

https://dspace.org/

PUBLIC BUDGETING

TEKLE, YEMANE BERAKI

2011-06-23
http://hdl.handle.net/10539/10182

Downloaded from a DSpace repository. https://dspace.org/

PUBLIC BUDGETING
AND
ITS ECONOMIC DEVELOPMENT IMPLICATIONS
IN ERITREA

BY

YEMANE BERAKI TEKLE

JULY 2006

Abstract

Public budgeting is an area in which the zeal for economic development has been particularly marked. The issue that is addressed in this study concerns the budget's possibilities when it comes to operating as an effective instrument of development and poverty reduction in Eritrea. The central question in the dissertation revolves around the problem of how budget techniques and methods of resource allocation should be designed in such a way as to promote economic growth to alleviate poverty. Moreover, the budget should generate confidence between the participants in the budget process. Since it is assumed that a budget must build on grounds of fact in order to function as an effective instrument in the reconstruction and rehabilitation process, particular attention is paid to the nature of the budgetary dialogue.

The empirical material for the dissertation consists of public budgeting development, i.e. the allocation of resources according to population base. Population-based models of resource allocation have been introduced in the country for the development of local services. The intention underlying here is that the country as whole should enjoy conditions that are possible to fulfill the residents' needs for local services. In the study the experience of population-based budgeting is examined. The results show that the acceptance of the population-based resource allocation system can be described, albeit some variations are there, as good. The study also shows that the incentives for behaving in an economically rational way in Eritrea have been strengthened, particularly as a result of greatly heightened budget discipline. As regards the political effects of the budget reform, the dissertation provides a somewhat more complex picture. The public budgeting in Eritrea can be described as a success in political terms, in that it has given the politicians more control over the scope of the budget.

Declaration

I hereby declare that this work is my own, unaided. It is being submitted in partial fulfillment of the requirement for the degree of Masters of Management in the field of Public and Development Management in the Faculty of Commerce, Law and Management at Graduate School of Public and Development Management in University of the Witwatersrand, Johannesburg. It has not been submitted as any degree or examination in any this or other universities.

_____

This the 10th of July 2006

Dedication

This work is dedicated to my father and mother for their endless support and patience in the past of my study and to all my brothers and sisters. It is also to my love Selemawit Tesfa-alem.

Acknowledgement

I wish to express my special gratitude to those who gave me their fruitful support.

I would like to thank all members of the staff of the Graduate School of Public and Development Management for their dedicate support during my stay in the University in South Africa. Special thanks go to Manyanya for his advice during the preparation of my research proposal. My deepest and sincere gratitude goes to my advisor Mr. Anthony Moonsamy for his dedicate and fruitful advice and guidance in a friendly environment to finish my dissertation.

At last but not least, I owe special thanks to my family, Selemawit Tesfa-alem, Almaz Mehari and Michael Andebrhan for their encouragement and endless support throughout my study. My special thanks also go to my colleagues for their best advice during my stay in South Africa.

List of tables

Table 4.1. Summary of budgetary process in Eritrea---------- 68
Table 4.2. Government expenditure, revenue, budget and
deficit as shares of GDP---------- 70
Table 4.3. Government spending by sectors---------- 77
Table 4.4. School enrollment ---------- 83
Table 4.5. Growth of Schools---------- 84
Table 4.6. Revenue and expenditure---------- 86

List of figures

Figure 5.1. Managed or controlled exchange rates---------- 92

TABLE OF CONTENT

Abstract---------- II
Declaration---------- III
Dedication---------- IV
Acknowledgement---------- V
List of Tables and Figures---------- VI

Chapter one

1.1. Introduction and background---------- 11
1.2. Purpose of study---------- 13
1.3. Research questions---------- 14
1.4. Significance of the study---------- 14
1.5. Limitation of the study---------- 14
1.6. Research methodology---------- 15
1.7. Data collection strategies---------- 15
a. Primary data---------- 15
b. Secondary data---------- 16
1.8. Data analysis strategies---------- 16
1.9. Presentation of the result---------- 16
1.10. Management plan, timeline and feasibility---------- 16

Chapter two

2.1. General background of public budgeting---------- 18
2.2. Objectives and purposes of public budget---------- 19
2.3. Scope of government budget---------- 20
2.4. Functions of public budget---------- 21
2.4.1. Allocation of resources---------- 22
2.4.2. Distribution of resources---------- 22

2.4.3. Stabilisation of the economy---------- 23
2.5. Budget circular---------- 23
2.6. Policy implications of budget---------- 24
2.7. Basic concepts of expenditure---------- 26
2.8. The role of the state and government expenditure---------- 27
2.9. Financing the spending---------- 29
2.10. Public goods approaches---------- 32
2.11. Determination of public expenditures---------- 33
2.12. Expenditure estimates---------- 34
2.13. Expenditure management---------- 36
2.14. Expenditure control framework---------- 36
2.15. Basic concepts of revenue---------- 37
2.16. Revenue estimation---------- 38
2.17. Sources of government revenue---------- 39
2.17.1. Level of taxation---------- 41
i, Structure of taxation---------- 41
ii, Non-tax revenue---------- 43

Chapter three

3.1. Macroeconomic policy---------- 45
3.2. Macroeconomic stability is necessary for growth---------- 45
3.3. Implications for macroeconomic policy---------- 47
3.4. Fiscal policy---------- 48
3.5. Development and functions of fiscal policy---------- 50
3.6. Application of fiscal policy---------- 54
3.7. Fiscal policy to control inflation and improve deficit budget---------- 55
3.8. Theoretical aspect of reducing the government deficit to control inflation- 56
3.8.1. Reflationary fiscal policy---------- 56
3.8.2. Deflationary fiscal policy---------- 57
3.9. Evolution of international monetary system---------- 58

3.10. Monetary policy---------- 59
3.11. Exchange rate system---------- 59
3.12. Determinants of exchange rates---------- 59
3.13. Factors to be considered in choosing an exchange rate regime---------- 60
3.14. Balance of payment---------- 61

Chapter four

4.1. Macroeconomic environment in Eritrea---------- 62
4.2. The budgetary system of Eritrea---------- 65
4.3. The budgetary process in Eritrea---------- 67
4.4. Government revenue, expenditure and budget---------- 68
4.5. Fiscal policy of Eritrea---------- 72
4.6. Taxation policy of Eritrea---------- 74
4.7. Expenditure policy of Eritrea---------- 75
4.8. Expenditure (spending) classification by types of services in Eritrea------- 76
4.9. Government expenditure to resuscitate the economy---------- 78
4.10. The impact of excessive government expenditure on the economy------ 79
4.11. Data analysis---------- 81
4.11.1. Critiques of the expenditure policy---------- 81
4.11.2. Rational for fiscal and expenditure policies---------- 82
4.11.3. Recent trends and their implications---------- 88

Chapter five

5.1. Eritrean monetary policy---------- 90
5.2. Managed or controlled exchange rates---------- 92
5.3. Black market---------- 93
5.4. Data analysis---------- 94
5.4.1. Critiques of controlled exchange rate---------- 94
5.4.2. Rational for adopting managed/controlled exchange rates----------96

5.4.3. Recent trend of controlled exchange rate regime---------- 98

Chapter six

6.1. Conclusion---------- 100
6.2. Recommendation---------- 103

Bibliography

Chapter One

1.1. Introduction and background

Eritrea is situated in the northeast of Africa, with a coastline of about 1,200 km along the Red Sea and bordering on Sudan to the west, Ethiopia to the south and Djibouti to the southeast. The Red Sea borders the country to the east. With an area of approximately 125,000 km2, the country is about three times the size of Denmark. Eritrea is divided into four geographic regions: the central highlands, the lowlands of the east and west and the Denkalia desert in the southeast. The capital Asmara is situated in the highlands and the country's most important ports are Massawa and Assab (http://www.um.dk).

The state of Eritrea was founded during the European colonial period[1]. Prior to colonisation, a number of kingdoms existed in the territory where present-day Eritrea is located. Eritrea's strategic location on the west coast of the Red Sea and its natural resources were some of the main factors that attracted colonisers from Europe as well as from the African continent (http://www.ucis.unc.edu). Italy established Eritrea as a geographic entity in 1890 and the area remained as Italian colony until 1941, when Great Britain took control of the country. After the Second World War the UN adopted a resolution declaring Eritrea a federation within Ethiopia from 1952. In so doing, the UN accommodated Emperor Haile Selassie's ambitions of securing access to the sea by control of Eritrea. In the course of the subsequent two decades Eritrea would become an important strategic post for the USA, which at that time had close relations with Ethiopia. Furthermore, according to (Udenrigsministeriet, 2000), from 1952-62, Haile Selassie gradually annexed Eritrea, and in 1962 the region was declared Ethiopia's 14th province. This took place without protestation from the UN, or any of its member countries. As a counter measure, sections of the Eritrean population established the Eritrean Liberation Movement in 1958 and in 1961 the

1 Negash (2001),

Eritrean Liberation Front (ELF) embarked on an armed struggle for independence (http://www.um.dk).

Eritrea is now Africa's newest nation.[2] Eritrea formalised its independence from Ethiopia by popular referendum, which was monitored by UN delegations on April 23-25, 1993 after a costly 30-year struggle. Eritreans voted overwhelmingly for independence from Ethiopia (http://www.usaid.gov).

During the Italian occupation, considerable investment was made in agriculture and infrastructure with the objective of producing agricultural products for Italy. Numerous food processing and building material enterprises were established in this period, and mineral exploration was started. By the end of the 1930s, over 700 industrial companies, and in excess of 2,000 commercial firms, existed in Eritrea. Eritrea was also a major exporter in this period. But in 1974 the Mengistu regime introduced a planned economy, which entailed nationalisation of the most profitable enterprises in the private sector. A number of Eritrean industries were also transferred to Ethiopia. These developments impeded productivity in agriculture and industry. The decline was intensified by the destruction caused by the war with Ethiopia for independence, recurrent droughts and famine, and lack of foreign exchange to pay for the import of production equipment (http://www.um.dk).

Most Eritreans depend on agriculture for their survival, but Eritrea's northern location in the erratic Sahelian rainfall zones limits food grain production. There are opportunities for export crop production. Agricultural activities, in Eritrea, employ 80% of the population but currently may contribute as little as 22% to GDP. As cited in the website http://www.usaid.gov, export crops include coffee, cotton, fruit, hides, and meat, but farmers are largely dependent on rain-fed agriculture, and growth in this and other sectors is hampered by lack of a dependable water supply.

[2] USAID Congressional Presentation (1997),

The new government in Eritrea faces formidable challenges. Beginning with no constitution, no judicial system, and an education system in shambles, it has been forced to build the institutions of government from scratch. The present government includes legislative, executive, and judicial bodies. As mentioned above, Eritrea is confronted with many economic policy challenges, caused by recurrent droughts and the restructuring from wartime to a peacetime economy, persistent macroeconomic instability, slow growth and deepening poverty (IMF, 2003; http://www.imf.org). The economy was devastated by war and the misguided policies of the Derg, which disrupted agriculture and industry. Some of the economic transformation challenges that the Government of Eritrea has faced are: to reconstruct and rehabilitate the destroyed infrastructure, demobilise soldiers, and develop human resources. Much of the transportation and communications infrastructure that was not destroyed by the war is outmoded and deteriorating. Therefore, the Government of Eritrea must develop governmental and public management systems in response to these challenges. Part of this has involved the development of public budgeting systems.

1.2. Purpose of study

The study analyses the impact of public budgeting as a tool of macroeconomic management in Eritrea with the purpose of examining options for future development of economic policy.

The purpose of the study is to determine the extent to which Eritrea provides sufficient budgetary information and access to citizens and civil society organisations so that they can participate effectively in the budget process.

The study utilises insights gained to make recommendations to the public policy institutions and government organisations involved with budgeting and public financial management programmes in Eritrea.

1.3. Research questions

The research will involve the interrogation of the operation of macroeconomic policy in Eritrea. The following questions will provide a framework for the research:

- How does the state allocate public resources to build up the economy?
- What is the nature of macroeconomic policies under implementation?
- What is system of public budgeting?
- What is the impact of setting a budget on the economy of the country?

1.4. Significance of the study

The study will be significant as much as attention is given to the drafting of the public budget and its impact on economic development and poverty alleviation.

It will provide significant information how the budget process gives detailed macroeconomic issues. The decisions made in the budget process affect the economic conditions of a nation as a whole, state and local governments, and individuals. Many budget decisions have worldwide significance. The study will provide an overview of the budget system and explains some of the more important budget concepts.

1.5. Limitations of the study

As Lee (1997) points out the researcher can be easily beguiled by discovering interesting information that lies beyond the precincts of the problem being investigated. In order to ensure that a framework is set to assist the researcher not to fail into this trap the limitations of this research need to be investigated.

A key limitation is the sensitive nature of the topic being researched. The research may be seen as a threat. Lee identifies the intrusive nature of the research in terms of privacy, sanction and political threat as potential limitations in sensitive research areas. The concerned bodies may not be willing to give information on the ground of confidential while it is important for the research.

1.6. Research methodologies

The study will utilise qualitative approaches, the data will be collected from documented data and interview. This will allow the researcher to study the topic in depth and detail as he tries to identify the emerging issues and leaning from the study through identifying themes.

The study will be applied research, as it will aim to contribute towards practical issues of problem-solving, decision-making, policy analysis and community development.

In order to establish the framework for objectivity and limit the degree of subjectivity the combination of literature review, interviews with concerned bodies will ensure that the data are triangulated. Klipin points out that Leedy argues “data triangulation attempts to ensure that theory is tested in more than one way” (2001: 31).

1.7. Data collection strategies

a. Primary data

Primary data will be sourced through the following means:

- Library research. Both formal university libraries as well as resource centers will be visited for information.
- Online computer searching through Internet.

- Bibliographies of books/articles that are found will also be scanned for additional resources.

b. Secondary data

Secondary data will be collected through the following:

- Documented data from concerned bodies.

1.8. Data analysis strategies

The data will be analysed on the basis of the theoretical framework of public budget. Based on the analysis and theoretical framework, the researcher will develop recommendations.

1.9. Presentation of research result

The result will be presented in a number of different forms. The first will be the formal research report submitted in fulfillment of the requirements of this degree. The second will be presented as an individual report prepared for the concerned organisations.

1.10. Management plan, timeline and feasibility

Durrheim and Wassner provided a practical framework for developing a management plan that takes into account time, money and additional resources in order to achieve a research product (cited Terre Blanche and Durrheim, 1999). The researcher has adopted the framework for the purpose of this proposal.

Months	Phase 1	Phase 2	Phase 3	Phase 4	Phase 5	
	Planning	Literature review	Data collection interview	Data analysis interview	Draft report	Final report
1	√					
2-3		√				
3-4			√			
4-5				√		
5-6				√		
7-8					√	
8-10						√

The cost of the study will be financed through Eritrea's Human Resource Development Project as part of the researcher's employment responsibilities. The cost covers the following:

- Human resource time of the researcher
- Transportation cost
- Stationery
- Equipment facility cost (computer typing and printer)
- Administrative costs (telephone, photocopy, fax, e-mail and air mail)
- Books necessary for the research
- Costs of editing the document and binding of the final report for submission

Chapter Two

2.1. General background of public budget

According to (Premchand, 1989), public budgeting has developed naturally and spontaneously rather than in a planned manner and, empirically rather than theoretically. It has been heavily influenced by political systems, economic theories; management approaches, accounting principles, and the conduct of public administration.

The Public Budget is defined differently. For instance, Aronson (1985) in his book “Public Finance” defines a public budget as a formal listing, or statement of expenditures and revenues of a governmental unit, as well as a financial plan for the future. From a different perspective, a budget is a reflection of political decisions on the allocation of public resources (Musgrave and Musgrave, 1980). Dejenie (2003) considers a public budget as the principal instrument by which government translates into action the policies and programs stated out in its development plans. In terms of his definition a public budget plays a pivotal role in the financial management of the economy.

A budget is a written plan of action in numerical form, says Vickie Montgomery, author of “The Smart Women's Guide to Starting a Business” as cited in The Union Budget (1996-97). Its purpose is to establish goals, develop a plan that achieves those goals and provide a format for periodically checking to see how you are doing (http://web24.epnet.com).

As Aronson (1985) implies, a public budget is also a planning tool. It focuses on people to compare the benefits of various projects with the costs of such projects and may put such people in a better position to make wise decisions. The budget should be comprehensive enough to provide a reasonably complete picture of the financial

transactions of the government with the public. It is also a document suited to the legislative needs of the government.

According to (Premchand, 1989), budget structure is divided between current and capital transactions. The underlying idea of separation the budget into two sections is that the current or operating budget is used to cover the current expenditure such as salaries, administration costs, transportation costs, interest price on borrowing, and other miscellaneous expenses. A capital budget is used to finance other productive sectors, which are able to pay back the money spent.

2.2. Objectives and purposes of public budget

A budget tends to have many objectives. According to (Patashnik, 1999), Some of these objectives are as follows: to remain steadfast on the course of economic reforms aimed at liberalisation and accelerating economic growth; to address the concern of the poor and provide them with the basic minimum services in a time-bound manner; to ensure broad-based growth in agriculture, industry and services to achieve high employment; to ensure fiscal procedure and macroeconomic stability; to enhance investment, especially in the infrastructure sectors; to strengthen key interventions to promote human development; and to ensure viability in the balance of payments through strong export performance and large foreign investment flows (web24.epnet.com).

