporting countries is good evidence for this. Also the shock that hit the oil market is recent evidence of the problem of dependence on the export of primary products.

Export Earnings

The performance of the export sub-sector during the 1980's was characterized by stagnation with some sporadic erratic fluctuations. During the late 1980's and early 1980's, however, a clear trend of decline in export earnings was observed. Export earnings during this period declined so drastically that they financed only 17 % of imports in 1991/92. In absolute terms, export earnings declined from USD 443.6 million in 1988/89 to USD 154.2 million in 1991/92.

The introduction of the reform measures in 1992 seemed to have a positive impact on export performance. Export earnings showed continuous revival in the years following the reform, reaching a level of USD 453.6 million in 1994/95, restoring export earning and the capacity of financing imports back to the 1988/89 level, 43 %. The relative importance that a considerable growth in export earnings was particularly registered in 1994/95. It was documented that a considerable growth in export earnings was occurred in 1994/95, mainly due to windfall gains from an increase in the world price for coffee. A marginal decline in export earnings was observed in 1995/96, which was mainly attributed to the decline of world coffee prices in that year. Export earnings, on average, showed an increasing trend during the post-reform period. For instance, total export earnings increased from Birr 923.8 million in 1985/86 to Birr 3,511.6 million in 1998/99. Moreover, non-coffee earnings accounted for 34.5 % of the total export earnings, while coffee accounted for the remaining earning's during the post-reform period.

In the year 2003, export earnings were Birr 4,470.9 million indicating a close to 27% increase from its level in 1998/99. But they could finance only around 19.4% of the import bills in 2003. Total merchandise exports reached USD 1.45 billion in 2008/09, about 1.2 % lower than the previous years exports. Earnings from coffee, pulses, leather products, and fruits and vegetables tended to falter. Export receipts from coffee declined by 28.3% as a result of lower volume and international price. The volume of coffee exports went down to 21.5% due to problems associated with the domestic trading system, to lower demand in the international market following the global economic recession, and to the import ban by Japan, the second largest buyer of Ethiopian coffee. Consequently, the share of coffee in total exports fell to 26% from 35.8% a year earlier.

Similarly, export revenue from pulses dropped to 36.8% because of the 40.8% fall in the volume of exports, despite a 6.7% increase in international prices. Thus, the share of pulses in total exports shrank from 9.8% to 6.3% during the period under consideration.
The global economic downturn worsened. Export earnings from leather and leather products fell to 24.1% as the volume of exports went down by 51% in spite of a significant rise in international prices. On the other hand, export earnings from oil seeds, the second largest export item, increased by 62.8% due to 88.7% surge in volume, offsetting the 13.7% decline in international price.

Consequently, the share of oil seeds in the total exports rose to 24.6% from 14.9% in the preceding fiscal year.

Similarly, due to increased export to the Middle East and better international prices, revenues from meat and meat products and from live animals went up by 27.3% and 28.9%, respectively. Despite fears of the global economic crisis, export revenue from flowers improved by 16.9% in 2008/09 as a result of higher volumes of exports to different destinations, despite a marginal decline in international prices. Exports of chat and gold also fared well. Revenue from these items rose by 28.1% and 24.2%, reaching USD 138.7 million and 97.8 million, respectively in 2008/09.

I *Public versus Private Exports*

The private sector development initiative that began to thrive during the Imperial Regime was thwarted with the advent of the totalitarian moves of the Derg. Private-sector participation in the export sector was marginalized, and government enterprises took the dominant role. For instance, the share of the private sector in total export earnings never exceeded 16 percent.

Following the introduction of the economic reform program, which encouraged a market-oriented system through reducing the role of the state in the economy and encouraging private-sector participation, the share of the private sector in export marketing grew continuously, increasing from 16% in 1990/91 to 48.2% in 1994/95, and then to 63% in 1996/97. This trend continued in 1997/98 when private exporters produced about 80 percent of the country's exports.

The general improvement in private-sector participation in the export sector was not accompanied by either a significant increase in the volume or in the diversification of export products. Just as in the case of overall export, the composition of private-sector exports is dominated by coffee, oil seeds, pulses, and chat, which altogether accounted for 85% of the private sector's annual export earnings. Coffee dominates the private sector's export earnings, accounting for 55% of the total revenue from exports.

II *Coffee Exports and Earnings*

Volume of Arrival and Export

As shown in Table 5.4, the export volume of coffee decelerated after it reached its peak in 1988/89, when 109.3 thousand tons of coffee arrived at the central auction market. It declined by 17% and 15% in the subsequent two years, falling to 60.2 thousand tons in 1991/92. From 1992/93 onwards, however, a strong resurgence in the export of coffee (volume of arrival) was observed, showing rises of 46% and 30% in 1992/93 and 1993/94, respectively. Indeed, the supply of coffee surpassed the 1988/89 peak and stood at 113.7 thousand tons in 1993/94, although this peak was followed by a slight decline to 102.3 thousand tons in 1994/95. The supply increased significantly to 141.4 thousand and 1165.5 thousand tons in 1995/96 and 1996/97, respectively. The growth momentum was slightly halted in 1997/98 as volume of arrival reduced to 155.4 thousand tons.