According to (Premchand, 1989) the purposes and associated features of the budget can be considered in terms of three aspects. These are (a) the budget as a tool of accountability. This means that government agencies are responsible for the proper management of funds and programmes for which funds are appropriated. (b) The budget as a tool of management. This implies that the budget must specify the cost, time and nature of the expected results. In addition a budget must clearly state the purposes of expenditure and provide the requirements for legislative action. (c) The budget as an instrument of economic policy. In terms of this aspect the budget

performs various roles. In its formulation, the budget must address the imperatives of economic growth, investment, employment, incomes, interest rates and prices. The budget must promote macroeconomic balances in the economy. The budget is also an important vehicle for reducing inequality, as well as an important determinant of the government's share in national income. Finally the budget should, in the manner of its development and implementation, permit a quick and meaningful measurement of the impact of revenue mobilisation and expenditures and borrowings on the national economy as a whole.

2.3. Scope of government budget

In terms of the Davis School District (no date given), budget administration and management is the process of regulating expenditures during the fiscal year to ensure that they do not exceed authorised amounts and that they are used for intended, proper, and legal purposes.

The determination of the scope of the budget is dependent on the scope of government and the purpose of the budget. Both have exerted strong influence on the shape of government budget (Permchand, 1989).

According to (Budget Guide, 2002), the general government sector covers all agencies that receive parliamentary appropriations or are regulatory in nature. Defining the budget Sector as equal to the general government sector improves transparency and accountability by providing:

- A comprehensive picture of the non-commercial operations of the government; and
- An independent definition of the budget's scope (http://www.treasury.nsw.gov.au).

The Budget Guide further added that the financial transactions of public financial enterprise (PFE) sector and public trading enterprise (PTE) sector agencies are not generally reflected in the budget aggregates (http://www.treasury.nsw.gov.au).

However, according to (The Budget Guide, 2002), there are two exceptions to the above, which the budget aggregates do include. These are:

- Explicit payments for "social programs", which are non-commercial functions required of public trading enterprises by the government; and
- Dividends, tax equivalent payments and guarantee fees payable by the public trading and financial enterprise sectors, which are shown as revenues in the general government sector (http://www.treasury.nsw.gov.au).

As cited in the website http://www.treasury.nsw.gov.au, another important measure of the government's performance is how the government is managing the total state sector balance sheet. Net financial liabilities include commentary on the management of total state sector financial assets and liabilities, including net debt and superannuation liabilities.

2.4. Functions of the public budget

As Premchand (1989) states public budgeting is continuous and is also undertaken in the spending agencies and in the ministry of finance. Budgeting involves the interplay of several forces. It is viewed in a wider connotation to deal with institutional factors, recognition of economic environment, formulation of relevant policies, patters of legal accountability, and responsibilities of the central and spending agencies. Premchand elaborates that expenditure controls refer to techniques that are utilised at selected stages of budgeting for the review of programmes and their financial estimates and for ensuring that the formulated budget estimates are adhered to in practice.

Budgeting involves different tasks on the expenditure and revenue sides. On the expenditure front, it involves the determination of the total size of the budget, size of the outlays on different functions, and the magnitude of outlays on various programmes. On the receipts side, the size of the overall revenues and foreign aid where applicable, needs to be decided. A decision is also needed on the size of the deficit, components of its financing, and the likely ownership of public debt (Permchand, 1989). These tasks are common to all countries, according to Premchand, irrespective of their political ideology, economic status, experience as independent country, or level of moral responsibility.

As Premchand (1989) stated there are three economic functions of the modern public budget. These are allocation, stabilisation and distribution. This implies the need for making a budget through a budgetary process.

2.4.1. Allocation of resources

This aspect of the public budget is concerned with the allocation of resources in the economy. Since all the goods cannot be provided in the right quantities through the market system, governments are concerned to correct for these deficiencies. The governments are also concerned with the split between investment and consumption goods. Governments try to correct shortages in the pricing mechanism due to monopoly elements, the existence of external economies or diseconomies, and the case where social costs diverge sharply from private costs (Hockley, 1992).

2.4.2. Distribution of resources

According to (Hockley, 1992), the distribution of income and wealth depends on a number of factors including work, educational opportunities, inheritance, gifts and government taxes and spending policies. The distribution of income and wealth is also distinctly skewed in most countries.

2.4.3. Stabilisation of the economy

Stabilisation objectives are concerned with achieving current government objectives. According to (Hockley, 1992), current objectives may include obtaining and maintaining a satisfactory level of growth, maintaining high employment, ensuring stability in the value of money, maintaining a satisfactory exchange rate and balance of payments. He further goes on to say that the mix of objectives changes with in time with some being left to free markets. Where government intervention takes place there is a possibility that this will achieve better results than non-intervention.

The listing of the aims of budgetary policy does not necessarily mean that they can all be achieved. According to (Hockley, 1992), often there will be direct conflict and the legislature has the tough job of weighing up the alternatives. Within the aims selected by society as being relevant, persons have been looking for countries for a general principle that could be used as a guide to apportion taxes.

2.5. Budget circular

According to (Premchand, 1989), budgeting involves the active participation of several agencies and individuals. If their efforts are to be coordinated within the time allotted, each participant must understand their role as well as the roles of others. In the budgetary process, the budget circular is the vehicle for conveying the policy goals of government to the participants. Although others viewed as a routine affair, it facilitates communication before and during the entire budget process.

Ideally, as Premchand noted, the budget circular should convey the national goals, state the economic prospects of the country, and reflects the policies proposed. It has an educational role in promoting better understanding of the budget itself. The circular should indicate the resource constraints and their impacts on budget. In light of this, it should cogently state the propose increases or reductions in allocations.

2.6. Policy implications of budget

Every government spends money and raises taxes to finance its expenditure. Every government must therefore regularly decide how much to spend, on what to spend and how to finance its expenditure. It must therefore have a policy in respect of the level and composition of government spending and taxation under the policy called fiscal policy (Mohr and Fourie, 2000).

> The main instrument of fiscal policy is the budget. The budget is essentially a reflection of political decisions about how much to spend, what to spend it on and how to finance the spending. But the size and composition of government spending and the way in which it is financed can have significant effects on important macroeconomic variables such as aggregate production, income and employment and the price level, as well as on the distribution of income. These effects have to be taken into account when the budget is prepared. In fact, the government often uses the budget to stimulate economic growth and employment, redistribute income, and control inflation or to address balance of payment problems. Fiscal policy is often regarded as an effective means for influencing total spending or the aggregate demand for goods and services in the economy. It is therefore classified as an instrument of demand management, i.e. as an instrument that can be used to manage or regulate the total demand for goods and services in the economy (Mohr and Fourie, 2000 pp: 451).

According to (Olekalns, 2000), the budget surplus can be achieved through reductions in expenditure. Revenue, as a share of GDP, is not expected to change to any significant extent. Reducing government expenditure whilst holding revenue constant implies a reduction in the government's demand for borrowings. This reduces interest rates and provides some stimulation of private investment. As Olekalns noted low interest rates reduce the attraction of foreigners placing their savings in Eritrea (http://www.economics.unimelb.edu.au). For example, as cited in the website http://www.afdb.org with respect to interest rates, savings deposit rate was 6.0 percent while lending rates ranged from 7.5 - 12.0 percent during the same period. Thus, the savings deposit rate was negative in real terms, a factor that could constitute a disincentive to savings. Moreover, this rate is 4 percent lower than the

one operating in Ethiopia. Given the defacto monetary union between the two countries, the interest rate differential could induce capital flight to Ethiopia (Fall, 2002).

As Olekalns (2000) states consumers' responses to the cuts in government expenditure also point to the budget surplus having only a small impact on aggregate demand. As long as reductions in government expenditure are not expected to be reversed, the move to a budget surplus implies a reduction in lifetime tax obligations and hence an increase in private sector wealth. Private consumption spending, therefore, could increase or be 'crowded-in' by the budget surplus (http://www.economics.unimelb.edu.au).

According to (Olekalns, 2000), these currency and wealth considerations suggest that the move to a budget surplus will have little impact on economic activity. This conclusion would have to be modified if the central bank's monetary policy is not coordinated appropriately with fiscal policy. Should monetary policy be tightened at the same time as the budget moves into surplus, the falls in interest rates will not be forthcoming and the overall effect of the budget surplus could be contractionary (http://www.economics.unimelb.edu.au).

As Olekalns (2000) notes, wages growth continues to be relatively moderate and recent microeconomic reforms mean that any stimulus to demand provided by import substitution and export growth is unlikely to lead to significant inflationary pressures. If anything, given the stubbornly high unemployment rate and what is close to a zero rate of inflation, some loosening of monetary policy could be justified (http://www.economics.unimelb.edu.au).

According to (Olekalns, 2000), policy coordination also works in the other direction since the achievement of a surplus adds credibility to the central bank's attempts to meet its low inflation target. The move to a budget surplus, therefore, can be seen as

making an important contribution to the central bank’s efforts to meet its low inflation target (http://www.economics.unimelb.edu.au).

2.7. Basic concepts of expenditure

Expenditure can be defined as all amounts of money paid out by a government during its fiscal year other than for retirement of debt, purchase of investment securities, extension of loans, and agency or private trust transactions. Under this definition, expenditure relates to external payments of a government and excludes amounts transferred to funds or agencies of the same government. Expenditure includes payments from all sources of funds, including not only current revenues but also proceeds from borrowing and prior year fund balances. It also includes amounts spent by all agencies, boards, commissions, or other organisations categorised as dependent on the government concerned. Expenditure covers outlays of all accounting funds of a government other than intragovernmental service (revolving), agency, and private trust funds (http://www.census.gov).

Government expenditures can be divided for analytical convenience into those for (a) traditional public goods and merit wants (defense, education etc.); (b) direct trading and industrial activities of governments; (c) transfers to productive sectors (e.g., industries, agriculture); and (d) transfer to households and individuals. Admittedly, each is dependent on the political perceptions of the state and on the reliance placed on the market system (Permchand, 1989). The government pays for defense, education, social security, health, roads, museums, libraries, the police and courts. All these are vital public services and any changes in the government's spending policies will have a major impact on the economy. Adjusting the level of government expenditure is a key part of the government's fiscal policy. It is possible to change the level of government expenditure in the model and see the effect both on the macroeconomic targets and on individual families (http://www.bized.ac.uk).

Government expenditure is vital for the efficient running of the economy. The need for much of the government expenditure arises from the fact that some goods will not be provided at all by a free market economy (public goods) and that others will be under-provided (merit goods). It is spending on these goods that accounts for a large proportion of government spending such as health, education, police and defence, etc. Some government expenditure is also aimed at providing a safety net for the less well off in society and ensuring that they are able to survive in the event that they lose their jobs or have insufficient income. Payments of this nature are known as transfer payments. Other government expenditure is aimed at various areas that may be considered important in a developed economy - providing a transport infrastructure, supporting the work of local government and servicing any debts that may have been accumulated in the past (http://www.bized.ac.uk).

Government expenditure should increase to meet certain basic needs. Such needs are natural and understandable. This is, whether, dealing with security, or helping families in need, or increasing the water supply, or providing aid for factories, encouraging difficulties in a competitive market, or improving education, particularly in development areas, or updating the items covered by the national scheme, or relieving traffic congestion in the major metropolitan areas, etc. (http://www.bankisrael.gov.il).

2.8. The role of the state and government expenditure

Analysis of, and judgment on the appropriate scale and balance of expenditure should begin with the reasons for government intervention. It is possible to distinguish among five groups of arguments. The force of these arguments, some but not all of which concern market failure in terms of departures from the standard conditions of welfare economics, can then be examined alongside an assessment and analysis of the problems of government action, or potential government failure.

- ***Market failure:*** including externalities, public goods, missing markets, and the violation of perfectly competitive behaviour.

- ***Poverty and income distribution:*** due to extreme deprivation and uneven distribution of income.

- ***Rights:*** to education, health, nutrition, and housing: this implies a state responsibility to provide literacy and to ensure basic nutrition, health care, and shelter.

- ***Paternalism:*** relevant examples may include the requirement to attend school, limitations on the use of certain drugs, and compulsory pension schemes.

- ***Future generations:*** the government puts dedicate concern on global warming, air and water pollution, conservation of rain forests, protection of species, and so on to have a healthy nation (http://web7.epnet.com).

All of the above arguments provide cogent reasons for government action. They point to particular areas of government expenditure, notably infrastructure, social security, education, health, pensions, and the environment, as well as to the government's role in keeping the economy competitive (http://web7.epnet.com).

Governments in developed countries spend more and have expenditures that are more concentrated on social security and health, whereas in developing countries these areas exhibit a smaller share with the bulk of expenditures going to economic services, general public services, and defense, though education also obtains a substantial share (http://web7.epnet.com).

As cited in Ahmed et al, Barro (1990) studies the effects of tax-financed government expenditure on investment and output. Higher income taxes reduce the after-tax return on private investment, and thus affect growth negatively by lowering investment. He divides tax-financed government expenditure into spending on unproductive services and spending on productive services, the latter of which includes resources devoted to property-right enhancements. Considering those two tax-financed expenditures, the spending on consumption services affects growth negatively, while the spending on productive services affects growth positively, if the growth resulting; from private capital accumulation induced by higher public capital and enhanced property rights exceed the negative effect of higher taxes on growth (http://web22.epnet.com).

2.9. Financing the spending

How is the expenditure to be financed? Government spending has to be financed in one way or another. There are basically four ways of financing government spending. These are income from property, taxes, borrowing (internal and external) and printing money. The emphasis here is on government revenue and some effects of other sources relevant to an assessment of the appropriate balance. The argument is that, in the long run, a healthy tax system must be at the heart of the public finances. The adjustment experiences of the less-developed countries over the last two decades have served to elevate fiscal issues to the head of the policy agenda. Fiscal correction is now seen as essential for long-term macroeconomic stability (http://web7.epnet.com and Mohr and Fourie, 2000).

According to Burton a government that wants to provide a great deal of goods and services to its people while not having the immediate tax revenue to fund that expenditure can turn to the capital markets to borrow the necessary money. They do this primarily by issuing securities. All levels of government will borrow money at some point. These securities are obligations compelling the government to repay the

borrowed amount at maturity and also to pay interest in the form of coupons at specific points in time (http://www.cato.org).

Barro (1974) and Bernheim (1987) cited in Burgess et al said that there are very special models in which extra domestic borrowing has the same, or equivalent effect on the economy as extra taxation. Strong conditions are required for Ricardian equivalence to hold, including: perfect capital markets and rational expectations; private agents being able to borrow or lend on the same terms as the government; non-distortionary taxes (http://web7.epnet.com).

As cited in (Burgess et al Sargent and Wallance, 1981) stated that debt is not neutral in the sense of equivalence; we may ask what constrains its use. Essentially there are two related problems, inflation and crowding out of private investment. Debt can be inflationary when a government has incentive to renege on part of the debt by a burst of unexpected inflation. Further if debt is used excessively, there will come a time when it will no longer be accepted and the government will have to resort to magnetising the debt. If sufficiently anticipated this can lead to inflation (http://web7.epnet.com).

According to (Buiter, 1989 cited in Burgess et al) debt financing, closely associated with inflationary aspects, are the problems of crowding out. Given the non-neutrality of debt, the authorities' decision making directly affects the private allocation of resources. For example, substitution by the government of borrowing for current taxes on labour income may increase private consumption. In an economy with full utilisation of resources this may lead to private investment being crowded out, or may result in an increase in the deficit on the current account of the balance of payments (http://web7.epnet.com).

As cited in Burgess et al governments may seek to use domestic borrowing when they face an unexpected shortfall in revenues, or to cover emergencies such as

floods or defence requirements. Such borrowing can substitute for sharp and substantial increases in taxation, which may be difficult or costly to implement (Goode, 1984). From the perspective of standard economic analysis they generally have serious shortcomings, although they can have advantages in constraining governments from pursuing undesirable policies. For example, one view is that borrowing is appropriate if it is used to finance capital expenditure, which is expected to yield a return over a number of years (Mohr and Fourie, 2000). This rule fails to distinguish between the relative costs and benefits that accrue from financing the project from alternative sources. Borrowing will involve greater taxation, or reduced expenditure, in the future and the government will have to compare the costs of doing this with taxing now (http://web7.epnet.com). Like any other borrowing, government has to pay interest on all borrowed funds, which leads to substantial increases in the interests on public debt. The increase in the interest burden means that there is a diminishing proportion of government spending on social upliftment and other priorities (Mohr and Fourie, 2000).

According to (Sachs, 1989 cited in Burgess et al) foreign borrowing differs from domestic in that it enables a country to command current goods and services in addition to those arising from domestic resources. Furthermore, the displacement of private investment may be less severe, although public foreign indebtedness may make finance more difficult for private borrowers. Over time debt servicing and repayment entail a reverse transfer of resources abroad. For foreign borrowing to be attractive the government should believe that the productivity of the loans along with the taxes generated will provide sufficient resources for the loan to be serviced and repaid in the future. Excessive optimism can lead to serious problems (http://web7.epnet.com).

Governments have at times resorted to financing expenditure by printing money. In this way governments can claim real resources from the population. Since demand for monetary assets tends to rise with economic growth, the government can, to a

limited extent, finance it by expanding the monetary base without causing inflation. However, when the rate of new money creation exceeds the increase in the demand for money, inflation may result. Inflation then imposes a tax on the population by reducing the value of real money balances (http://web7.epnet.com).

As cited in Burgess et al Fischer (1986) stated that high inflation has many disruptive and distortionary effects on economic functioning. In addition, Tanzi (1991 cited in Burgess et al) said that due to collection lags and the structure of taxation, inflation would have a negative impact on real tax revenues in less-developed countries. Further, the inflation tax may hit the poor, particularly as they tend to hold a large proportion of their wealth as currency (http://web7.epnet.com).

Two central messages have emerged from the experience of less-developed countries during the last two decades. First, there is no viable, long-term, and substantial alternative to taxation as a means of financing government expenditures. Second, successful adjustment and macroeconomic stability rely on profound and permanent fiscal corrections being made in the short and medium run (World Bank, 1991 cited in Burgess et al, http://web7.epnet.com).

2.10. Public goods approaches

As Premchand (1989) noted, public goods are those for which no private mechanism exists to provide them and which are consumed in equal amounts by all in which people who have not paid for them be excluded from their enjoyment. Public goods are also likely to be qualitatively different from those provided by the private sector (merit wants) and may have a distribution impact different from privately provided goods and services. They include a wide variety of goods and demand for them becomes an important element in the determination of public expenditures. According to Musgrave as cited in Premchand, governmental functions are performed through three branches of decision-making. These are allocation, distribution, and stabilistion. The function of allocation is to provide goods and services toward satisfaction of

wants. For purpose of formulating the budget, it is assumed that the proper state or desired state of income distribution is exogenously determined as the stabilisation function. Once, added Premchand, these goals are given, the manager in charge of allocation has to analyse the preferences for public versus private goods. Premchand has noted that taxes to finance the allocations are determined on a benefit basis. The interdependence between distribution and allocation is recognised, and it is expected that the impact of allocation on factor incomes is fully taken into account. The function of stabilisation to ensure full utilisation of resources while maintaining the value of the money.

2.11. Determination of public expenditures

Primary concerns are the allocation of resources between public and private sectors and among various services within government. Determination of total expenditure takes place in two ways. In a model of devaluation, such totals would be decided by the central finance or planning agency and communicated to all other agencies. In an aggregative model, the individual expenditure requirements of each programme would be complied and consolidated. Central agencies that are charged with fiscal management need to determine the appropriate level of expenditure in the light of the resources available and the permissible levels of deficit (Premchand, 1989).

As it stated in the book titled “Public expenditure management” written by Premchand (1989), the major determinants of public expenditure are estimates of total revenues and the desired level of defense spending. He further noted that revenues and deficits are considered as economic policy instruments, and non-defense expenditures are thought of as remainders after defense needs are attended to. It could be argued that, in developing countries, the primary determinant of expenditure is the share of development expenditure, within non-development expenditures treated as a remainder.

2.12. Expenditure estimates

Formulation of budget involves making a forecast of the next year's requirements. Informal and preliminary forecasts undertaken by the spending and central agencies are useful in charting their requirements and needs. Usually the forecasts take into account (a) continuing needs for which commitments were made on a long-term basis, (b) changes in the costs of these services, (c) announcements of new expenditures or legislation affecting the expenditures enacted during the year, (d) share of outlays for continuing projects, and (e) outlays on new projects or programmes (Premchand, 1989). Such estimates, as noted by Premchand, will also take into account any decisions made during the year to wind up or abandon some government activities. The important aspect for decision-making is the determination of the new outlays, their magnitude and their allocation pattern, and changes in the outlays for continuing activities, involving reallocation of those margins to others and determination of their requirements during the year. As Premchand states the estimates also take into account the previous relationships between estimates and the actual expenditures, performance ratios and factors contributing to their variations, and commitments made during previous years but requiring cash payments during the current year. These estimates are routinely compiled by the administrative agencies and the finance ministry.

The allocation of expenditure among programmes is determined through the normal decision process used by administration. The process is characterised the application of convenient rules of thumb, cost benefit or feasibility studies for new projects, and bargaining. The extent to which one or all of these are utilised varies with the nature of the expenditure and the administrative system (Premchand, 1989).

The task of formulating estimates of expenditure for the next year tends to be easier when a medium-term expenditure forecast is available. Given such forecasts, the task for the annual budget is to adjust for exogenous factors, such as changes in economic climate (which may involve more or less subsidies or public outlays),

changes in cost (rate of inflation), or changes in demographic profiles (e.g., net addition to the number of pensioner could entail more pension payments). Attention could be focused on new proposals. In the absence of such medium-term expenditure forecasts, the above factors would need to be given detailed consideration in the expenditure estimates, involving a deeper probe into the expenditure categories. Similarly, projects are usually included in a capital budget need more attention. Performance during previous years, availability of materials for the next year, and the likely emergence of bottlenecks and their impact on the pace of construction would need to be reviewed (Premchand, 1989).

According to (Premchand, 1989), annual estimates for capital projects must take into account the nature of the budget previously. In countries that have an obligation-based budgetary system, all funds necessary for the life of the project may need to be shown in the budget. Supplementing such a presentation, data on annual cash outlays are provided separately.

Annual expenditure estimates must pay particular attention to two other elements whose importance has grown considerably in recent years: (1) government lending operations, and (2) the spillover of the effects of operations of revolving funds and trading accounts. A cursory analysis of government operations indicates that lending to government agencies and to the public has been growing. In developing countries, such growth in transaction partly reflects the international borrowing channeled through government budgets. The lending operations imply that the social and economic purposes of government are carried out by autonomous or other agencies and that their activities are financed by loans. Annual estimates for these need the same attention as other estimates. Decision-making on loans is different from other decisions in that it is not restricted to marginal adjustments but revolves around the old as well as new loans, and final decisions are based on the capital market conditions and the purposes of lending. Specific attention would be needed for the estimation of the element of subsidy involved in lending (Premchand, 1989).

2.13. Expenditure management

As noted in the book “Public Expenditure Management” by Premchand (1993), the expenditure management system recognises the resource constraints in the various stages of governmental decision-making, from determination of the total magnitude to the allocation and management of expenditures. Expenditure management is viewed as a composite process contributing to timely and effective decision making on the use of public money. According to (Premchand, 1993), the operational framework of expenditure management comprises a three stage administrative process: (a) determination of the policies and objectives and the resources needed to attain them; (b) allocation of resources needed to attain the objectives; and (c) assurance that specific tasks are carried out economically, efficiently, and effectively. In practical terms, these correspond to formulating a fiscal plan, formulating a budget (operational framework), and implementing a budget. These can also be examined in terms of resource allocation planning, resource use management, and information system.

2.14. Expenditure control framework

Premchand (1993) stated that the ability to formulate prudent budgets depends on the quality of guidance provided to the spending agencies and on their capacity to comply with the guidance. This in turn requires strengthening their financial management capacity for compiling costs, formulating estimates and contingency plans, reformulating spending priorities when confronted with short-falls in revenue resources, avoiding excess expenditures over allotted amounts, and using resources economically. Premchand (1993) went on to say that as the agencies become equipped with an internal control, incentives and penalties to ensure compliance with prudent financial management would be required.

To enable the agencies to perform their new tasks better, budget classification should be revised to serve the needs of agencies’ internal management as well as those of

legislative oversights. At the agency level, budget classification has to be revised to meet the needs of computing costs of programmes. The role of the appropriate classification system in prudent house management and in providing transparency can hardly be overemphasised (Premchand, 1993).

The accounting system should also be strengthened to reflect user needs. Reporting has to be prompt and classified to serve as a window on government operations, while also being suitable to address the problems of the agencies in cost measurement and containment. Its role will thus have to be reoriented from that of a conduit to a statistical system of central planning to that of an information supplier to the immediate decision maker, to the general public, and ultimately to influence the decisions on expenditure control (Premchand, 1993).

2.15. Basic concepts of revenue

Revenue can be defined as all amounts of money received by a government from external sources during its fiscal year, net of refunds and other correcting transactions, other than issuance of debt, sale of investments, and agency or private trust transactions. Under this definition, revenue excludes amounts transferred from other funds or agencies of the same government. Revenue comprises amounts received by all agencies, boards, commissions, or other organisations categorised as dependent on the government concerned (http://www.census.gov).

It is apparent that revenues pour into the government from three main sources: the individual income tax, social insurance taxes, and the corporation income tax. The remaining funds are generated by excise taxes, estate and gift taxes, and custom duties (Aronson, 1985). As cited in the website http://countrydata.bvdep.com government revenues are raised largely through taxes, social security contributions, fees or charges for services, and some miscellaneous sources such as interest on government loans. A few governments also conduct trading activities, which generate income.

Government activities are not financed only by taxation. There are many other sources of public or government revenue: public-sector profits, mineral royalties, net revenue of marketing boards, and so on. In addition to taxes, the government can meet its obligations by borrowing or by printing money (http://web7.epnet.com).

2.16. Revenue estimation

According to (Premchand, 1989), revenue estimation can be viewed in terms of the formulation of both the immediate year's estimates and those over the medium-term. Estimates of revenue for the following year must be made before expenditure ceilings can be conveyed to spending agencies. He went on to say that preliminary estimates, which are based on existing taxation, may change over time and, eventually, as the final estimates of proposed expenditures emerge, it may be necessary to take discretionary measures for mobilising additional revenues if the level of deficit is to be maintained or curtailed. Revenues and levels of deficit represent the policy variables that determine the broad level of expenditures. He further added that revenue estimates facilitate the consideration of expenditure policy options and therefore are to be formulated with care. Each expenditure programme cannot be viewed against revenues except for expenditures financed from earmarked funds. The aggregate expenditures are determined in that light, and in the iterative process adjustments are made in expenditures to be within the revenue limits.

As it stated in the book entitled "Government budgeting and expenditure controls: Theory and practice", experience with revenue estimates reveals that organisational and attitudinal factors have generally impeded the usefulness of revenue forecasts. Organisationally, said Premchand, revenues are estimated by agencies that are responsible for revenue collection and thus are conservative, partly because of a desire to show a better actual performance. Such conservative estimates are also preferred by the budgeteer, as they provide a margin when higher expenditures must be financed during the course of the year. As PremConservative estimates also encourage the spending agencies to believe that revenues will cover expenditures. In

some countries, revenue estimation is carried out crudely, without adequate attention to the impact of government expenditures on taxation or feedback effects of previous changes in taxation. In few countries, the distance between the revenue and budget agencies is a real and physical one. Estimates are often provided at too late a stage to permit an appraisal of expenditure. In some cases, the revenue estimates are formulated, processed, and printed without the consideration of expenditures.

Revenue estimation, as noted by Premchand (1989), must be well organised and integrated into the budget cycle. To protect against undue volatility and a consequent rush in expenditure adjustments, revenues must be planned on varying assumptions. As expenditures are planned in a zero-base budget system on different assumptions of resource availability, revenue forecasts could similarly be formulated on different assumptions. In undertaking such assumption, a reciprocal adjustment is made between expenditures and revenues. From the expenditure side, revenue may be assumed to be as given, and plans may be formulated either for expenditure adjustment of further discretionary revenue measures. According to Premchand, from the revenue side, the level of expenditure could be assumed, and different packages of additional revenue could be formulated. Additional revenue may be accrue from several sources such as new measures, improved tax collection, and enforcement being among the options available to decision makers. Given that each new tax has an effect on production and consumption, formulation of different packages provides an opportunity to assess the merits of each package.

2.17. Sources of government revenue

As cited in Burgess et al in all countries government revenue is raised from a number of sources and through a variety of mechanisms. The main source of government revenue is taxation, which contributes close to 80 percent of total government revenue for less-developed countries (IMF, 1989; http://web7.epnet.com). Taxation is one of the most emotional of all economic issues. People do not like paying taxes

and every taxpayer feels that he or she is bearing the brunt of the overall tax burden. The argument is that when tax burdens are increasing, we must put into consideration that taxation is a very sensitive social and political issue (Mohr and Fourie, 2000).

Taxes are compulsory contributions exacted by a government for public purposes, other than for employee and employer assessments and contributions to finance retirement and social insurance trust systems and for special assessments to pay capital improvements. Tax revenue comprises gross amounts collected (including interest and penalties) minus amounts paid under protest and amounts refunded during the same period. It consists of all taxes imposed by a government whether the government collects the taxes itself or relies on another government to act as its collection agent (http://www.census.gov).

The overall proportion of taxation in GDP is higher in industrial than developing countries and there is a greater share of direct taxation in that total. Tax structure varies strongly between countries and across regions. For most countries taxation constitutes the main source of government revenue, but some developing countries obtain a substantial share of total revenue from sources other than taxation and on average the share of non-tax revenue in total revenue is much larger than for industrial countries (http://web7.epnet.com). Taxes are classified in two major categories. Direct taxes are levied on the income or wealth of individuals and organisations. They include personal income tax, company tax and estate duty. Indirect taxes are levied on goods and services and are usually paid by those who consume these goods and services. These, for instance, include VAT, customs duties and excise duties (Mohr and Fourie, 2000).

2.17.1. Level of taxation

The level of taxation may differ from country to country. Though higher income exerts some influence on overall tax share, there are many other influences involved; historical, social, political, and economic factors. All contribute to the explanation of differences in both the level and structure of taxation. The share of non-tax revenue, import and export ratios, literacy rates, urbanization, level of indebtedness, the share of agriculture, and the monetization and openness of the economy are all correlated with the total share of taxes in GDP. Ability to tax is closely associated with administrative capability and this is likely to improve with economic development thus reducing the gap between the statutory tax system and the real or effective tax system, as tax bases broaden the temptation to impose high rates on constricted bases lessens and this may have a positive effect on enforcement and hence revenue. (http://web7.epnet.com)

i, Structure of taxation: Developing countries obtain the bulk of their revenue from: domestic taxes on goods and services; income taxes; and social security contributions.

- ***Personal income tax:*** it is the most important form of direct taxation and also the most important single source of tax revenue in any country. Personal income tax is levied on the taxable income of individuals. Taxable income is the legal tax base and is obtained by deducting personal and other allowances from an individual's total income. Tax tables are then used to determine how much tax should be paid. The tax tables consist of a number of tax brackets. For each tax bracket there is a minimum amount of tax and a tax rate that is applied to each by which taxable income exceeds the starting point of the bracket, which is called the marginal tax rate. The so-called marginal tax rate is thus the rate at which each additional of income is taxed (Mohr and Fourie, 2000).

Bird and Oldman (1990 as cited in Burgess et al) stated that the constraints on raising revenue through personal income taxation in developing countries are many and include problems of income measurement, administrative capability, low literacy, and poor accounting. An economic structure dominated by agriculture and small-scale enterprises makes it difficult to trace, and hence tax, incomes. As a result, revenue from this source in developing countries tends to accrue largely from taxes on the wages of employees in public-sector enterprises and foreign corporations to whom tax laws can be more easily applied. Collection from such a narrow base, often at high rates, creates resistance, which is apparent in the experience of a number of countries (http://web7.epnet.com).

- ***The corporate income tax:*** Firms can also be taxed on their economic profit, defined as the return to owners of the firm in excess of the opportunity costs of the factors used in production (Rosen, 1992).

- ***VAT, Excise taxes and customs duties:*** VAT is a general tax since it is levied on most goods and services. Excise taxes are consumption taxes. In general, the intention is to tax the user of the goods such as alcohol, tobacco, and motor vehicles. Customs duties are taxes on imported goods. Here the intention is not so much to penalize the user of the product, as it is to offer economic protection to the domestic manufacturer of the product (Aronson, 1985; and Mohr and Fourie, 2000).

- ***Social security contributions:*** This is in sharp contrast to industrial countries where they constitute one of the major sources of government revenue. While this may partly reflect a low priority being attached to social security in developing countries, one must recognize that there are considerable difficulties connected with operating formal social security systems in developing countries. The problems of extracting social security contributions

are similar to those for individual income taxation (Burgess and Stern, 1991). For this reason, coverage is often restricted to employees in the formal sector leaving out most of those in the informal sector and in rural areas, while in industrial countries coverage is often close to universal (Ahmad et al, 1991 cited in Burgess and Stern). Taken together, these taxes constitute the least important form of taxation in developing countries, contributing a mere to the total tax revenue. Their importance in industrial countries is also negligible. As wealth and ownership of property is commonly concentrated in the hands of a small section of the population this result is striking, especially as these taxes have exhibited considerable importance in the past (Hinrichs 1966, and Wald 1959 cited in Burgess and Stern). The poor performance of these taxes may be traced to two factors (i) difficulties of observation, measurement and administration, (ii) political and social resistance (http://web7.epnet.com).

ii, Non-tax revenue: According to (IMF, 1989 cited in Burgess et al) in most countries the bulk of government revenue is raised through taxation. Governments do, however, obtain substantial revenue from a number of other sources. On the whole this non-tax revenue is more important for developing than opposed to industrial countries (http://web7.epnet.com).

As cited in Burgess et al (Newbery and Stiglitze, 1981) said that a notable feature of many non-tax interventions is that revenue can accrue directly to the government. In some cases, people may not be fully aware that they are being taxed, thereby easing collection. On the other hand, non-tax sources of revenue can exhibit a substantial degree of variability. In countries where there is a strong dependence on revenue from mineral and agricultural bases, fluctuations in world prices lead to large swings in government revenue and these shocks have many adverse effects (http://web7.epnet.com).

- ***Nationalised Industries:*** Developing countries devote a much higher proportion of expenditure to the supply of economic services than industrial countries. This often reflects a view of the role of the state as the driving force behind growth and development through ownership and control of natural resources, public utilities, transport and communications, construction and manufacturing, heavy industry, and so on. Revenue from public-sector enterprises constitutes the main component of non-tax revenue and is important in some countries. (http://web7.epnet.com)

- ***Revenue from mineral sources:*** According to (Garnaut and Ross, 1983 cited in Burgess et al) the mineral sector with its high visibility and large rents is often seen as convenient revenue handle. Governments employ a variety of means to extract mineral rents which include royalties, property/ wealth taxes, corporate income taxes, and direct monopoly control. All these mechanisms may be effective in raising significant revenue. The method or combination of methods employed is determined by factors such as the stage of development of the domestic mineral industry, administrative concerns, judgments concerning the relative efficiency of public versus private mineral companies, and considerations of national security and bargaining power. (http://web7.epnet.com)

- ***Agricultural marketing boards:*** In many developing countries, agriculture is the largest sector. Taxation of agriculture is problematic. In some countries, there has been an attempt to raise revenue through the establishment of agricultural marketing boards. The government acts as a monopolistic buyer and where farm-gate prices are set systematically below world or consumer prices, with the margin designed to exceed transport, storage, and distribution costs, government revenue is generated (http://web7.epnet.com).