Table 5.4 **Volume of Domestic Supply and Actual Export of Coffee (in tons)**

Year	Domestic Supply	Actual Export	Actual exports as % of domestic supply	
Level	% Growth	Level	% Growth	
1987/88	83,411	-5.5	72,262	-0.8
1988/89	10,9299	31.04	77,707	7.5
1989/90	90,650	-17.06	83,251	7.1
1990/91	77,316	-14.7	534,57	-35.8
1991/92	60,155	-22.2	36,078	-32.5
1992/93	87,699	45..7	69,362	92.2
1993/94	113,680	29.7	73,004	5.2
1994/95	102,302	-10	78,420	7.4
1995/96	141,361	38.2	101,823	29.8
1996/97	165,536	17.1	117,979	13.7

1997/98	155,377	-6.1	121,365	2.9

Source: *MEDac, 1999.*

World Prices of Ethiopian Coffee

Ethiopia is a price taker in almost all of its export commodities. The world price for Ethiopian coffee usually depends on the price performance of the major coffee suppliers (like Brazil and Colombia) in the world market. In most cases, Ethiopian coffee-price booms have been associated with some form of supply shortfalls from major coffee suppliers. The price of Ethiopian coffee has been characterized by erratic fluctuations over the years. For instance, in 1988/89, the price of Ethiopian coffee was 151 U.S. cents per pound. It dropped to 99 U.S. cents per pound in 1989/90 and further to 93 U.S. cents per pound in 1990/91. A modest recovery was recorded in 1991/92 but immediately reversed in the following year. Then, the price of Ethiopian coffee registered a significant leap in 1994/95, when a pound of coffee fetched 182 U.S. cents. This resulted in a windfall gain in foreign exchange earnings to Ethiopia.

I *Trend in the Value of Imports*

In the second half of the 1980's, Ethiopian imports had stabilized at around USD 1 billion, except for slight declines to USD 874.8 million and USD 915 million in 1991/92 and 1993/94, respectively. The level of imports remained more or less stable within the same order of magnitude until 1994/95. A growth in imports, however, was registered in 1995/96, when imports increased to USD 1.4 billion, showing a nominal growth of 32.9% over the previous year. The preliminary estimates for 1996/97 and 1997/98 indicated that imports stabilized within the ranges of the 1995/96 level. Imports were estimated at USD 1.4 billion for 1996/97 and at USD 1.45 billion for 1997/98. As a share of GDP, imports consistently increased from 8.7% in 1991/92 to 23% in 1995/96 but slightly declined to 20% in 1996/97.

As indicated in Table 5.5, in 2009, the value of imports was about Birr 9 billion, which was 5.1 times more than exports for the year. The annual average growth rate for the Reform Period far exceeded the performance during the 1980's. The construction and rehabilitation efforts following the initiation of the reform and the balance-of-payment support from external financiers enhanced the growth of imports.

5.3.3 Major Trading Partners of Ethiopia

The major route of Ethiopia's external trade is towards Europe, followed by Asia.

As indicated in Table 5.6, during 2008/09, Europe remained the largest market for Ethiopia's exports, accounting for 41.7% of the country's total exports. Among the European countries, Germany, which mainly imported coffee and flowers, was the largest buyer of Ethiopian goods. The Netherlands, the main destination for Ethiopian flower exports during the review period, was the second biggest market in Europe, followed by Switzerland, the sole importer of gold from Ethiopia. Italy, whose main imports included leather and leather products, coffee, and textiles and garments, held the fourth place. Exports to the Asian market accounted for 35.6%, of which 35.3% went to China, 21.6% to Saudi Arabia, 11.2% to the United Arab Emirates (UAE), and 7.8% to Israel. The major export items to China included oilseeds, leather, and leather products. Meat and meat products, coffee, live animals, and oilseeds constituted the bulk of exports to Saudi Arabia, while meat and meat products, pulses, and live animals were the major items exported to the UAE. Israel mainly imported oilseeds from Ethiopia. When we consider export destinations by country over the years, some fluctuations have been witnessed. For instance, 16.6% of Ethiopia's exports went to African countries, of which about 88.6% went to three neighboring countries: Somalia, the Sudan, and Djibouti. Chat was the principal export item to Somalia, followed by live animals. The major exports to Djibouti include chat, pulses, fruits, and vegetables. The Sudan mainly imported coffee, pulses, live animals, and spices. The share of the Americas in total exports was 5.7%, of which 73% was to the United States of America, 9.8% to Canada and 1.6% to Mexico. The main export items to the US were coffee and oilseeds.