Chapter Three

3.1. Macroeconomic policy

As cited in the website http://www.revisionguru.co.uk, macroeconomic policy is concerned with issues, objectives and policies that affect the whole economy. All economic analysis that refers to aggregates is macro. The unemployment rate, the inflation rate, and the rate of economic growth are aggregates and therefore macro issues. Major objectives of macroeconomic policy are: (i) full employment, (ii) price stability, (iii) a high, but sustainable, rate of economic growth, and (iv) keeping the Balance of Payments in equilibrium.

3.2. Macroeconomic stability is necessary for growth

As cited in Ames et al macroeconomic stability is the cornerstone of any successful effort to increase private sector development and economic growth. Cross-country regressions using a large sample of countries suggest that growth, investment, and productivity are positively correlated with macroeconomic stability (Easterly and Kraay, 1999). Although it is difficult to prove the direction of causation, these results confirm that macroeconomic instability has generally been associated with poor growth performance. Without macroeconomic stability, domestic and foreign investors will stay away and resources will be diverted elsewhere (http://www.imf.org).

According to (Ames et al, 2001), to safeguard macroeconomic stability, the government budget, including the country's poverty reduction strategies must be financed in a sustainable, no inflationary manner. The formulation and integration of a country's macroeconomic policy and poverty reduction strategy is an iterative process. As Ames et al noted poverty reduction strategies need first to be articulated (i.e., objectives and policies specified), then coasted, and finally financed within the

overall budget in a no inflationary manner. They added that the amount of finance, much of which will be on concessional terms, is, however, not necessarily fixed during this process: if credible poverty reduction strategies cannot be financed from available resources, World Bank and IMF staff should and will actively assist countries in their efforts to raise additional financial support from the donor community. Nonetheless, in situations where financing gaps remain, a country would have to revisit the intermediate objectives of their strategy and reexamine their priorities. Except in cases where macroeconomic imbalances are severe, there will usually be some scope for flexibility in setting short-term macroeconomic targets. However, the objective of macroeconomic stability should not be compromised (http://www.imf.org).

As Ames et al (2001) noted macroeconomic stability exists when key economic relationships are in balance—for example, between domestic demand and output, the balance of payments, fiscal revenues and expenditure, and savings and investment. These relationships, however, need not necessarily be in exact balance. Imbalances such as fiscal and current account deficits or surpluses are perfectly compatible with economic stability provided that they can be financed in a sustainable manner. There is no unique set of thresholds for each macroeconomic variable between stability and instability. Rather, there is a continuum of various combinations of levels of key macroeconomic variables (e.g., growth, inflation, fiscal deficit, current account deficit, international reserves) that could indicate macroeconomic instability. While it may be relatively easy to identify a country in a state of macroeconomic instability (e.g., large current account deficits financed by short-term borrowing, high and rising levels of public debt, double-digit inflation rates, and stagnant or declining GDP) or stability (e.g., current account and fiscal balances consistent with low and declining debt levels, inflation in the low single digits, and rising per capita GDP), there is a substantial gray area in between where countries enjoy a degree of stability, but where macroeconomic performance could clearly be improved. Finally, macroeconomic stability depends not only on the macroeconomic

management of an economy, but also on the structure of key markets and sectors. Ames et al (2001) stated that to enhance macroeconomic stability, countries need to support macroeconomic policy with structural reforms that strengthen and improve the functioning of these markets and sectors (http://www.imf.org).

3.3. Implications for macroeconomic policy

In light of the importance of growth for poverty reduction, and of macroeconomic stability for growth, the broad objective of macroeconomic policy should be the establishment, or strengthening, of macroeconomic stability. As Ames et al (2001) stated, policymakers should therefore define a set of attainable macroeconomic targets (i.e., growth, inflation, external debt, and net international reserves) with the objective of maintaining macroeconomic stability, and pursue macroeconomic policies (fiscal, monetary, and exchange rate) consistent with those targets. In cases where macroeconomic imbalances are less severe, a range of possible targets may be consistent with the objective of stabilisation. Precise targets can then be set within that range, in accordance with the goals and priorities in the country's poverty reduction strategy (http://www.imf.org).

The other thing is that most developing countries will likely have substantial scope for enhancing the quality of growth, that is, the degree to which the poor share in the fruits of such growth, through policies aimed at improving income distribution. These policies (e.g., land tenure reform, changes in marginal and average tax rates, increases in pro-poor social spending, etc.) often are politically charged, and usually require supporting structural and governance reforms that would empower the poor to demand resources and/or ensure that resources intended for them are not diverted to other groups of the population (Ames et al, 2001). Although the above items pertain more broadly to political economy, rather than exclusively to macroeconomics, they reinforce the point that economic growth alone is not sufficient for poverty reduction and that complementary redistribution policies may be needed to ensure that the poor benefit from growth (http://www.imf.org).

3.4. Fiscal policy

As Ames et al stated fiscal policy can have a direct impact on the poor, both through the government's overall fiscal stance and through the distributional implications of tax policy and public spending. Structural fiscal reforms in budget and treasury management, public administration, governance, transparency, and accountability can also benefit the poor in terms of more efficient and better-targeted use of public resources. As indicated above, there is no rigid, pre-determined limit on what would be an appropriate fiscal deficit. An assessment would need to be based on the particular circumstances facing the country, its medium-term macroeconomic outlook, and the scope for external budgetary assistance. The terms on which external assistance is available are also important. There is a strong case, for instance, for allowing higher grants to translate into higher spending and deficits, to the extent that those grants can reasonably be expected to continue in the future, and provided that the resources can be used effectively (http://www.imf.org).

According to (Hockley, 1992), fiscal policy looks initially at the role of the state, public choice, government expenditure, taxation and debt. It goes on to analyse in greater depth the aims and principles of public finance, covering the various ways the budget impacts on the economy, ability to pay, wealth, poverty and social security. Micro and macroeconomic policy is examined and the problems associated with multi-level government are considered in depth. Microeconomics is a branch of economics that studies decisions made by individual households and firms while macroeconomics deals with the economy as a whole. For instance, in macroeconomics, instead of looking at the output or prices of individual goods and services we look at the overall level of output or prices (Parkin and King, 1995). Macroeconomic policy is used to describe the actions of governments when they try to change the economy so as to achieve some objectives of distribution, allocation or stabilisation (Hockley, 1992). Policy instruments used to this end include fiscal policy, monetary and financial policy, and legislative controls.

The term fiscal policy also refers to the expenditure a government undertakes to provide goods and services and to the way in which the government finances these expenditures. It has undergone a transformation during the last five decades. It is now on the threshold of further changes. The fiscal machinery is being adjusted to meet the changing requirements of fiscal policy. An understanding of the fiscal policy is essential for gaining proper perspectives on the different aspects of budgeting (Premchand, 1989).

As Biggs (1997) noted, fiscal policy is the budgetary stance of government and it deals with how much revenue is raised, the way it is raised and spent. It mainly focuses, added Biggs, on government taxation and expenditure. Fiscal policy issues are debatable as they often involve crucial decision making in competing sectors of the government. Outlined in the annual budget of the government, fiscal policies document expenditure plans, proposed tax rates for the coming year, public sector borrowing (if required) and reflect the government's real priorities, at times contrary to what it claims on the mass media. Briefly speaking, the main functions of fiscal policy are termed as allocation function (which deals with the provision of public goods and services), distribution function (income redistribution either through expenditure or revenue side of the budget) and stabilisation function (when the economy is below full employment) (Biggs, 1997).

To carry out the above functions successfully, the government must mobilise resources and generate revenues. As Todaro (1997) noted, whatever the prevailing political or economic ideology of a country, its economic and social progress largely depends on its ability to generate sufficient revenues to finance an expanding program of essential, non-revenue-yielding public services such as health, education and other components of the economic and social infrastructure. Briefly speaking, there are two principal sources of tax revenue- direct and indirect taxes. Major sources of direct tax are personal income and property taxes, and corporate income taxes. Indirect taxes on commodities in the form of import, export and excise duties

are, on the other hand, the largest sources of revenue in developing countries (Todaro, 1997).

Therefore, the assumption is the government finances all its spending from the different kinds of taxes, user charges and other sources of revenues. If the government expenditures (including both purchases of goods and services and transfer payments) are equal to its revenues, then the government is said to have a balanced budget. However, the budget is not in balance most of the time as the expenditures exceed the revenues, in which case the budget is said to be in deficit. If the reverse happens, the government will have a budget surplus (Gwartney and Stroup, 1990).

Although the effects of fiscal policy are extensive, they are particularly measurable in areas such as employment, price stability, saving and investment, and the balance of payments. As Premchand (1989) noted, fiscal policy aims at using its three instruments – taxes, spending and borrowing- as balancing factors in the development of the economy. Formulation of fiscal policy presumes the identification and clear recognition of the institutional aspects of government finance, such as tax systems, their incidence and shifting, budget formulation and execution, and financial management. The focus of budgeting is on the attainment of efficiency in the allocation of resources within the public sector and is influenced at each stage by the goals of fiscal policy (Permchand, 1989).

3.5. Development and functions of fiscal policy

Premchand (1989) noted that the term fiscal policy came into popular use during the Great Depression. Until then, he argued, it was used to denote a policy that affected the royal or public treasury. The policy itself was an extension of the prudent fiscal behaviour excepted of an individual for balancing his income and outflow. The application of the principle involved a major difference that recognised the larger functions of the state and permitted it to borrow during emergencies. According to

(Premchand, 1989), the guarantee of fiscal prudence lay in aiming at a modern surplus so as to avoid the possibility of a budget deficit. The constraints of the balanced budget, he added, became a key operating factor for politicians and civil servants and any departure from this approach were considered to be journeys towards profligacy that would erode the prosperity of the country and eventually lead to financial ruin. The management of the taxpayers' contributions could not be left to the mercies of the spending departments, and a finance ministry or treasury was expected to provide a vigilant supervision of the activities of the spending departments. As Premchand stated, the primary responsibility of the central agency was to economise effectively and promote financial order within the government. As cited in Premchand, Durell noted that the embodiment of the general principle of a balanced budget as the guiding star of the treasury that there is some authority which will watch the progress of expenditure, the obligations which the different departments are incurring and will give timely warning if that expenditure or those obligations are either out running the revenue provided for the year or engaging the nation too deeply in the future years. Budgetary scrutiny and review therefore concentrated on the legality, propriety, economy, and efficiency of expenditures. Macroeconomic functions were not a part of the lexicon of the operating budget officials; their approach was dominated by accounting and administrative considerations (Permchand, 1989).

The onslaught of the depression in 1929 raised a number of leading issues on the role and policies of government budgets. Initially, efforts were mainly directed toward combating the depression by providing money at lower costs in order to encourage investment. However, as Permchand (1989) stated, there was no increase in investment, as businessmen were reluctant to borrow and invest at a time when the profit outlook was dim. Money became cheap but proved ineffective as an instrument of inducing investment in the private sector. He continued to say that households were not spending enough, nor governments. The situation prompted the financial policymakers to envisage government deficits to reactivate the economy and to

reduce the levels of unemployment. However, there was also the official view, reflecting in a way that continuing influence the balanced budget approaches, that government expenditures financed by borrowing did not necessarily increase employment and could be construed as merely diverting resources that would have been otherwise invested by the private sector.

Keynesian contributions, as cited in Premchand (1989), have influenced economics in more than one sphere, and they may be broadly examined in terms of economic theory, as policy prescriptions to deal with unemployment and as a philosophy that believed in government intervention for managing the economy to minimise unemployment. Keynes pointed out (cited in Premchand, 1989) that the fundamental cause of the depression was the lack of spending. The decision to save in the household sector did not necessarily lead to a decision to invest, and the government therefore had to step up its expenditures in order to prime the pump of the economy. According to (Premchand, 1989), it was recongnised that public borrowing absorbed private saving, but such borrowing contributed to greater economic activity, while money retained in the private sector would have more likely contributed to greater unemployment than to increased private investment. In Keynesian terms (cited in Premchand, 1989), budget deficits were viewed as positive instruments to shore up aggregate income to stimulate all sectors to spend more. As cited in Premchand, Keynesian economics freed the thinking of the treasury from the narrow concept of the balancing the budget to the wider role of the balancing the whole economy. Premchand noted that the Keynesian view of the state implied that it had both an obligation and an ability to control any instability in the economy and to restore functioning order.

The increase in expenditure that accompanied the more active role assumed by the state brought with it a transformation in the size of the budget, since fiscal policy could be meaningful only when public expenditure comprised a substantial portion of the gross national product (GNP). Budgets have come to be linked with management

of the economy, in turn bringing a greater consideration of the effects of expenditures on the economy. As most expenditure has come to be financed by borrowing from the public, it also becomes necessary to consider the productive capacity of the programmes being financed in order to ensure future financial viability. The budgetary process becomes more important, because the administrative, accounting, economic, and financial objectives interfaced and collectively produced a coherent fiscal policy (Permchand, 1989).

Fiscal policy became two-dimensioned as the instruments of taxation, expenditure, and borrowing could be used to control aggregate demand. Fiscal policy extended beyond its definition as a series of measures intended to provide compensatory action to fluctuations in private spending in the context of a trade cycle to the achievement of stabilisation in the economy through its influence on aggregate demand. It had to contend with both recession and inflation (Permchand, 1989).

The level of aggregate demand is not immutable, and the impact of the budget depends not on the internal consistency of its accounts but on the nature and state of the economy. As it is stated in the book entitled “Government budgeting and expenditure controls: Theory and practice”, if the economy is characterised by inflation, the formulation of a balanced budget is unlikely to be of any use. Its contribution would be, added Premchand, limited to the negative aspect of not adding any more inflationary pressure of its own. He went on further to say that the budget will have to take into accounts the trends and magnitudes of consumer expenditures and use appropriate fiscal instruments. As the nature of the economy changes either in the medium term and short term, or even during the fiscal year, it is obligatory for the government to adjust its policies and to switch horses in midstream. Thus, pursuit of stabilisation as a goal of fiscal policy involves budgetary planning and a continual assessment of the dynamics of the working and impact of the budget (Permchand, 1989).

Management of aggregate demand is a short-term function of fiscal policy. According to (Premchand, 1989), fiscal policy has aimed at stability in a growing economy. Emphasis on growth has different implications in industrial and developing countries. In the former term, the aim of fiscal policy is to ensure the full utilisation of the capacity and productive use of resources, while in the latter, it has the aim of increasing the flow of saving to the government sector for financing development expenditure and for providing related infrastructure that in turn generates more growth. As Premchand (1989) noted, fiscal policy can be used to stimulate demand and thus ensure a market for the goods and services produced, and on the other hand, to encourage the appropriate use of labour and capital to increase employment. Another role of fiscal policy is to minimize the adverse distributional impact of government policies.

3.6. Application of fiscal policy

In the early days of development of fiscal policy, it was assumed that the same technique could be used in both industrial and developing countries (Premchand, 1989). But this assumption proved to be incorrect, in view of differences in the relative levels of development. He added that fiscal policy in industrial countries was first identified with reducing unemployment by stimulating demand through deficit spending. During periods of weak demand, industrial countries have large pools unemployed productive resources, including underutilised capital equipment and managerial skills, and fiscal policy can minimse the cyclical impact through the maintenance of aggregate demand.

The situation is different in the developing countries, said Premchand, where unemployment is chronic and reflects structural bottlenecks of the economy rather than those that are cyclical in nature. In developing countries, added Premchand, injection of increased purchasing power tends to work itself out through the increased imports and increases in price rather than leading to increased production. According to (Premchand, 1989), fiscal policy is used in developing countries as an integral part

of development plans with the aim of making appropriate structural adjustments in the economy. Developing countries also used fiscal policy to counteract inflationary pressure. He further noted that fiscal policy may be directed to mopping the increases in real income and to diverting for use in financing economic development.

In developing economies, the role of fiscal policy in the long run is more positive. It seeks to reflect the aspirations of all developing countries. Fiscal policy is geared to the mobilisation of revenue resources, to their allocation among competing priorities, and to ensuring that the broad directions of the movements in the economy are in conformity with national aspirations. Particular emphasis is laid on the financing of the budget in such a way that no new inflationary pressures are generated (Permchand, 1989).

3.7. Fiscal policy to control inflation and improve deficit budget

According to the UK economist consultants to help the economy grow, you will need to maintain the level of demand in the economy. You can do this by using your fiscal policy to influence the level of demand. If you find that the economy is growing too slowly then you can try to boost demand. To do this you need to encourage spending and so you could cut taxes. This will help give people more money to spend, therefore boosting demand. Alternatively, you could as government spends more yourself - increase the level of government expenditure (to invest your money in productive economic activities). These policies are all called reflationary policies. (http://www.bized.ac.uk).

To increase growth you may therefore want to:

- Cut taxes (direct taxes or indirect taxes) Taxes are paid either directly or indirectly. Income taxes and company taxes are examples of direct taxes. A direct tax is paid directly to the government. And custom duties on imported goods are indirect taxes. Indirect taxes are paid to a secondary party (Abedian *et al*, 1997).

Taxes are ordinarily classified as being progressive, proportional, or regressive.

- ❖ A tax is progressive if its rate increase as income increases.
- ❖ A regressive tax is one whose rate decline as income increases.
- ❖ A tax is proportional when its rate remains the same, regardless of the size of the income (McConnell, 1984).

- ➢ Increase the level of government expenditure. This can be done by cutting unproductive government expenditure to shift the level of expenditure of the government into productive investment and development of the economy.

3.8. Theoretical aspect of reducing the government deficit to control inflation

According to UK economy policy advisors, to help imagine how fiscal policies work thinks of the economy as a balloon. The air in the balloon is the level of demand or economic activity. If the balloon is a little low and short of air you want to reflate it, but if it is over-expanded and in danger of bursting then you deflate it. The same is true of the economy, though when it is over-expanded instead of bursting we get other problems such as higher inflation and a larger balance of payments deficit. To solve these problems we have different policy majors given by UK advisers (http://www.bized.ac.uk).