5.4.1 Trade Balance

Trade balance refers to the difference between the export and import of goods and services. If the difference is positive, it is called a trade surplus, and if it is negative it is called a trade deficit. A chronic trade deficit has remained the dominant feature of Ethiopia's in external trade in merchandise in the past two decades or so. With relatively small but significantly expanding exports and sizable imports, the trade deficit generally widened between 1991/92 and 1997/98. A clear trend of decline in the trade deficit existed in the period 1991/92-1994/95. However, the trade deficit has been in a general state of expansion since 1995/96, owing to the increase in imports which was much faster than exports. In 2008/09, for instance, the trade deficit was estimated at USD 6.27 billion.

5.4.5 Trade, Globalization, and Economic Integration

In the 1990's "globalization" as a vehicle for development became the strategy used most often in major international initiatives in the world. Ethiopia and its least developed allies went through a broad agenda of reform and voiced optimism in global forums about the potential for reversing decades of socioeconomic stagnation.

5.4 developments In the BAlAnce of pAyments In ethIopIA

In a very rudimentary sense, the economic dimension of globalization entails the process of integrating an economy with world markets. The economic interdependence that results from such process encompasses both product market (a market where goods and services are bought and sold) and factor market (a market where resources such as labor, capital, land etc., are bought and sold) and involves transactions in goods and services, investment and finance. The overriding principle underlying globalization is beneficial to all parties in an environment of voluntary exchange on the bases of comparative advantage, which in turn is enhanced through specialization. The source of comparative advantages for a country might be one or a combination of natural endowments and acquired endowments such as superior knowledge and specialization. Least developed countries (LDCs), including Ethiopia, generally possess comparative advantage natural-resource-based and labour-intensive industries

Opportunities

In principle, globalization could offer the following opportunities:

- ✓ *Appropriately acquired and correctly channelled, it could Provide badly needed investment capital that could enhance productive capacity*
- ✓ *Enhance facilitate the easy flow of technology transfer*
- ✓ *Open markets for domestic products*
- ✓ *Make a domestic economy more competitive by imposing work ethics, discipline, and overall productive efficiency; and*
- ✓ *Strengthen international division of labour based on comparable advantages*

Challenges

If proper policies are not in place, especially in the transition period, globalization may be hazardous to less developed countries' economic health. Some of theseeconomic-health risks include:

- ✓ *Weakening or destroying whatever little productive capacity there is, particularly in the manufacturing sector, due to world competition.*
- ✓ *Complete vulnerability of the domestic economy to external shocks.*
- ✓ *Loss of the sovereignty of governments to address distributional and other social issues as they see it fit. This is because World Trade Organization (WTO) rules and the significant role of transnational would directly or indirectly put a constraint on what policies governments could pursue, and*

- ✓ *Trigger competitive devaluation and unproductive competition among the least developed countries, since most of them have similar endowments and comparative advantages. For instance, both Kenya and Ethiopia mainly rely on the export of coffee and tea.*

Economic co-operation's attractions are largely due to the advantages it offers through the enlargement of economic size and improvements in efficiency, and through the extension of the range and complementarity of resources available among countries.

Expected economic gains from regional economic integration are:

- ✓ *increased production arising from specialization according to comparative advantages,*
- ✓ *increased output arising from improved exploitation of scale economies.*
- ✓ *improvement in terms of trade with the rest of the world. For example, trade between the EU and the USA, Japan, etc.*

In Africa there are different regional forms of economic integration, which include these collaborations:

- ✓ *PTA (the Preferential Trade Area). The PTA was established in 1982. It has 19 member countries, and Ethiopia is one of them.*
- ✓ *Another regional integration is the ECOWAS (the Economic Community of West African States). It was founded in 1975 and has 16 member countries.*
- ✓ *The SADCC (the Southern Africa Development Coordination Conference), and*
- ✓ *The COMESA (the Common Market for East and Southern Africa).*

UNIT SUMMARY

- According to the Ethiopian National Income Account classification, trade and tourism are components of the service sector. In this connection, trade is classified under distributive services. The main objectives of this chapter have been to examine the role of trade in the Ethiopian economy and to identify the major constraints of these sectors.

- Trade can be domestic or international (external). In both cases people are better off when their governments engage in trade than when they don't. Domestic trade refers to the exchange of goods and services among citizens in a country. It can be local or inter-regional exchange in a country. It refers to pure exchange activities within a national boundary.

- International trade, is the exchange of goods and services among citizens of independent or sovereign countries. Many factors account for the rise of international trade. Some of them are differences in resource endowment, demand, and economies of scale and specialization. For example, the differences in resource endowments lead to differences in relative costs of production of goods and services among countries. Economies of scale provide additional cost incentives for specialization in production. That is, instead of manufacturing only a few units of each and every product that domestic consumers desire to purchase, a country specializes in the manufacture of large amounts of a limited number of goods and trades for the remaining goods. Specialization in a few products allows manufacturing firms to benefit from longer production runs, which lead to decreasing average costs.

- While demand patterns seem to be similar throughout the world, especially among similar socio-economic income classes, differences in tastes and preferences certainly exist. For example, in country A, where demand is very strong for steel, the price of steel that intensively uses the relatively abundant factor is relatively higher than its price in trading, country B. With the opening of trade between the two countries, country A would find itself exporting say, cloth, and importing steel, from country B because B's steel is relatively cheap at international prices. This occurs because the demand in country A for the product using the abundant factor intensively leads to such a high price for that product and the factor used intensively in its production that the physically abundant factor is the scarce factor from the standpoint of the price definition. Because this is the result of a particular set of demand conditions, it is referred to as demand reversal.

- International trade allows a country to specialize and export those goods and services that it can produce at relatively low cost and to import those goods and services whose domestic production is relatively costly. As a consequence, international trade enables a country to consume and produce more than it could without trade. Moreover, international trade encourages the diffusion of knowledge and culture.

- During the Derg Period, both domestic and foreign trade activities were under the control of the government. However, after the downfall of the Derg and the seizure of power by EPRDF, a number of reform measures were undertaken, particularly in the areas of trade and tourism. As a result of the liberalization measures taken by the government, participation of the private sector increased significantly in the trade and tourism sectors. Because of this, the magnitude of export earnings has increased from that of the post-Derg period.

- Balance of payments is a summary statement that summarizes all transactions conducted between Ethiopia and the rest of the world (i.e with its trade partners). As recent datas clearly indicate, the current account deficit is declining due to the significant increase in net capital flows.

UNIT 6

Fiscal Policy and Public Development in Ethiopia

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

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 bereflected 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*

6.4 ANALYSIS OF GOVERNMENT BUDGET AND DEFICIT FINANCING

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 present*

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 servic*

- ***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*

6.5 FISCAL DECENTRALIZATION AND PUBLIC SECTOR REFORM IN ETHIOPIA

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 decisionmaking 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 decisionmaking 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'

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**

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) × 0% = 150 × 0% = 0
 (150 - 650) × 10% = 500 × 10% = 50
 (650 - 1400) × 15% = 750 × 15% = 112.5
 (1400 - 2350) × 20% = 950 × 20% = 190

(2350 - 3000) × 25% = 650 × 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.

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 nontax.

- ✓ 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.

Unit 7

Monetary Policy and Financial Sectors in Ethiopia

INTRODUCTION

Monetary policy refers to the management of the money supply and its link to prices, interest rates and other economic variables. More generally, monetary policy is a bundle of actions and regulatory stances taken by the central bank including all of the following:

- ✓ *Setting a minimum interest rate on deposit*
- ✓ *Setting reserve requirements on various classes of deposit*
- ✓ *Increasing or decreasing commercial bank reserves through open market purchase and sales of government securities.*
- ✓ *Constraining commercial bank financial activities by setting minimum capital requirement*
- ✓ *Intervening in foreign exchange markets to buy and sell domestic currency for foreign exchanges*
- ✓ *Decide the level of total-deposit required reserve of commercial banks*

The principal objective of the monetary policy of the National Bank of Ethiopia (NBE) is to maintain price and exchange rate stability and support sustainable economic growth of Ethiopia. Price stability is a measure for macroeconomic stability which is important in private sector economic decision-making about investment, consumption, international trade and saving. Macroeconomic stability also fosters employment and economic growth. Maintaining exchange rate stability, on the other hand, promotes competitiveness in international trade.

Financial institutions (FIs) such as commercial banks, credit unions, insurance companies, etc. perform the essential functions of channelling funds from those with surplus funds (suppliers of funds) to those with shortage of funds (users of funds). Hence, the existence of such kinds of institutions helps to facilitate domestic saving and investmen

7.1.1 Historical Development of Money

Before the invention of money, trade was based on the barter system. It is a system of transaction where goods and services are directly exchanged with goods and services. The barter system had many pitfalls. Among others, the need for double coincidence of wants was the prominent problem of barter system. People have to find someone who has a good or service they want and who also wants the good or service they have to offer.

Money is anything that people are willing to accept in payment for goods and services or to pay off debt. Some form of rudimentary financial activities and exchange with the help of money in Ethiopia is dated back to the Axumite kingdom. Coins were mainly minted to facilitate external trade transactions. Usually, these coins were made of precious metals such as gold, silver, and bronze. Iron and salt bars were used to conduct domestic trade transaction. Later on, due to the fact that the intrinsic value of some precious metals and coins was greater than their face value, and hence used for making ornaments and other purposes, exchanges of goods and services were replaced by commodity money.