3.8.1. Reflationary fiscal policy

Governments may choose to use reflationary fiscal policy in times of recession or a general downturn in economic activity. In this situation they will use their fiscal policy to give a boost to the economy. They may do this by lowering taxes in some form or by increasing the level of government expenditure (for productive investments). This will encourage people to spend more. If they lower indirect taxes then this will lower the prices of the taxed goods and encourage more demand. Alternatively they could lower direct taxes. This will raise

people's disposable income and therefore encourage them to spend more. Either way the level of demand in the economy should rise or help encourage economic growth.

Reflationary fiscal policies could therefore include:

- Cutting the lower, basic or higher rates of tax
- Increasing the level of personal allowances
- Increasing the level of government expenditure (investing like in infrastructure, social welfare)

3.8.2. Deflationary fiscal policy

Deflationary fiscal policy is likely to be most appropriate in times of economic boom. If the economy is growing at above its capacity, this is likely to cause inflation and balance of payments problems. To try to slow the economy down the government could either raise taxes in some form or perhaps reduce government expenditure. Either of these will reduce the level of demand in the economy and therefore the level of economic growth. It may increase indirect taxes, which will raise prices and deter people from spending so much, or it may increase direct taxes, which will leave people with less money in their pockets and so stop them from spending so much.

Deflationary fiscal policies could therefore include:

- Increasing the lower, basic or higher rates of tax
- Reducing the level of personal allowances
- Reducing the level of government expenditure

3.9. Evolution of international monetary system

"In recent history the nations of the world had used three different exchange rate systems. Over the 1879-1934 periods with the exception of the World War I years- an international monetary system known as the gold standard prevailed. From the end of World War II in the mid-1940 until 1971 the so-called Bretton wood system prevailed. These two systems both stressed fixed exchange rates, although the latter allowed for periodic rate adjustment. Since 1971 a system of essentially freely flexible or floating rates has been in operation" (Mc Connell and Brue, 1990:481). Furthermore, (Mohr and Fourie, 2000:463) said:

> Gold played an important role in the international monetary system prior to 1971. In the late 19th and early 20th centuries most countries were on gold standard. This was an international monetary system in which (i) currencies were defined in terms of gold, (ii) money supplies were linked to gold (in specified ratios) and (iii) balance of payments deficits were settled in gold. Each country adhering to the gold standard established as its monetary unit a gold coin containing a legally specified amount of gold. With currencies tied to gold there was a set of basic exchange rates expressing their relative gold content. More over, each central bank was obliged to buy or sell gold at the official price. All balance of payments imbalances between countries were also settled in gold. At the end of World War II a new exchange rate system was created. This was named the gold exchange standard or Bretton woods system. Under this system each country again fixed the value of its currency in terms of gold, as under the old gold standard, but the currencies were not backed by gold reserves. By fixing the various currencies in terms of a common denominator, exchange rates between the different currencies could be determined. These exchange rates could be changed by devaluing or revaluing currencies against gold and therefore against each other. This international system came under immense pressure during the late 1960s and eventually broke down in 1971 when the major industrialised countries switched to a system of floating currencies whereby exchange rates are determined by market demand and supply.

3.10. Monetary policy

Monetary policy is identified as one of the tools that a national government uses to influence its domestic economy. It relies on two instruments. The interest rate at which the central bank lends to its various clients, mainly the government and the commercial banks, but including other financial and even non-financial institutions in a number of countries; and the rate at which the central bank issues liabilities against itself that creates money. Control over the second instrument may be weakened to the extent that the monetary authorities fix an exchange rate, thus obliging the central bank to issue money against the presentation of foreign exchange (Little et al, 1993).

3.11. Exchange rate system

According to (Batiz, 1994; 50-51) “the intervention of central bank in the foreign exchange market is related to the exchange rate regime under which a nation is governed”. Batiz identified three exchange rate regimes. These are: (a) a freely flexible (or free-floating) exchange rate regime; (b) a fixed (or pegged) exchange rate regime; and (c) the managed or controlled, floating exchange rate regime. My focus will be on the managed or controlled exchange rates.

According to (Batiz, 1994: 51), the managed or controlled, floating exchange rate regime “exists when the governments intervene in the foreign exchange market in order to influence the exchange rate but does not commit itself to maintaining a certain fixed exchange rate or some narrow limits around it”. Batiz further goes on to say that under such a system the central bank manipulate the market places for foreign exchange; however, it does not intervene to fix the private of exchange as it would in a system of fixed exchange rate.

3.12. Determinants of exchange rates

Exchange rate could be determined by many and different factors. McConnell and Brue (1990:462-463) have identifies five elements that determine exchange rates:

- ***Change in tests:*** any change in customer tastes or preferences for the products of a foreign country will alter the demand for, or supply of, that nation's currency and change its exchange rate.

- ***Relative income changes:*** if the growth of a nation's national income is more rapid than other countries, its currency is likely to depreciate. A county's imports vary directly with its level of income.

- ***Relative price changes:*** if the domestic price level rises rapidly. Forth, relative real interest rates: restricting the growth of the money supply (tight money policy) in order to control inflation.

- ***Speculation:*** if it is widely anticipated that the economy of the country will (a) grow faster than the other economies (b) experience more rapid inflation, and (c) have lower future real interest rates than other economies. All these expectations would lead one to believe that in the future the currency will depreciate and, conversely, the other currency will appreciate.

3.13. Factors to be considered in choosing an exchange rate regime.

The choice of exchange rate regime could have either positive or negative impact on the economy of a nation. The choice of a specific regime, therefore, requires careful investigation, analysis, and assessment of the economic situation of the nation under consideration. According to (Shatz and Tarr no date given), relevant factors in selecting an exchange rate arrangement includes:

- ***The size and degree of openness of the economy*****.** The higher the share of trade in output, the higher the costs of exchange rate volatility. Thus, small, highly open economies should opt for a pegged exchange rate regime.

- ***The level of inflation*****.** A country that maintains a rate of inflation that is higher than that of its trading partners needs to maintain a flexible exchange rate to prevent a loss in competitiveness.

- ***The degree of price and wage flexibility*****.** The more rigid real wages are, the greater the need for exchange rate flexibility to respond to

external shocks. In the absence of such flexibility, asymmetric real shocks that require real exchange rate adjustments may cause large drops in output in countries with rigid labor and product markets.

- ***The degree of financial development*.** In countries with thin and poorly developed financial markets, a flexible exchange rate regime may lead to large fluctuations in the exchange rate because of a limited number of transactions in the foreign exchange market.

- ***The degree of credibility of policymakers.*** The weaker is the anti-inflation reputation of the central bank, the stronger the case for pegging the exchange rate in order to build confidence that inflation will be controlled.

- ***The degree of capital mobility*.** The more open the economy is to capital movements, the more difficult it is to defend and maintain a fixed exchange rate regime. A fixed exchange rate, in a world of high capital mobility, is a target for speculators because it offers a one-sided bet.

3.14. Balance of payments

The concept of balance of payments is indispensable in the discussion of foreign exchange. The balance of payments is "a systematic statistical account of all economic transactions between the residents of a country and the residents of other countries in a specified period" (Mohr and Fourie, 2000:460). Credit entries are those entries that will bring foreign exchange into the country, whereas debit entries record items that would mean a loss of foreign exchange. Dornbusch et al (1996: 188) said,

> The balance of payment measures the amount of foreign exchange intervention needed from the central bank. So long as the central bank has necessary reserves, it can continue to intervene in the foreign exchange markets to keep the exchange constant. However, if a country persistently runs deficits in the balance of payment, the central bank will eventually run out of reserve of foreign exchange and will be unable to continue its intervention. However, before that point is reached, the central bank is likely to decide that it can no longer maintain the exchange rate and will devalue the currency.

Chapter Four

4.1. Macroeconomic environment in Eritrea.

Eritrea is Africa's newest nation, having formalised its independence from Ethiopia by popular referendum in 1993 after a costly 30-year independence struggle. The long struggle left Eritrea with neglected and devastated institutions and infrastructure; however, it also forged a strong determination to build a self-reliant new nation, economically and politically.

With the return of peace in 1991, following three decades of war to gain independence, Eritrea has embarked upon the road to development and poverty reduction. In a short period of time, it has made significant progress in restructuring institutions, establishing key elements of a functioning government, eliminating a number of restrictive policies from the colonial period, and expanding investment in human capital. Although, in some ways, Eritrea is still operating in a post-conflict reconstruction phase, it is eager to move ahead to the next phase of development. The goal of poverty reduction is implicit in its development policies and programs that emphasise economic growth and the development of human capital.

One of the basic goals set in the nation building process after independence has been the establishment of a strong economic order that could guarantee the full progress, prosperity and improvement in the standard of living of the people. The national development objective is the creation of a modern, technologically advanced and competitive economy. The centrepiece of the strategy is the establishment of an efficient, out-word looking, private sector led market economy, with the government playing a proactive role to stimulate private economic activities.

The economy of the country was completely shattered by the long war and the deliberate Ethiopian colonial policy. On top of recovering the economy in the

immediate years after independence, the country started the challenging task of rehabilitation in order to embark into the challenging take-off stage. The main problem in Eritrea was however, the presence of a very weak and devastated economy and the inability of the country to rehabilitate the economy with national investment. The private sector is characterised by low capital, technology and management base. The market economy with the private sector playing a major role has been the most important choice for the establishment of a strong and competitive economy. The role of government has been limited to create conditions conducive to the economic development, draw up polices and strategies develop human resources and ensure responsible utilisation of resources (http://www2.unesco.org).

The main priorities of the government in terms of economic progress and prosperity have been agriculture, infrastructure development and fisheries. The national policy does not discriminate against any sector as it adheres to an integrated strategy of development but a great deal of effort has been made to raise agricultural productivity and create self-sufficiency in food within a short time. To reach these goals, the main strategy in the overall economic development is self-reliance. This is a philosophy developed and successfully implemented during the National Liberation Struggle. Eritrea achieved independence without virtually getting any outside support and assistance, by assuring the highest participation of people and a great reliance on internal capacity by properly mobilising its own resources. While this experience still holds greatly, the strategy in general does not, however, imply negating international collaboration. The basis of the philosophy is that of avoiding dependence, promoting the struggle and determination of the people towards progress and prosperity through hard work and effort and greater emphasis on the effective mobilisation and utilisation of available resources in the country (http://www2.unesco.org).

Unfortunately macroeconomic performance has been seriously impaired by the lingering effects of the border conflict with Ethiopia during 1998-2000, which has

resulted in large-scale destruction of infrastructure and dislocation of the population. The authorities have also remained concerned about the unresolved border issue and have only hesitatingly begun to implement the donor-supported demobilisation program for some 200,000 combatants. Reflecting these factors, economic growth in 2002 was negative at -1.2 percent, against 8.7 percent in 2001. The weakness of the economy and tight supply situation resulted in a sharp acceleration of inflation, with consumer prices rising by 24 percent by the end 2002, compared with 8 percent at end-2001.

Unsustainably large macroeconomic imbalances persisted in 2002 despite some reductions in the fiscal and external current account deficits. Because of substantially lower externally financed capital spending, fiscal policy turned out to be much less expansionary than foreseen under the approved budget. In the event, the overall fiscal deficit, including special programs and grants, amounted to some 30 percent of GDP, compared with 35 percent of GDP in 2001. As in previous years, covering the government deficit required a large increase in domestic monetary financing, which contributed to inflation and put additional pressure on the external balances, foreign reserves, and the exchange rate. The external current account deficit nevertheless declined to 15 ½ percent of GDP in 2002 from 18 ½ percent in 2001, owing mainly to an increase in private transfer receipts, exceptional gold sales by the Central Bank, and the shortage of foreign exchange for private transactions that curtailed imports. Official reserves of Eritrea dropped below one month of imports of goods and services in 2002.

For 2003, the Ministry of Finance prepared an austerity draft budget intended to reduce the domestic fiscal deficit (excluding all foreign-financed spending) to some 6½ percent of GDP, compared with 21 percent in 2002. On the revenue side, large increases were expected from the sales of government-owned houses and apartments, as well as the privatisation of three hotels. On the expenditure side, the principal savings were planned to come from the demobilisation of 130,000

combatants, which would have cut the defense budget in half. Because measures on both the revenue and expenditure side may be more difficult and time-consuming to implement than initially believed, the staff now projects a domestic fiscal deficit of 13 ½ percent of GDP.

In order to promote economic recovery and reduce poverty, the authorities hope to press ahead with a swift demobilisation of combatants, which would relieve the severe shortages of labor especially in the private sector, including agriculture. In addition, the authorities plan to continue their investment in human capital to raise labor productivity and improve competitiveness, and to further advance the rehabilitation and expansion of economic and social infrastructure. They are also strengthening prudential regulation and supervision to promote a sound and healthy financial sector. Other structural reforms that would increase economic growth include policies to reduce the role of government in commercial activities and strengthen private sector development. The government will be improving the dissemination of information on economic policies to increase transparency and facilitate the dialogue with the private sector.

4.2. The budgetary system of Eritrea

The determination of the national budget is through methods that all-inclusive and participatory, reflecting the broader mandates of stakeholders in society. In this regard budgetary and fiscal policies help define the political framework of general economic policies. At the “heart” of fiscal policy is the public budget, which is a mechanism of public policy in the allocation of public goods and services. In summary, the public budget is:

- A mechanism for the mobilisation of resources;
- A planning instrument that helps in the selection and financing of Government programmes;

- A projection of how Government intends to allocate public funds over the next period;
- A statement of how public funds have been allocated in previous periods, typically the previous year; and
- A specification of sources and uses of public funds over a given period, which is one year.

According to (Zerizghi, 2003), the budgetary system of Eritrea is incremental. This means a list of resource items are by listing objects of expenditures. All ministries, state agencies and budgetary bodies in Eritrea draw up their resource item requirements by filling the listed objects of expenditure. In doing this budgetary bodies can calculate their budget proposal by making plus or minus some percent on their previous year's budget.

There are various actors in the budget process. The key agencies in the preparation of the budget include the Ministry of Finance as the central coordinating agency, Government ministries as spending units and managers of the votes.

The Ministry of Finance has specific responsibility over financial and economic policies. The mission of the Ministry of Finance is to formulate and administer national financial and related economic policies, which are conducive to sustainable growth and development through the mobilisation, management and control of public funds, the enactment of appropriate legislation and the provision of necessary support services for the betterment of welfare of the people in Eritrea.

In addressing its mission and as part of the management of economic policy reforms the Ministry of Finance mobilises, manages and exercises a general direction and control on all public moneys. The Ministry formulates the national budget. In this regard the ministry identifies resources for the finance of government programmes, which are designed and prioritised accordingly.

4.3. The budgetary process in Eritrea

The annual budget preparation, in Eritrea, starts in mid of April each year with the presentation of macroeconomic projections including objectives of fiscal policy by the Minister of Finance to the Cabinet of Ministers. Then after, by mid of May the MOF, sends out a budget call after receiving general guidelines from the Cabinet on national priorities. This budget call includes budget preparation guidelines and the estimated ceiling for all ministries and budgetary bodies (State of Eritrea, 2001).

As cited in Zerizghi, each budgetary body based on the guidelines received can complete its budget proposal by August and submit the proposal to the MOF very soon. Then after, immediately budget hearing would begin. In practice, the hearing includes discussions with ministries about the budget proposal and broad programmes that are proposed to perform with this proposed money. Finally the Executive Committee would approve, disapprove or change the requested figure (State of Eritrea, 2001). For having clear insight of the theme, in the following diagram illustrated below, a summary of the main activities of the budgetary process in the State of Eritrea is presented.

Table 4.1. Summary of budgetary process in Eritrea

Time	Main activities
By mid of April	The Minister of Finance presents macroeconomic projections to the Cabinet and then after the Cabinet set out the national priorities
By mid of May	MOF sends budget guidelines and ceilings to all budgetary bodies.
By mid of August	Finalisation and submission of budget proposals to the MOF by all budgetary bodies.
By mid of September	Hearing of budget proposals in line with policy objectives and priorities.
By the end of September	The Executive Committee would approve, disapprove or change the proposal.
By the end of October	The MOF submits the consolidated budget proposal to the Cabinet of Ministers.
By the end of November	The President submits the budget draft to the National Assembly.
By mid of December	The National Assembly approves the budget, by the appropriation bill to become the legal budget for the fiscal year.

Source: State of Eritrea (2001)

4.4. Government revenue, expenditure and budget

As discussed before the people of Eritrea have suffered from decades of war, intermittent drought and economic depravation. Before independence economic opportunities were limited. As a result, most of the people now live in a state of poverty (State of Eritrea, 1998). Therefore, Eritrea as a new nation emerging from protracted devastation war for independence has many and varied challenges.

However, to meet the challenges effectively there is a need of rational fiscal management processes.

According to (Zerizghi, 2003), this involves flexible fiscal management, which can enable to increase tax collection and effectively planned government spending and budgeting. In this regard analysis of public revenue, expenditure, budget deficit and financing of budget deficit is presented below.

The table below depicts that the tax and non-tax revenues have been increasing steadily from 13 percent of the GDP in 1996, exceeding 23 percent in 2002. During the period 1996 to 2002, tax revenue averaged 83 percent of total revenues excluding grants. Similarly, as Zerizghi notes, the reform of the tax system and improvement of tax administration is expected to strengthen the performance of the tax collection process.