In addition to the intrinsic value, the downfall of the Axumite kingdom eliminated the circulation of coins, and trade was conducted by the traditional form of exchange, using commodities that served as medium of exchange. This is what is known as the stage of commodity money. Commodities such as bars of salt, pieces of cloth, bars of iron and different types of shells were used as a medium of exchange.

Other currencies that were issued and circulated in and around Harar city after the Axumite coins were the “Mahalek” and the “Ashrafi” that existed from 1789-1887. These were hand-made currencies for local use by the habitats of Harar. Later the entire region used “Amole Chew” (Salt Bar) for many years. In the nineteenth century and early twentieth century, Austrian thaler (the Maria Theresa dollar) served as a medium of exchange together with the use of Amole.

The thaler was first minted in Vienna, the capital city of Austria in 1741 and named after the Empress Maria Theresa of Austria. It had a silver purity of 800 karats, which means it contained 80% of pure silver. Hence, after a long time the country was back to metallic money. Thaler was a widely acceptable means of exchange until it was replaced by the national currency in 1945. During the Italian short occupation (1935 – 1941) there were about 50 million Marie Theresa thalers circulating in the economy.

In 1894 coins bearing the image of Emperor Menelik II appeared, these were. Made of silver and copper, the first national currencies after the fall of the

Axumite kingdom. In 1908, "Birr", containing the image of Emperor Menelik II, was declared as a medium of exchange and a legal tender throughout Ethiopia by proclamation.

7.1.2 The Financial Sector in Ethiopia

Historical Note

Modern banking in Ethiopia started in 1905 with the establishment of Abyssinian Bank, which was based on a fifty year agreement with the Anglo-Egyptian National Bank. In 1908 a new development bank (called Societe Nationale d' Ethiope Pour le Development de l'Agriculture et du Commerce) and two other foreign banks (Banque de l'Indochine and the Compagnie de l'Afrique Orientale) were also established. These banks were criticized for being wholly foreign owned.

7.1.3 The Roles and Functions of the National Bank of Ethiopia and Commercial Banks of Ethiopia

Roles and Functions of the National Bank of Ethiopia

Among the most important players in financial markets throughout the world are national banks, which are the government authorities in charge of monetary policies. National banks' actions affect interest rates, the amount of credit available, and the money supply, all of which have direct impacts not only on financial markets, but also on aggregate output and inflation. A national bank is a financial institution established to act on behalf of the government to control and regulate activities of the financial sector. It has different names in different countries. It is usually referred to as Central Bank, which is the apex of the banking sector. For instance, in Kenya it is "Central Bank of Kenya", in the U.S.A., "The Federal Reserve Bank.", in the U.K, "The Bank of England.

Unlike commercial banks, the objective of national banks is not generating profit by transacting with the general public in depositing, borrowing, and lending activities. The duties and responsibilities of national banks are far more extensive than those of commercial banks or of any other financial institutions.

The National Bank of Ethiopia (NBE) was established with capital of Birr ten million. It was owned and operated by the government and managed by a board of directors. The NBE was restructured by the government with Proclamation No

206/1963 and began its operation in 1964. After the fall of Emperor Haile Sellasie I, it was restructured by Proclamation No 99/1976. The roles and functions of the NBE were redefined again after the downfall of the Derg in Proclamation No 83-84/1994. The bank has now, among other things, the following responsibilities. It

- *has the exclusive right to mint coins and print (issue) currency notes that circulate in the national economy;*
- *issues government debt instruments or securities such as bonds, treasury bills, and promissory notes on behalf of the government;*
- *promotes the existence of balanced and accelerated economic growth;*
- *reduces the level of unemployment and maintains low levels of inflation;*
- *encourages the formation of micro and other financial institutions and supervises and regulates the activities and operations of these financial institutions in general and of commercial banks in particular;*
- *acts as the banker of the government: deposits government money and provides direct advances to the government;*
- *acts as a last resort for commercial banks that need to borrow money at times of shortage;*
- *regulates the money supply, interest rates and other charges, and the creation of credit by commercial banks;*
- *formulates the monetary policy framework for the country;*
- *manages and administers the international reserve of the country;*
- *regulates the foreign exchange of the country and organizes the foreign exchange auction market for the determination of the exchange rates; and*
- *prepares regular reports on the money supply, production of goods and services, and official international economic transactions carried out by the country*

Roles and Functions of Commercial Banks and Insurance Companies

A *The Commercial Bank of Ethiopia (CBE)*

The Commercial Bank of Ethiopia is the biggest and the leading commercial bank in Ethiopia. It had 32.9 % of the banking sector in Ethiopia in 2008/09. It had 209 branches throughout the country and 5 billion Birr capital in the same year. It was incorporated as a share company in December as per the Monetary and Banking Proclamation No 207/1995. It took over the banking activities of the former State Bank of Ethiopia and began operation in January 1964. The initial capital of the bank was Birr 20 million.