Zerizghi (2003) states that public expenditure has been dictated by the abundant need to meet the rehabilitation programme, mainly in infrastructure and capacity building. However, after the border conflict with Ethiopia in May 1998 broke out, expenditure for defense purpose and emergency relief also increased. In general between 1996 and 2002 total government expenditure grew from Nakfa 2513.8 million to Nakfa 5176.9 million respectively. Furthermore, during the same period, Zerizghi went on to say that current expenditures grew from Nakfa 1674.7 million to Nakfa 3656.0 million, while capital expenditures grew from Nakfa 869.0 million to Nakfa 1527.3 million. The following table depicts government revenue, budget deficit, 2003 fiscal year budget, economic growth, inflation rate, and deficit financing.

Table 4.2. Government expenditure, revenue, budget and deficit as shares of GDP

	Millions of Nakfa							
	Actual budget							
Item	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
1. Revenue	**1384.9**	**2022.8**	**1688.7**	**1895.5**	**2108.3**	**1987.3**	**2291.4**	**3341.8**
1.1. Tax revenue	1210.4	1407.3	1489.3	1537.4	1456.2	1851.7	2091.0	2352.3
1.2. Non-tax revenue	174.5	615.5	199.4	358.1	652.1	135.6	200.4	989.5
2. Grants	478.6	287.9	519.4	489.0	1204.8	1374.6	1118.4	3495.0
3. Total revenue and grants (1+2)	**1863.5**	**2310.7**	**2208.1**	**2384.5**	**3313.1**	**3361.9**	**3409.8**	**6836.8**
4. Current expenditure	1674.7	1412.8	2781.6	3213.9	3364.2	3287.3	3656.0	3005.2
5. Capital expenditure	869.0	1147.8	1437.4	2245.7	727.2	1356.6	1527.3	5278.6
6. Net lending (transfer)	-29.9	-2.5	-0.2	8.3	45.0	-98.6	-	-11.9
7. Total expenditure (4+5+6)	**2513.8**	**2558.1**	**4218.8**	**5467.9**	**4136.4**	**4545.3**	**5176.9**	**8271.9**
8. Overall balance (3-7)	-650.3	-247.4	-2010.7	-3083.4	-823.3	-1183.4	-1767.1	-1435.1
9. Deficit financing								
9.1. Domestic borrowing	595.8	62.6	1774.9	2563.0	290.0	1049.0	845.9	665.5
9.2. External loan	54.5	184.8	235.8	520.4	533.3	134.4	921.2	769.6
10. GDP at current market price	**4436.4**	**4974.0**	**5530.0**	**5982.0**	**6201.0**	**7771.0**	**9031.0**	**11154.0**
11. Deficit including grants (% of GDP)	14.00%	5.00%	36.00%	52.00%	13.00%	15.00%	20.00%	13.00%
12. Deficit excluding grants (% of GDP)	25.00%	11.00%	46.00%	60.00%	33.00%	33.00%	32.00%	44.00%
13. GDP growth (%)	9.20%	7.70%	3.90%	0.30%	-12.00%	8.70%	-1.20%	5.40%
14. Consumer price index (%)	9.30%	3.70%	9.50%	8.40%	19.90%	14.60%	16.90%	18.80%
15. Exchange rate (per USD)	6.7	7.2	7.4	9.8	9.8	13.8	14.19	14.32

Source: IMF (2003a: 31-32)

A highly expansionary budget for 2003 was approved in February and envisaged an overall fiscal deficit about 13% of the GDP including grants. In view of the need for infrastructure development, the 2003 budget called for a large expansion of capital expenditure to reconstruct the economy. Capital budget is amounted to 47 percent of the GDP in 2003, compared with 17 percent in 2002 and encompasses 64 percent of the total budget (Zerizghi, 2003).

Table 4.2 depicts government revenues, expenditure and budget deficits with its financing. As shown in the Table between 1996 and 2002, total government deficit excluding grants declined from 25 percent of GDP in 1996 to 11 percent in 1997 before rising to 46 percent in 1998. Whereas as 60 percent in 1999 and then declining to 33 percent in 2000 and 2001, and finally fall to 32 percent in 2002. The corresponding deficit including grants were 14 percent, 5 percent, 36 percent, 52 percent, 13 percent, 15 percent, and 20 percent, in 1996, 1997, 1998, 1999, 2000, 2001, and 2002 respectively (Zerizghi, 2003).

In this regard, taking the magnitude of the deficit it was necessary for the government to borrow from both the domestic and external sources. As a result, in 1999 alone the domestic public dept rose to 42 percent of the GDP from 13 percent in 1996, while the external public dept to 9 percent from 1 percent in 1996. Taking into consideration the various challenges of the country, which required major public resources for the rehabilitation, and reconstruction of physical and social infrastructures, deficit financing were unavoidable. It is important to note that the increase in the deficit in a reflection of increase in capital expenditure, which has been reflected in the infrastructure development activities of the country and also the increase in defense purpose, due to border conflict with Ethiopia (Zerizghi, 2003).

4.5. Fiscal policy of Eritrea

Fiscal policy is the exercise of tax and public expenditure functions of government, directing overall economic activity through the mobilisation, allocation, and distribution of both public and private resources, and also the stabilisation of the economy. According to (Biggs, 1997), fiscal policy is the budgetary stance of government and it deals with how much revenue is raised, the way it is raised and spent. As Black et al (1999) notes fiscal policy is government decisions regarding government expenditure, taxation and borrowing aimed at pursuing particular goals. These decisions of government about the allocation and distribution of resources are embodied in its fiscal policy and reflected in its budget. In my view, fiscal policy issues are debatable as they often involve crucial decision making in competing sectors of the government. Outlined in the annual budget of the government, fiscal policies document expenditure plans, proposed tax rates for the coming year, public sector borrowing (if required) and reflect the government's real priorities.

As IMF (2003) states the authorities in Eritrea agreed that the fiscal deficits observed over the past four years were unsustainable. They explained that the border conflict and the need to rehabilitate economic and social infrastructure had been important factors behind the recent fiscal developments. In addition, according to IMF (2003), they pointed out that significant investments in human capital were made to strengthen the country's competitiveness and its capacity to absorb new technologies. While recognising these expenditure needs, the staff argued the authorities to reduce the fiscal deficit to more manageable levels, given the existing high ratios of domestic and external public debt to GDP.

Briefly speaking, the main functions of fiscal policy are termed as allocation function (which deals with the provision of public goods and services), distribution function (income redistribution either through expenditure or revenue side of the budget) and stabilisation function (when the economy is below full employment) (Biggs, 1997).

To carry out the above functions successfully, the government must mobilise resources and generate revenues. As Todaro (1997) notes, whatever the prevailing political or economic ideology of a country, its economic and social progress largely depends on its ability to generate sufficient revenues to finance an expanding program of essential, non-revenue-yielding public services such as health, education and other components of the economic and social infrastructure. Briefly speaking, there are two principal sources of tax revenue- direct and indirect taxes. Major sources of direct tax are personal income and property taxes, and corporate income taxes. Indirect taxes on commodities in the form of import, export and excise duties are, on the other hand, the largest sources of revenue in developing countries (Todaro, 1997).

Therefore, the assumption is the government finances all its spending from the different kinds of taxes, user charges and other sources of revenues. If the government expenditures (including both purchases of goods and services and transfer payments) are equal to its revenues, then the government is said to have a balanced budget. However, the budget is not in balance most of the time as the expenditures exceed the revenues, in which case the budget is said to be in deficit. If the reverse happens, the government will have a budget surplus (Gwartney and Stroup, 1990).

Given this brief theoretical introduction on fiscal policy, I will now proceed into the practical statements of fiscal policy as outlined by the Government of the State of Eritrea in its 1994 Macro-Policy document. As stated in the Macro-Policy document of the State of Eritrea (1994) the objectives of Eritrea's fiscal policy are:

- Promote the optimal allocation of resources across sectors, institutions and regions.

- Promote an equitable distribution of income and wealth so that the benefits of development are overtime more and more equitably distributed across members of the society.
- Enhance the competitiveness of Eritrea's export products in foreign markets.
- Ensure adequate incentives for both domestic and foreign private capital so as to achieve an increasing rate of investment overtime.
- Promote domestic saving.
- Foster greater competition in the domestic market.
- Ensure that the revenue yield of the tax system as a whole grows at least in line with the growth rate of GNP.
- Strengthening tax administration.

To achieve the above-mentioned objectives, the fiscal policy has set certain specific policies namely: taxation policy (both direct and indirect tax), policy on other sources of revenue, external financial resources and expenditure policy.

4.6. Taxation policy of Eritrea

The Government of Eritrea (GOE) generates revenue predominantly from the following sources (State of Eritrea, 1994):

- Direct taxes;
- Indirect taxes; and
- Other non-tax revenues.

As part of its overall fiscal strategy the Government of Eritrea has introduced a major tax reform in October 2001. As South Africa's 2004 Budget Proposals indicated that the proposals contain a moderate easing of tax burden on income, Eritrea had the aim to reduce the tax rate, broadening the tax base and simplifying the tax schedules. As a result, the unincorporated business profits and personal income

taxes have been reduced to 38% from 51% and 85% respectively. Similarly the rate of incorporated firms profit has been reduced to 35%. The number of customs tariff rates was reduced from twelve to three, with the maximum rate cut to 25% from 200% (Melake, 2002).

The tax reform mainly the reduction of tax rate is expected to encourage and boast direct foreign investment as well, promote efficient use of resources and achieve greater equity. As usually done in many countries in Eritrea the departments of Inland Revenue and Customs Office are responsible for tax administration and revenue collection as vested by law on them.

4.7. Expenditure policy of Eritrea

In modern society government expenditure plays a vital role by influencing economic, social and political activities. This is because, efficient and equitable delivery of public goods and services is largely dependent on the expenditure policy. In this regard, government's allocation and distribution of resources is embodied in their expenditure policy reflected in the budget (Black et al, 1999).
In the State of Eritrea public expenditure allocation is governed and directed by the needs to meet the emergency and rehabilitation programmes.

Government policy with respect to expenditure is geared to:

a. The provision of essential governmental services (like defense, foreign affairs, law and order and other regulatory services).
b. The provision of basic social services (primary education and primary healthcare) with minimum charges and ensuring equal access to such services.
c. Supporting the reintegration of demobilised ex-combatants into the civilian economy.

d. Supporting the rehabilitation of war and drought dislocated, war disabled, orphans and other disadvantaged sections of the population.
e. Promoting the rehabilitation, conservation, development and proper exploitation of natural resources (afforestation, geological mapping, soil conservation, etc.).
f. Supplying supplementary services to enhance the growth of the directly productive sectors of the economy like:
    - Agricultural research and extension services.
    - Dissemination of information on investment and market opportunities.
    - Industrial and marketing research.
g. Assisting the expansion of private investment (domestic and foreign) by:
    - Undertaking complementary investment in economic and social infrastructures (power, water, finance, transport and communications, housing, education, health, etc.).
    - Initiating investment jointly with the private sector or alone in strategic productive sectors where the supply of private entrepreneurs is too short.
h. Ensuring overall macroeconomic stability by minimising the overall deficit.
i. Expenditure policy will give proper attention to prudent debt management practices.

4.8. Expenditure (spending) classification by types of services in Eritrea

As Zerizghi (2003) noted, in Eritrea, the annual budget is presented by types of services and functions. As stated in the Public Financial Regulation Act, 1994 (State of Eritrea, 1994) all Eritrean ministries and state agencies are grouped into four groups, namely administrative and general services, economic services, social services and unallocated contingency expenditures. It is as follows:

Table 4.3. Government spending by sectors

Sector	1999	2000	2001	Average
Administrative and general services	**56.56%**	**45.10%**	**40.20%**	**47.29%**
Ministry of Local Government	3.91%	4.30%	4.70%	4.30%
Defense	35.00%	37.20%	24.20%	32.13%
Others	17.65%	3.60%	11.30%	10.85%
Economic services	**25.34%**	**22.00%**	**23.20%**	**23.51%**
Ministry of Agriculture	3.41%	4.20%	2.70%	3.44%
Ministry of Fisheries	1.83%	0.80%	0.42%	1.02%
Ministry of Trade and Industry	0.18%	0.13%	0.16%	0.16%
Ministry of Tourism	0.08%	7.90%	0.03%	2.67%
Ministry of Transport and Communication	1.27%	1.70%	3.90%	2.29%
Ministry of Public Works	7.99%	3.70%	4.33%	5.34%
Ministry of Energy and Mines	7.73%	1.70%	0.60%	3.34%
Ministry of Land, Water and Environment	0.90%	0.87%	0.70%	0.82%
Financial Institutions	1.95%	0.80%	0.36%	1.04%
Emergency and Reconstruction Programme	0.00%	0.20%	10.00%	3.40%
Social services	**14.82%**	**29.20%**	**28.20%**	**24.07%**
Ministry of Education	3.48%	3.74%	3.96%	3.73%
University of Asmara	0.29%	0.26%	2.04%	0.86%
Ministry of Health	4.55%	3.10%	3.95%	3.87%
Ministry of Information	0.25%	0.32%	0.51%	0.36%
Ministry of Labour and Human Welfare	0.26%	0.32%	0.35%	0.31%
Relief and Refugee Commission	2.64%	13.70%	13.60%	9.98%
National Organisations	0.77%	0.81%	0.54%	0.71%
Support to Families of Reserve Army	2.35%	3.60%	3.16%	3.04%
Human Resource Development	0.17%	3.30%	0.00%	1.16%
Coordination of National Festivals	0.06%	0.05%	0.09%	0.07%
Unallocated Expenditure	**3.28%**	**3.70%**	**8.40%**	**5.13%**
Various Bank Charge	0.01%	0.00%	0.02%	0.01%

Subsidy	1.01%	0.44%	2.16%	1.20%
Pension Payment	0.30%	0.36%	0.30%	0.32%
Interest on Internal Dept	1.77%	2.60%	3.15%	2.51%
Interest on External Dept	0.19%	0.30%	0.99%	0.49%
Unallocated Contingency	0.00%	0.00%	1.78%	0.59%
Total Spending	**100.00%**	**100.00%**	**100.00%**	**100.00%**

Source: Ministry of Finance, Eritrea (1999-2001).

4.9. Government expenditure to resuscitate the economy

The Italian-built rail line that once stretched from the port of Massawa to Asmara and on to Agordat was totally destroyed during the war. It has been repaired within the port area and for now serves as Massawa's commuter line. The original line is slowly being repaired by hand with the purpose of decentralising Massawa's port storage capacity. The Ministry of Transportation and Communication plans to increase the storage of the Port of Massawa by building storage and transfer point in Ghindae for truck access to Asmara and Dekemhare roads for goods headed for Ethiopia (http://strategis.ic.gc.ca).

Airport construction and renovation is also part of the infrastructure development program. The Government of the State of Eritrea (GSE) has earmarked 200 million Nakfa (Eritrean currency) for the renovation of Asmara airport over a five-year period. Currently the Massawa airport is under construction, at a cost of over 280 million Nakfa (approximately US$38.9 million). The importance of the Massawa airport cannot be understated, considering the port city's importance as a tourist center, a source of export commodities including salt and fish, and the ongoing plan to convert the port into a free trade zone (http://strategis.ic.gc.ca).

Upgrading of the ports in Massawa and Assab is crucial to the GSE's development strategy of staying competitive with Djibouti as a regional service hub. A ten year

630 million Nakfa development project has begun by the end of 1998 to upgrade and convert Massawa and Assab into regionally competitive ports. In addition studies are underway to construct a new port at Tio, midway between Massawa and Assab (http://strategis.ic.gc.ca).

Construction of hospitals to give sound medical services particularly in the remote areas, government buildings, residential houses to residential shortage in poor communities, schools to increase education opportunities especially in villages and other important facilities. These constitute some of the major projects because they had minimal or little consideration during the Derg Regime while Eritrea was under the colony of Ethiopia. Based on a study conducted by the Ministry of Public Works, over 2,400 million Nakfa will be needed for construction of residential houses within the next ten years. Government expenditure in the building of hospitals, schools, government buildings, health facilities and other necessary utilities is expected to amount to 1.6 billion Nakfa. Similarly the GSE has allocated over 1.3 billion Nakfa (approximately US$180 million) for constructing four major water supply dams to expand or improve providing pure water to the people everywhere in the country. For instance the Toker Dam presently its construction almost completed by a South Korean company and began to distribute water to the people (http://strategis.ic.gc.ca).

4.10. The impact of excessive government spending on the economy

Through excessive spending, the government negatively affects the long-run economic growth rate of a free economy. Government spending reduces labour force participation by creating disincentives to work and make the labour markets more rigid by hampering the efficient flow of workers from declining industries to expanding industries, increases unemployment, and reduces productivity growth rates by inhabiting innovation and capital accumulation (http://www.house.gov).

To ensure well-functioning markets, government must expend resources to enforce contracts, provide national security, and protect against criminals. Increased government expenditures, above minimal level, have a diminishing effect on the growth of the economy. At some level of spending, the impact of government expenditures on the production of goods and services is negative (http://www.house.gov).

If resources are taken from citizens and consumed by the state, they are not available for private investment or consumption regardless of how government expenditures are financed. In the short-term, if the government grabs more resources from citizens, citizens can pay the additional burden from savings. However, in the long run, increased government expenditure reduces private investment and consumption. The economy cannot grow without increased private investment and consumption (http://www.house.gov). For instance we can take the Eritrean case. It was on May 6, 1998 a war opened between Ethiopia and Eritrea due to border conflict. It was the worst time for Eritrea because it started heavily to finance this unnecessary war. The increasing government budgetary expenditure to finance the war has slowed down its investment on other area of productive public sectors. Since Eritrea's resources have been pointed towards the war, the economy of the country was severely damaged. It is common knowledge that the war has forced the government to impose new taxes such as surtax. Increased direct taxes on business income depress saving and investment of the business sector thereby resulting in supply shortage and the rise in prices.

The diversion of the productive labour forces from the agricultural, industrial and service sectors of the economy into the war front has also created a serious shortage of labour thereby resulting in shortage of supply of goods and services. On the other hand, the defence sector into which productive labour force is diverted is non-productive and simply increases the demand for goods and services.