The first private bank that was in operation together with the Commercial Bank of Ethiopia was Addis Bank S.C. It was established in October 1964 as a joint venture (JV) between Ethiopians and National and Grindlays Banks of London. The bank was established with a paid up capital of 2 million Birr. Its capital increased to 5 million Birr by the year 1968 with a total of 26 branches and 300 employees. By 1976, Addis Bank was merged with other banks, of Italian origin, under Proclamation No 69/1975. The capital had increased to 20 miilion Birr, and there were 34 branches and 480 employees, making it the second largest commercial bank in the country.

Due to the change of regime and the Derg economic policy, the Addis Bank and the former Commercial Bank of Ethiopia were merged to form the present day Commercial Bank of Ethiopia on August 2, 1980. In the same year, the bank had 65 million Birr capital and 155 branches throughout the country.

Roles and functions of CBE:

 Help to encourage households to save money, since saving is important for investment;

- ✓ *Accept Deposits of different kinds, such as saving, time, and demand deposit;*
- ✓ *Advance loans, credit, overdrafts, and other services for individuals and firms;*

- ✓ *Conduct supervision and follow-up on the use of credit and loans provided to customers*
- ✓ *Maintain safe-deposit vaults and lockers and receive valuables and securities for safe custody;*
- ✓ *Sell and purchase foreign currencies;*
- ✓ *Issue letters of credit (LC), travellers cheques, etc;*

- ✓ *Issue bonds and participate in the buying and selling of treasury bills, bonds, and other negotiable instruments and securities;*
- ✓ *Conduct the transfer of money from one place to another;*

 Prepare regular financial reports to the NBE

- ✓ *Accelerate the process of monetization in the economy.*

Broadly speaking, the following are the major types of bank, classified based on their functions:

 Commercial Banks: *advance short-term funds/loans to business people and traders. Their deposits are only for a short period. The loan period extends from 3 to 6 months.*

 Industrial Banks: *provide long-term loans to industries*

 Agricultural Banks: *meet the requirements of the agricultural community, particularly in a predominantly agricultural country.*

 Foreign Exchange Banks: *specialize in facilitating foreign trade by making international payments.*

B *Development Bank of Ethiopia (DBE)*

One of the two specialized banks established in the 1940s, during the Imperial region, was the Agricultural Bank. It was initially established in 1945, and it was replaced by the Development Bank of Ethiopia in 1951. The purpose of the bank was to foster the development of the agricultural sector. On the other hand, the Investment Bank of Ethiopia (IBE) was established in 1963 for the purpose of developing the industrial sector. The Agricultural and Industrial Development Bank (AID Bank) was established in 1974 with the paid up capital of 100,000 Birr by the government to take over the activities of the former DBE and IBE. The objectives, functions, and roles of the AID bank include the following:

- ✓ *To advance loans and credit for the development of both the agricultural and industrial sectors;*
- ✓ *To act as agent or representative of individuals and firms to effect payment on their behalf*
- ✓ *To act as a guarantor to viable agricultural and industrial projects;*
- ✓ *To supervise and control the activities of projects financed by the bank;*
- ✓ *To engage in investment of equities; and*
- ✓ *To perform other similar functions and responsibilities like the commercial banks.*

C *The Construction and Business Bank (CBB)*

The other specialized bank was the Housing and Saving Bank (HSB) which was established in November 1975. The bank was created by amalgamating the former Imperial Saving and Home Ownership Public Association and the Saving and Mortgage Corporation S.C. The purpose of the bank was to encourage the construction of residential houses by providing long-term loans at a low rate of interest in urban areas. The working capital of the bank in 2008/09 was 196 million Birr. It had 32 branches by the same year.
The objectives, functions and roles of the bank are, among other:

- ✓ *Provision of long-term loans and credits in the construction and acquisition of buildings;*
- ✓ *Accepting saving, demand, and time deposit so as to mobilise funds for investment in construction;*
- ✓ *Conducting, monitoring and following up end uses of loans advanced;*
- ✓ *Discounting promissory notes and other securities issued by other parties; and*
- ✓ *Performing similar other functions as commercial banks as per the Commercial Code of Ethiopia.*

UNIT SUMMARY

- Monetary policy refers to the management of money and its links to price, interest rates and other economic variables. The historical development of money started in barter systems, exchanging goods for goods, and then the market system changed and transactions started using coins and paper money. In different governments, different types of coins and paper money have been used. Leaving the long history aside, modern banking in Ethiopia started in 1905 with the establishment of Abyssinia Bank. Then different banks were established during the Italian occupation time.
- NBE was established and started operation in 1964 with different powers, roles and functions to control all banks in Ethiopia. During EPRDF different public and private banks and insurance companies have been established.
- The Imperial, Derge and EPRDF governments set and reformed different types of policies and reforms.