Due to the above reasons Eritrea is forced to import skilled human labour from Eastern Europe and Far East Asia to fill the gab. It is definitely true that Eritrea has been paying high salaries for these imported skilled. The fall in the level of unemployment due to forced employment in the defence sector has already created scarcity of labour force for the productive sectors of the economy thereby bidding up wages. My analysis is, to reduce the unnecessary expenditure; Eritrea must manage properly its human resources.

4.11. Data analysis

4.11.1. Critiques of the expenditure policy

- Most developing countries, in the absence of fully developed and locally controlled money markets have to rely mainly on fiscal measures to stabilise their economy and to mobilise domestic resource (Todaro, 1997). From this point of view, Section (h) of the expenditure policy, which argues towards 'ensuring overall macroeconomic stability by minimising the overall deficit' is a good start. However, it did not analyse whether the current deficit is sustainable or not and why and how should it be minimised. If so, it should not be without any analytically sound and empirically justified target of this reduction in the overall deficit. This means, the outcome cannot be objectively and critically analysed at a given period of time, unless there is a yard stick against which such analysis could be conducted.

- Its 'macroeconomic stability' policy as described in section (h) seems ambitious despite the daunting tasks of providing basic social services, supporting thousands of demobilised ex-combatants and rehabilitation of over a million war and drought dislocated, war disabled orphans and other disadvantaged groups of the population as outlined in section (c) and (d) of

this policy. The fiscal policy implications of these programmes are not clearly articulated.

- The policy objectives as outlined in the macro-policy are qualitative descriptions of what the government aspires to achieve. They are not quantitatively expressed for a specific time period. However, objectives should be SMART (which stands for- Specific, Measurable, Achievable, Realistic and Timely).

4.11.2. Rationale for fiscal and expenditure policies

The above stated objectives of the fiscal policy are derived mainly from the allocation, distribution and stabilisation functions of the policy. These functions are more relevant to Eritrea, a new country that is rising from the ashes of war, destruction, conflict and conflagration, colonial rule and oppression entering towards a new era of peace and prosperity, of development and democracy. These objectives are also part of the government's focus on social services (such as education and health) and infrastructure based on the belief that such expenditures are productive as they, not only promote the country's economic well-being but also encourage private investment. On top of that it is mainly derived from the government's understanding of governance as a process or system that leads to growth and economic development by directing its focus into human capacity development, rebuilding public institutions and infrastructure, and providing efficient services and development programmes. If we take education, health infrastructure and energy source in pre and post-independent Eritrea, for instance, it reveals a remarkable improvement. The following brief overview on these sectors will highlight some of its significant achievements in relation to public service delivery as outlined in section (a) and (b) of the Expenditure Policy.

- ***Education:*** as to my analysis comparing Eritrean education with that of South Africa, it is as South Africa took education, training and skills development as key foundations of social and economic progress, and preconditions for addressing inequality and division in society, Eritrea has taken these as major concern and gave priority to put them into action. During the long periods of colonisation, Eritreans had limited access to formal education, though the people traditionally placed a high value on learning. To improve access to education since independence (1991), the Government of the State of Eritrea has increased its annual expenditure on education from 4 percent 7 percent. Moreover, the government plans to further increase this share of expenditure by 15 percent annually between 2001 and 2005 (Ministry of Information, 2002). Investment in quality of education and promotion of work related training opportunities should remain the first priorities of the Government over the decade ahead as South Africa doing to produce quality human resource in the country. If we take formal early childhood education, for instance, in Eritrea it is divided into primary school (grades 1-5) and middle, or junior secondary school (grades 6-7). According to (the Ministry of Information, 2002), formal early childhood education has improved dramatically. As we can see from the overview of the 2004 Budget of South Africa, the literacy rate has increased from 38% to 96% between 1996 and 2001; Eritrea has also achieved the following percentages since independence. The following tables reveal this fact.

Table 4.4. School enrolment

School Enrolment	1991/92	1999/2000	% Increase
Elementary	109,087	295,941	270%
Middle	27,556	74,317	270%
Secondary	32,140	59,626	185%

Table 4.5. Growth of schools

Growth in schools	1991/92	1999/2000	% Increase
Elementary	214	655	306%
Middle	59	131	222%
Secondary	19	38	200%
Technical/Vocational	2	10	500%

Source: Ministry of Information (2002: 99).

Similarly literacy and informal education, secondary school, and post-secondary education are also improving both in quantity and quality. To encourage competition among the students, those who perform above average are eligible for financial assistance with education-related expenses, though all tuition costs are covered by the state. On top of that qualifying students also have the opportunity to go abroad on scholarships for post-graduate study in South Africa, Europe, USA and elsewhere. Students who are/were in South Africa for skills development are typical example for this huge investment in Eritrea. The $60 million World Bank concessional loan funded Human Resource Development Programme reveals the government's commitment to upgrade its human capital so as to realise its development objectives. In relation to vocational training, the government moved rapidly to set up skill development programmes within existing secondary schools and in new centers to meet post-war reconstruction and development needs and to facilitate the reintegration of people disadvantaged by the decades-long conflict.

- ***Health:*** Providing adequate healthcare to meet the basic needs of its citizens is an important aspect of Eritrea's strategy to reduce poverty and develop the country. Since independence, the Ministry of Health has focused on bringing quality primary healthcare services to all people at low or no cost. To ensure equity in the distribution of public healthcare services, the Ministry of Health

trains community health workers and provides them with ongoing advice and assistance. Special care is paid to delivering health services to the nomadic population, who use care facilities less often than settled villagers. Moreover, the Ministry works all over the country to eradicate malaria, TB, HIV/AIDS, common childhood diseases, diarrhea diseases and other communicable and non-communicable diseases. Successful achievements in the health sector include: immunisation rates that increased from 10 percent in 1991 to 60 percent in 1999, eradication of polio and diphtheria since 1998, and all communicable diseases (Ministry of Information, 2002).

From distribution point of view, to bring healthcare services to rural Eritreans, the government built or upgraded 45 health centers, 48 health stations, and 37 small clinics from 1993-1999. A decade after liberation, nearly 75 percent of all Eritreans live within ten kilometers of healthcare facility, compared with just 10 percent in 1991 (Ministry of Information, 2002).

- ***Infrastructure:*** when it comes to infrastructure comparing with that of South Africa, to accelerate the pace of economic growth, South Africa took measures to invest in infrastructure and improved maintenance of public assets, which remain critical challenges for the decade ahead. Eritrea has also done huge investment to rebuild the infrastructure to develop or increase economic growth. This investment has been done almost in every part of the country. As mentioned in the introduction part Eritrea's infrastructure lay in ruins. It had been badly destroyed by the long war and neglected for decades by the occupying power. Since then the roads connecting major towns and cities have been repaired and improved, the seaports have been substantially rehabilitated, airports have been expanded, and work on railway has resumed operations, but much more remains to be done.

Even though they are only quantitative descriptions of the changes over the last decade and not followed by financial implications, all these and other basic social services should definitely cost the government more than its current revenues. In such situation, as already discussed, the government is said to have a budget deficit. According to the World Bank, Eritrea's fiscal deficit (including grants) increased from 6% of GDP in 1997 to 48% in 2000. It seems that the government is spending more on these in an attempt to influence aggregate demand in a typical Keynesian view. Perhaps the following table from the IMF (2000) could summarize the increasing trend of the overall expenditure than the revenue.

Table 4.6. Revenue and expenditure

	1995	**1996**	**1997**	**1998**	**1999**
	(Percentage change)				
Total Revenue	38.9	3.9	43.4	-11.0	-2.9
Total Expenditure	33.6	1.5	-4.9	48.0	20.8
	(In percent of GNP)				
Total Revenue	28.4	26.7	32.9	29.5	24.9
Total Expenditure	57.6	53.1	43.3	64.5	67.9
Overall balance (cash, excl grants)	-29.2	-26.3	-10.4	-35.0	-43.0

Source: Adapted from IMF Statistical Appendix (2000).

- ***Energy expenditure:*** The energy sector also represents a very substantial portion of national infrastructure development. The Hirgigo power plant and grid expansion project has an investment cost of at least $160 million over about five years. This represents more than $30 million per year of capital investment expenditure. In 1997 capital expenditures by the Eritrean government were 19 percent of gross national product, and capital investments by the private sector were 829 million Nakfa or 14 percent of GNP. Energy sector investments are at least 5 percent of GNP and represent

more than 15 percent of national capital expenditures recently (http://www.punchdown.org). The Hirgigo power plant has already started distributing energy almost to the whole part of the country.

According to Buskirk the macro economic data described above shows that the energy sector has a very substantial role in Eritrea's development. Energy sector investments are very important for long-term economic strategy for several reasons. One reason is that the size of the energy import expenses and the drain that they provide on national balance of payments. The second reason stems from the importance that access to electricity has economic development and improved standards of living. The effectiveness of electrification in enhancing productivity means that the pace of electricity demand growth will continue at its current rapid rate. The current electrification rate in Eritrea is about 20 percent, and as complete electrification is attained, we can expect national expenditures approaching 500 to 1000 Nakfa per year for electricity supply. The third factor that makes energy sector development a crucial strategic issue is the fact that current and future biomass consumption is a potentially growing drain on Eritrea's ecosystem. There is rather limited biomass in Eritrea because biomass production is limited by scarce rainfall. Therefore energy sector investments that decrease biomass consumption will have a large impact on Eritrea's future environmental capital. Energy sector investments in the near-term will have a dramatic impact on future energy sector expenses and environmental sustainability (http://www.punchdown.org).

Based on the above analysis from my own point of view the critical argument is that if there are no improvements in efficiency in the energy sector, then the rapid growth of energy demand will degrade Eritrea's environmental capital and expand Eritrea's already large international trade deficit. My argument is if aggressive investments are made in all subsectors of energy development I

believe that both substantial environmental rehabilitation can be achieved, and Eritrea's trade deficit can be improved with enhanced national capital accumulation.

4.11.3. Recent trends and their implications

Since the publication of the Macro-Policy in 1994, a number of political-economic developments took place. Eritrea, while working hard towards the realisation of its development objectives, has passed through a number of challenges and hard times.

Due to the drastic effects of the 1998-2000 border conflict with Ethiopia, the growth rate of Gross Domestic Product (GDP) decreased from 7.7 percent in 1997 to 0.3 percent in 1999 and fell to –11.9 percent in 2000 (World Bank, 2002). Prior to mid 1999, inflation was largely under control but increased to 19.9 percent by 2000. From public expenditure point of view, in addition to the sudden displacement of approximately 1.1 million people and deportation of around 70000 Eritreans from Ethiopia, the direct war damage to roads and bridges, power and telecom installations, schools, clinics, water supply and sanitation facilities, factories and farms was estimated to total some US$582 million, about 88 percent of GNP in 1999 (Eritrea-Demobilisation and Reintegration Program, 2001). The mobilisation of around 200,000 soldiers, heavy spending on new military hardware and the loss of revenues from the port of Assab (Eritrean port, which was mainly used by the Ethiopians) have combined effect to depress the economy. According to the preliminary IMF data (2000), had a trade deficit of US $481 million, with exports earning only US $26 million. Due to the continued political instability, the country is unable to use its strategic location along the Red Sea coast to develop its tourist industry and export oriented manufacturing industry.

The conflict brought significant challenge to the realisation of the ‘Expenditure Policy’ of the macroeconomic policy. Consequently, provision of basic social services such as education and primary healthcare, supporting and rehabilitation of war and

drought dislocated, war disabled, orphans, etc. and performing the other activities of the policy proved quite difficult, if not impossible.

To implement the main functions of fiscal policy – allocation, distribution and stabilisation function the government needs large sum of revenue but on the contrary, the tax collection rate also decreases from 20 percent in 1997 to 16.5 percent in 2000. Hence, Eritrea, like many other less developed countries, is currently facing problems of rising fiscal deficit (a situation where public expenditures are greatly in excess of public revenue), rising debt burdens, rising commodity prices, growing trade imbalances and declining foreign private and public investment flows.

Chapter Five

5.1. Eritrean monetary policy

Monetary policy is an instrument that complements fiscal policy through the finance of the public sector borrowing requirement, monetary management and also through the supervision of the banking, monetary and financial systems. The primary objective of macroeconomic stabilisation policy is to create a conducive environment for business to grow, and for households to experience an improvement in welfare through low prices and low interest rates.

Until 1997, when the Nakfa (nfa) Eritrean currency was introduced, the legal tender in Eritrea was the Ethiopian Birr. However, after November the Nakfa has replaced the Ethiopian Birr.

There are economic reasons why Eritrea took the important step of introducing its own currency. During the seven years common currency era, the Ethiopian monetary authorities conducted a monetary policy for the Birr as a whole. Eritrea was in no position either to conduct its own monetary policy or to influence Ethiopian monetary policy. The goal was, therefore, to take control of Eritrea’s monetary policy and ensure independence from Ethiopia. This strategy enabled the National Bank of Eritrea to adopt a rate of exchange policy that allows each bank to set exchange rates and convert Nakfa to hard currency freely (http://home.planet.nl).

The year 1997 was the first time in its history; Eritrea has the authority to formulate and conduct its own monetary and foreign exchange policy. The Bank of Eritrea, the country's central bank, has already established policies based on market principles. It has eliminated foreign exchange declaration requirements for visitors coming into and leaving Eritrea. Exporters are allowed full retention of their foreign exchange

earnings. The fixed exchange-rate policy of the common currency era has been abandoned for a managed-float exchange-rate system (http://home.planet.nl).

According to (IMF, 2003), monetary policy has in recent years been dominated by the financing needs of the government's sizeable fiscal deficits. Money supply increased by 26 ½ percent in 2001 and 18 ½ percent in 2002, with credit to the government as the driving force (http://www.imf.org).

Because of the precarious international reserves position and the virtual fixing of the official exchange rate, a dual exchange rate system has emerged in which the differential between the official and parallel market rates has risen markedly. Under the system, official transactions and other priority needs are being conducted in the official market, while the vast majority of private transactions, including bona fide current transactions, are being channeled through the parallel market. While the official rate has been kept largely unchanged at some ERN 14 per U.S. dollar since September 2001, the rate in the parallel market has lately moved up to between ERN 22 and ERN 24 per U.S. dollar.

Directors of the IMF observed that monetary and exchange rate policy had, over the past years, been entirely subordinated to the large financing needs of government. They called on the authorities to restore the effective independence of the Central Bank, and strengthen its transparency and accountability, so that it can concentrate on achieving the inflation and external balance objectives. They supported monetary tightening and a return to positive real interest rates. In addition, directors urged the Central Bank to develop a coherent and transparent monetary policy framework that is better coordinated with fiscal policy, is supportive of the exchange rate regime to be put in place, and provides for a firm nominal anchor.

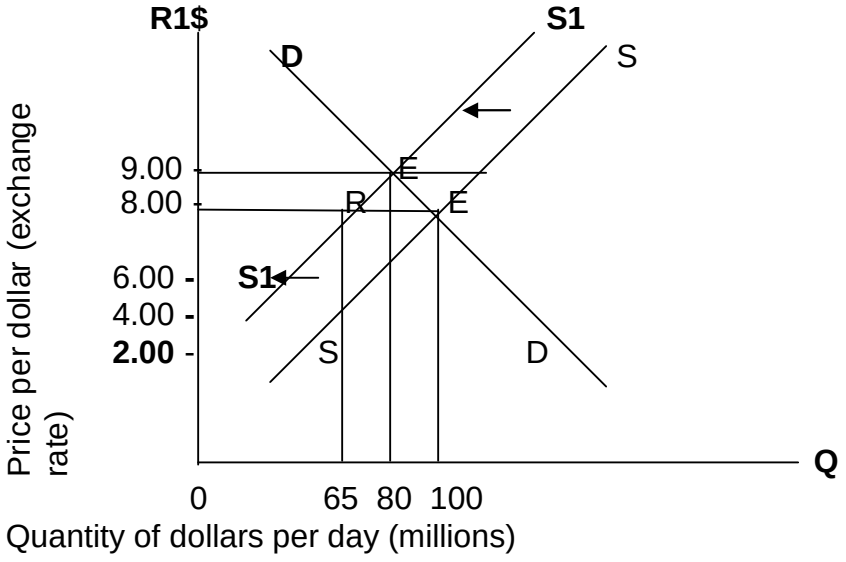
As IMF (2003) noted directors expressed concern about the pervasiveness of exchange restrictions and distortions under the present dual exchange rate regime.

They stressed the importance of unifying the official and parallel foreign exchange markets and introducing a single flexible exchange rate. The move toward such a regime should be supported by a phased removal of the existing exchange restrictions on current transactions.

5.2. Managed, or controlled exchange rates

Mohr and Fourie (2000:472) said that, “If the foreign exchange market is left to its own devices, exchange rates will probably fluctuate quite wildly since the demand for and supply of foreign exchange are not synchronised on a day-to-day basis”. Mohar and Fourie further said that, as a result of this, and because the authorities often wish to use the exchange rate to pursue particular policy objectives, the exchange rate between say, the US dollar and the Nakfa is to some extent manipulated or managed by the Central Bank (Bank of Eritrea). This is called managed floating. Controlled or managed exchange rate regime could be explained more with the help of the following figure.

Figure 5.1



Adopted from Mohr, and Fourie (2000:471).