- The performance of financial sectors in Ethiopia is set to make credit available and to allocate it to end users. In the Derg Regime, government-owned banks performed poorly due to discriminatory and restrictive policies.
- The major problem of financial sectors are limited circulation of money and limited financial institutions to solve this problem, the current government is expanding financial institution at large.

Unit 8

The Economic Reform Program in Ethiopia

8.1.1 Introduction to the Structural Adjustment Program

In response to the near collapse of the Ethiopian economy, coupled with unsustainable internal and external imbalances like the high inflation rate, negative interest rate and unviable debt ratio, the government of Ethiopia (GOE) in 1993 initiated a Structural Adjustment Program (SAP) for the period 1993-1996 with the support of the International Monetary Fund (IMF), World Bank (WB), African Development Fund (ADF) and other multilateral and bilateral donors.

The Structural Adjustment Program's refers to the reorganization of institutions, economic activities and the entire social system, in line with market-oriented economic systems. The overall goal of SAP was stabilization and adjustment.

The stabilization policy focused on restoring macroeconomic balance and reducing inflation and government budget, controlling the economy and the like.

The Structural Adjustment Policy focused also on removing constraints on the supply side and pay a close attention to the production of export crops through depreciation of the real exchange rate and other incentives.

The Structural Adjustment Polices were also aimed at encouraging the development of the private sector, fostering competition throughout the economy and promoting the process of market determination of all prices, including exchange rates and interest rates. The main objectives of SAP include revival of economic growth, reducing macroeconomic distortion, improving economic efficiency and resource allocation and expanding the productive capacity of the economy.

Broadly speaking, the structural adjustment program has three components

- *Expenditure reducing policy*
- *Expenditure switching policy*
- *Institutional policy reform*

A ***Expenditure reducing policys:*** it is a policy of reducing spending level in the economy by adopting stringent monetary policies such as tight money supply, credit control and reducing public deficit. The aim of this policy is to curtail domestic demand so that demand-pull inflation can be prevented and domestic saving can be promoted.

B ***Expenditure switching policy:*** it is a policy of redirecting productive resources from non-productive sectors to productive sectors or investments. Such a policy incorporates exchange rate devaluation, trade intervention, taxes, tariffs, and deregulation of price.

C ***Institutional policy reform:*** it is a policy of restructuring institutions towards competitiveness and efficiency through a market-oriented economy. The policy reform includes trade liberalization, privatization, reducing the state holdings in the economy, fiscal reform, financial market reform, and the like.

8.1.2 Structural Adjustment Policy Measures Undertaken in Ethiopia

Ethiopia responded to the problem discussed in 8.1 by undertaking appropriate policy measures aimed at correcting imbalances in the economy, promoting the role of market forces in allocating resources, and removing impediments to the development of the private sector. The main policy measures for achieving the country's development objectives were:

1 Macroeconomic reforms include:

- *Monetary policy*
- *Exchange rate policy*
- *Fiscal policy and*
- *Interest rate policy*

A ***Monetary policy:*** the government of Ethiopia pursues a tight monetary policy to ensure consistency in money expansion with low inflation, rapid economic growth and external balances.

B ***Exchange rate policy:*** in 1992, a devaluation scheme was adopted to encourage exports and discourage imports. This helps to narrow the gap between export and import and thereby improve current account. It also helps to narrow the gap between official and black-market rates and abolish illegal trade in the country.

C ***Fiscal policy:*** is defined as the part of government economic policy which deals with taxation, expenditure, borrowing and the management of public debt in the economy. Such policy reform is undertaken to reduce fiscal deficit by greatly reducing government expenditure and expanding the tax base. At a time of depression and unemployment, the government should spend more than its revenue and thus insure a deficit in the budget.

D. Interest rate policy: interest rate ceilings were abolished so as to enable it to reflect the state of the finical sector.

2. **Privatization:** with the objective of economic efficiency and profitability, a number of public enterprises have been privatized, and the process of privatization is still underway.

3 **Transport deregulation:** zonal restriction on transport service was abolished. To improve the financial performance of the sector, transport tariff rates have been revised.

4 **Domestic price liberalization:** price controls were abolished; prices of state-owned industrials and agricultural products were left to be determined by the market force of demand and supply.

5 **Foreign trade liberalization:**restrictions on trade were lifted by introducing a system of open general license. Export taxes on all commodities, except on coffee, were removed. Trade liberalization reacquird removal of import barriers inclining the replacement of quantitative restriction (quota) by tariffs whose rates are to be revised over time. Accordingly tariff rates have been revised and reduced.

6 **Private sector reform:** this measure is undertaken to encourage the participation of the private sector in the economic growth and development endeavors of the country. As a result the investment policy was revised in such a way as to promote both domestic and foreign investments and also to expand production activities and employment in the country. Absorption of foreign technology know-how and technical skills by Ethiopian entrepreneurs were also parts of the investment objective.

8.2 PERFORMANCE OF THE ECONOMY AFTER THE NEW ECONOMIC REFORM PROGRAM

The trend of economic growth for the period between 1960 and 1992 was unsatisfactory. This very dismal economic performance was caused by a number of factors, including rigid macroeconomic policies, protracted war, and recurrent droughts, which drained huge amounts of the country's resources and created a hostile external environment. The problem of the drought was the most severe of all.

It has been documented that the extent of drought varies from period to period, and that, between 1960 and 1992, drought and famine occurred at least nine times. The size and magnitude of rainfall has substantial effect on the performance of the entire economy, and so the above-mentioned drought conditions shrank the economy significantly.

Between 1963/64-1998/99, regardless of the policy regime, real GDP grew, on average, by 2.97%, while population grew, average, by 2.9%, resulting in a 0.06%

(2.97%-2.91% = 0.06) annual growth rate per-capita income. This indicates that the economy had stagnated for the last three decades or so.

It is widely known that the ancient country of Ethiopia underwent a period of turmoil, economic stagnation and famine during the 1970s and 1980s. In 1991, the Military government was replaced by the Transitional Government of Ethiopia with the introduction of new political and economic policies. In terms of the economic reform policy, a new program was launched with one of its primary objective being to build an economy in which the private sector plays a leading role. To enhance the role of private investment in the development process, various policy measures have been taken by the government. The policy measures were designed to eliminate discrimination against the private sector and to create a conducive environment for private investment.
Investment Proclamation No. 15/1992 was issued as the first policy measure by the Transitional Government of Ethiopia (TGE) for the purpose of encouraging both domestic and foreign investment. This proclamation removed restrictions

on private investment and allowed for wide participation of the private sector. Several investment incentives were provided under Article 13 of the proclamation. The proclamation states that domestic and foreign investors shall be entitled to exemption of import and export related taxes and duties, income tax withholding and some other benefits. Further more the proclamation listed available investment opportunities in the country.
The investment areas that are reserved only for government are:

- ✓ *Defence*
- ✓ *Heavy industry*
- ✓ *Large-scale electrical and energy work*
- ✓ *Large-scale air and marine transportation*
- ✓ *Postal and telecommunication servicese.*

  The minimum investment capital requirement for the private investors in the country was also indicated. In the proclamation foreign investors were required to have a minimum investment capital of $USD 500,000 and deposit in cash of not less than 25% of the investment capital. With regard to domestic investors, they were required to have a minimum capital of Ethiopian birr 250,000. However, it is stated that these minimum investment capital requirements could be lowered in areas of special interest such as technology and know-how.
  Later, Proclamation No 15/1992 was revised as Proclamation No. 37/1996. The new proclamation solved the shortcomings of Proclamation No. 15/1992, by reducing the minimum capital requirement for foreign investors from the previous $USD 500,000 to as low as $USD 100,000 and by lifting off 25% of the cash deposit.
  The new investment Proclamation No. 280/2002 amended by Proclamation No

375/2003 was enacted with a view to:

- ✓ *Encouraging and promoting the private sector in the economic development of the country.*
- ✓ *Widening the scope of participation of foreign investment.*
- ✓ *Creating a transparent and efficient system of investment administration; this investment proclamation provides that a foreign investor can investment either*
- ✓ *As a sole proprietor with full equity ownership or*

Jointly or in partnership with domestic investor(s) or the government

The law also stipulates the following capital requirement:

- ✓ *A minimum capital of $USD 100,000 for a single investment project in cash and /or in kind for wholly foreign owned inventors.*
- ✓ *A minimum capital of $USD 50,000 in cash and /or in kind per project in areas of engineering, architecture, accounting and audit service projects or business management consultancy services.*

UNIT SUMMARY

- The three important sectorial components are agriculture, industry and service. In terms of the economy as a whole, the sectors have not shown any structural transformation for the last three decades. In an attempt to convert from traditional to modern manufacturing, Ethiopia made a transition from a pro-capitalist economy system to a totally controlled economy that pushed the economy downward In 1974/75. Famine and war created a huge humanitarian disaster.
- The poverty situation in the country was the worst, and 50% of the population could not afford the minimum food requirement.
- The transitional government, which came to power in 1991, took steps to rehabilitate and reconstruct the war-damaged economy by adopting a market-oriented economic policy and Structural Adjustment Program (SAP). Broadly speaking, the Structural Adjustment Program has three components: expenditure reducing policy, expenditure switching policy and institutional policy reform.
- The unsatisfactory performance of the economy was caused by poor macroeconomic policy, drought and war.
- The investment policy and climate in Ethiopia during the post-1991 period introduced new economic and political programs. An investment policy was implemented to encourage local and foreign investors.