When the supply of dollars decreased from SS to S1S1, the result was an excess demand for dollars at the original exchange rate of $1= nfa 8. 00. This excess demand is indicated by the difference between $ 100 million and $65 million. At an exchange rate of $ 1=nfa 8,00 the quantity supplied according to the supply curve S1S1 is $65 million (which corresponds to point R) but the quantity demanded according to SS is $ 100 million (corresponding to point E). The difference of $35 million, which is also indicated by the line between R and E, is the excess demand for dollars. In the absence of any Reserve Bank intervention, the excess demand will push up the price of the dollar to Nakfa 9.00. However, if the Bank of Eritrea has the necessary dollar reserve, in order to avoid such a depreciation of the Nakfa, it can sell 35 million dollars to the market at Nakfa 8.00 each. In other words it can add to the supply of dollars at that exchange rate. By doing so the Bank of Eritrea avoids the development of an excess demand for dollars and avoids an appreciation of the dollar (i.e. a depreciation of the Nakfa) as well. This is how managed floating works. The Bank of Eritrea (Reserve bank) monitors developments in the foreign exchange market and decides whether or not to intervene if it decides to intervene it can also do so partially by supplying fewer than RE (i.e. 35 million) dollars. In such a case the exchange rate will settle somewhere between Nakfa 8.00, and Nakfa 9.00 per dollar. The Bank of Eritrea can intervene to stabilise the exchange rate if it has the necessary reserves to do so, unless there is an excess supply of dollars which it can then purchase and add to its reserves.

5.3. Black market

It is evident that, developing countries generally do not permit free markets in foreign exchange and impose many restrictions on foreign currency transactions such as government licensing requirements, limited amounts of foreign currency that may be purchased, or at times out right prohibitions. Therefore, as the result of government restrictions or legal prohibitions on foreign exchange transaction, illegal markets in

foreign exchange develop to satisfy traded demand. These illegal markets are known as black markets (McConnell and Brue, 1990).

In Eritrea foreign exchange laws are strictly enforced. According to the foreign exchange laws, exchange of foreign currency could take place only at commercial and housing banks (which are owned by the state) or at the small private bureau de exchanges, which are licensed to undertake such business. Any exchange activities outside of this is construed as illegal and is punishable by law. The macroeconomic implication of black market is to create inflation and has the potential of destabilising the economy. However, due to the limited foreign currency reserve of the country and because the Central Bank allows foreign exchange at official rate only to the strategic imports, many importers could not get the required amount from the government at an official rate and therefore are compelled to buy foreign currency at a relatively higher rate from the black market which is illegal.

5.4. Data analysis

5.4.1. Critiques of controlled exchange rate

- As explained earlier Eritrea had liberalised the country's foreign exchange market in 1997. Accordingly several foreign exchange bureaus received licenses and are continuing to operate. In order to defend the values of a national currency and thereby maintain the stability of the exchange rate and price, controlled exchange rate regime is of paramount significance. In the case of Eritrea, the Central Bank has played a great role in preserving the value of the national currency (Nakfa) and thereby stabilising the price by entering the foreign exchange market when necessary. In its endeavour to stabilise the currency Nakfa, for instance, Eritrea has managed to preserve the value of the currency. That is the currency (Nakfa) remained fairly stable until 1998. However, as it is well known the controlled exchange rate regime operates well as long as the Central Bank has sufficient reserve. In other words the Central Bank continues to intervene in the foreign exchange market

and maintain the exchange rate only if it has adequate foreign reserves. The problem with controlled exchange regime appears when countries experience a continuous balance of payment deficit. Under such a circumstance the Central Bank can no longer be in a position to defend the value of the currency and maintain the exchange rate. Therefore, the bank in the end will be compelled to devalue the currency. This was what exactly happened in Eritrea. The official exchange rate in the country in 1997/1998 was $1 to 7.2 Nakfa; in 1999/2000 was $1 to 10.2 Nakfa and from 2001 to present $1 to 14 Nakfa (http://www.usatrade.gov).

- In order to intervene in the foreign exchange market thereby maintain the exchange rate, countries opting controlled exchange regime should secure a sufficient and sustained foreign currency reserve. However, in the case of Eritrea this seems not feasible in the short run. Because, firstly, the highest foreign exchange earner in the country is remittances from nationals abroad, which bring in around $300 million annually (http://www.geocities.com). As to my analysis from the data obtained remittance is not reliable source and its sustainability is questionable. Secondly, Eritrea's international trade experience i.e. export and import activities shows that, there is a big discrepancies in the $ value between what is exported and what is imported. For instance, in the year 1996 exports and imports were $95 million and $514 million respectively. In 1999, the export decline to $26 million mainly due to the boarder war with Ethiopia and import was increased to $560 million (http://Africa.Iafrica.com). In all transactions imports are exceeding by far exports, in other wards; demand for foreign currency (dollar) is higher than its supply (U.S. Embassy Asmara, 1998). Actually, this massive problem was the consequences of the three-year border dispute with Ethiopia that depleted all the foreign currency to defend the country and preserve it sovereignty.

- According to (McConnell and Brue, 1990: 473) the controlled exchange rate regime has both pros and cons. According to the proponents, the system has functioned far better than anticipated during its relatively brief existence. Trade growth and managing turbulence are among the advantages of the system. However, on the other side the critics argue volatility and adjustment are the problem of the system i.e. the exchange rate has been excessively volatile under the managed float. Furthermore, the critics argues that the managed float is basically a “no system” i.e., the rules and guidelines circumscribing the behaviour of each nation vis-à-vis its exchange rate are not efficiently clear or constraining to make the system viable in the long run. In other world nations will inevitably be tempted to intervene in the foreign exchange markets, not merely to smooth out short-term but to prop up their currency if it is chronically weak or to purposely manipulate the value of their currency to achieve domestic stabilisation goals.

5.4.2. Rationale for adopting managed/controlled exchange rates

Freely fluctuating exchange rates may have several significant problems. For example uncertainty and diminished trade and instability. The risks and uncertainties associated with flexible exchange rates may discourage the flow of trade. Besides, a nation’s terms of trade will tend to be worsened by a decline in the international value of its currency. Freely fluctuating exchange rates may also have destabilising effects upon the domestic economy as wide fluctuations stimulate and then depress those industries producing internationally traded goods (McConnell and Brue, 1990). DiLiberto (1989) also said, it is certain that a system of free exchanges would lead to extremely undesirable results. It would incite capital flight and violent fluctuations. There are very few instances of really free exchanges in monetary history and none that could be called successful. According to Sadie (1979) (cited in Dornburch, Fischer, Mohr and Rogers, 1996:423), “Truly free floating would produce only instability”. Therefore, for the above reasons, I argue that free floating is not an ideal

exchange rate for Eritrea. Fixed rates exchange regime has got also a problem, which could halt the development effort of Eritrea. McConnell and Brue (1990:468) have identified the following objections to this regime.

> First, like trade controls- tariffs, quotas, and export subsidies- exchange controls distort the pattern of international trade away from that based upon comparative advantage. Second, the process of rationing scarce foreign exchange necessarily involves discrimination among importers. Third, controls impinge upon freedom of consumer choice. Fourth, there are likely to be enforcement problems. The market forces of demand and supply indicate that there are importers who want foreign exchange badly enough to pay more than official rates. In other wards there would be the creation of 'Black market'.

Fixed exchange regime was a system adopted during the common currency era with Ethiopia. It has proved itself to be problematic for the country. Among other things, it does not fulfill the requirements of the development cooperation partners of Eritrea.

When it comes to dual exchange rates; although in principle a dual exchange rate system could provide a greater degree of stability to the commercial foreign exchange market than other exchange rate systems, in practice the regime suffers from certain problem. First, there is a danger that the commercial exchange rate will be fixed at an artificially low level, which would result in an overvaluation of the domestic currency. Dual exchange rates are often established by governments whose goal in setting up the system is to avoid domestic currency devaluation. This overvaluation cheapens foreign currencies and encourages domestic imports at the expense of exports. It is evident that, such a move curtails the ability of the country to export competitive products in the world market (Batiz, 1994). In the case of Eritrea, however, this is absolutely against its development plans because the country is pursuing export oriented development approach. In other words, it encourages domestic importers rather than exporters and hence the dual exchange regime is not an option for Eritrea.

The Government of Eritrea adopted the controlled exchange rate regime, according to the best of my understanding for the following reasons. First of all the other foreign exchange regimes i.e. free floating and fixed are not suitable for the development scheme of the country. On top of that, Eritrea is a small size country, which needs only about $350 million per year to undertake all its trading activities according to the Ministry of Trade. I think this is an amount which the government would be able to secure from different foreign currency source such remittances, exports, and donations, provided that peace is prevailing. Therefore, if peace prevails and if the country puts its full attention on its development efforts then the country would be in a position to generate all foreign (hard currency) which is sufficient for the country. Hence under such a circumstance the controlled exchange regime would be appropriate for the country.

The other reason can be, the Central Bank of Eritrea like all other reserve banks has the responsibility to defend the currency and maintain its stability. Furthermore, according to the macroeconomic policy of the country, price of the basic goods and service should be stabilised and as far as possible should remain constant. In order to realise this objective the Central Bank has to intervene, to a certain extent, in the foreign market for stabilisation purpose.

5.4.3. Recent trend of controlled exchange rate regime

In this globalisation era, adjustable fixed systems have not proved viable over any lengthy period, especially for countries that are integrated into the international capital markets. Fixing the exchange rate is therefore not an option to consider seriously in an environment characterised by close integration of financial markets (Reserve Bank of New Zealand, 2002). According to Bond (2001:22), most of the macroeconomic reforms that IMF and World Bank teams insisted Africa countries pursue are:

> Government budget cuts, and privatisation of state enterprises, the lifting of price controls, subsidies and any other distortions of market forces, higher interest rates, and deregulation of local finance, the removal of import barriers (trade tariffs and quotas), and the liberalisation of currency controls and currency devaluation.

Most Africa countries have undergone financial liberalisation and deregulation reforms. Some others are on progress. Because financial liberalisation is one of the criteria imposed by the World Bank, IMF, and other donor institutions on the third world countries in order to cooperate and assist them on their development endeavours.

According to (Mnyanda, 2003), the International Monetary Fund (IMF) gave strong support to South Africa's policy of removing exchange controls gradually, warning that a big bang removal could trigger large capital outflows. Mnyanda goes on to say, in its annual report on SA, IMF said, it was also possible removal of controls could bolster confidence and trigger capital inflows. However, IMF agreed any further "significant relaxation of the controls should proceed only once a period of stability has been restored to the foreign exchange market and international reserves had been rebuilt to comfortable levels". Therefore, this is to mean that, the controlled exchange regime is also favoured or supported by the IMF (International financial institution), which insist on financial liberalisation.

Therefore, the recent trend on the foreign exchange policy (controlled exchange regime) adopted by Eritrea is in line or in agreement with most countries, more importantly with the principles and policies of the major cooperation partners. Hence I presume it would have a positive impact on its development endeavour.

Chapter Six

6.1. Conclusion and recommendation

6.2. Conclusion

Budget is the quantification of activity plans or strategic plans in monetary terms and has to be preceded by meticulous and proper planning of activities through the participation of implementers. It has been always the case that budgets not prepared through the participation of the concerned are not realistic and will not be implemented effectively and efficiently. The final implementation of the strategies in an effective, efficient and economic way requires full-hearted participation of all the concerned. Therefore, the final implementers need to participate in the preparation of action plans, strategies and in-fact, preparation of budgets.

Budget is the principal instrument by which government translates into action the policies and programs stetted out in its development plans, and it plays a pivotal role in the financial management of the economy.

In a nutshell, the process of participatory budgeting is grounded on elements of accountability, transparency, local capacity building, and ownership and sustainability that have profound implications to poverty reduction and good governance.

The budget framework follows three important stages which include (a) design, (b) consideration by Cabinet, and (c) distribution to line ministries. The budget framework is formulated in view of resource limitations facing government, as represented by the revenue base. Revenue is a critical element in the development of the annual budget, with the revenue assumptions being dependent upon economic performance. The budget framework also goes further to determine what outcomes are associated with various levels of revenue and expenditure, such as the budget

deficit, inflation, interest rates, balance of payments and size of domestic and foreign debt.

Fiscal policy on the other hand refers to the exercise of tax and public expenditure functions of government in addressing objectives of macroeconomic stabilisation and development policy. The key objectives of macroeconomic policies can be summarised as stabilisation and growth. Working in complementary fashion monetary and fiscal policies allow government to respond flexibly and proactively in dealing with business and economic cycles and in addressing attendant problems of recession, unemployment, inflation and incomes. In terms of stabilisation fiscal and monetary policies allow government to engage counter-cyclical strategies and also minimise the incidence or impact of financial and economic shocks. Fiscal policy allows public policy, through deliberate government tax and expenditure programmes, to respond to concerns of society on issues that directly impinge of welfare such as inflation, incomes, employment, investment and economic growth. In this regard fiscal policy also helps define the political framework of general economic policies.

Eritrea is confronted with a wide range of serious economic challenges, including management crisis and macroeconomic stabilisation in the near term and moving toward peacetime economy in support of growth and poverty reduction over the medium term. The most critical immediate challenge is the management of the worst drought since the country's independence. Despite shortages of skilled human resource, government bodies are working hard to address these challenges. The environment is focusing on macroeconomic policies as well as strategic policy issues such as sources of growth.

Given the country's natural resources, the labour force is Eritrea's most promising source of growth. Government bodies argued that rapid implementation of the demobilisation programme would be needed to relieve the widespread shortage of

skilled labour in the private and public sectors. To raise labour productivity and competitiveness, there is a pressing need to provide extension services, distribute improved seeds and other inputs in the agriculture sector, and to promote human capital development. Investment in education and health sectors are increasing from time to time. Considerable resources are spent under the demobilisation and national service programmes to provide combatants and civilians with useful skills formation.

The authorities of Eritrea stated that they are aware of the seriousness of the macroeconomic imbalances facing the country. They regarded 2003 as a year of transition, during which they intend to provide clear signals about their commitment to macroeconomic stability and lay the foundations for a more formal conduct of macroeconomic and development policies.

Choice of exchange rate regime can affect macroeconomic and financial outcomes. “Developed countries differ from emerging market economies in several ways. They have a higher per capita income; long-established institutional structures associated with rules-based democracies and significant social welfare programmes. All of this allows for a greater measure of robustness in response to economic shocks of various kinds”(Reserve Bank of New Zealand, 2002).

However, it is apparent that from the prevailing economic situation of Eritrea, the Eritrea monetary system, like the US and major western system, could not meet the conditions necessary to implement a policy of free floating. Furthermore, as Dornbusch *et al* (1996) suggested; in world of floating exchange rates, countries of third world, like Eritrea, importers and exporters are subject to significant currency risk, which makes planning difficult. Hence, adopting the policy of free exchange rate would be detrimental to the development effort of the country (Eritrea).

Monetary policy has been entirely subordinated to the financing needs of government, despite a central banking law that gives the Bank of Eritrea significant

independence. An autonomous monetary policy became possible with the introduction of a domestic currency, but the border conflict with Ethiopia that followed shortly thereafter did not give much room to the Bank of Eritrea to pursue its main statutory objectives, notably to safeguard the value of the national currency. Instead, the net claims of the Bank of Eritrea on the government increased strongly, exceeding 80 percent of the bank's net domestic assets since 1999. These developments have led to rising inflation and growing current account deficits and foreign reserve losses. The staff, therefore, underscored the importance of reducing the fiscal deficit and curtailing its bank financing.

Last but not least in order to maintain the value of the national currency thereby stabilise the exchange rate and the price of goods and service the adoption of the controlled exchange rate regime for the countries like Eritrea is indispensable.

6.3. Recommendation

In the analysis I found that there are about 200,000 soldiers on the process of demobilisation who are beyond the capacity of the country to be hold as permanent. They are also active productive forces to the country. Therefore, the Government of the State of Eritrea should accelerate the demobilisation programme to let them participate in the process of reviving the economy of Eritrea severely affected during the border conflict. To do this the Government should allocate huge budget. Besides, the establishment of peacetime economy requires to dedicatedly engaging to reintegrate them into the society. It also requires reassessment of the role of the government in the economy and adoption of policies aimed at promoting private sector development in support of broad based growth, employment generation, and poverty reduction.

Because of the small size of the Eritrean economy, significant economic growth and transformation can only take place if Eritrea exploits all opportunities for export of

goods and services, both traditional and new, and is open to foreign investment. In this effort, Eritrea can take advantage of its strategic location in the north-eastern part of Africa, a long history of sea-trade through the two ports of Massawa and Assab, a past industrial tradition, and the skill, knowledge and wealth of its expatriate community. It should continue to implement and deepen its policies towards a liberal trade regime, the promotion of foreign and domestic investment, and the maintenance of a pragmatic exchange rate policy. It should also rehabilitate critical port and road infrastructure.

Applying Keynesian model to the Eritrean context, where the country's economic resources are under utilised due to the recent border conflict (for instance over 200,000 economically productive labour relocated to defence) and overall economic underdevelopment (like any developing country), expansionary fiscal policy can stimulate aggregate demand and help direct the economy to its full employment capacity. Of course this will happen only if the current peace process is implemented successfully. However, expansionary fiscal policies can stimulate real output during recession, but in normal times higher rates of interest and/or higher expected future taxes can substantially decrease such stimulation effects.

It is also important for the Government the State of Eritrea to be cognisant of the impacts of this policy and its debt financing for future generations. Most stabilisation attempts focus on cutting government expenditure to achieve budgetary balance. But, the burden of resource mobilisation to finance essential public developmental efforts must come from the revenue side, not from excessive borrowing. Therefore, in the long run it is the efficient and equitable collection of taxes on which the government must base its development aspirations. As described in section (i) of its Expenditure Policy proper attention to prudent debt management practices should focus on the impact of fiscal policies for future generations. Unless the interest liability accompanying its debt grows less rapidly than its national income, the burden imposed on the economy will have a worrisome trend. Hopefully, the government's

focus on basic social infrastructure and human capital development accompanied by political stability will boost future economy and secure future generations from the burden.

As an alternative source of financing, the focus more on its strategic location on the Red Sea and develop its tourism and manufacturing industry. This could generate enough funds that could be diverted to finance its public expenditure, and particularly for investment purposes to accelerate the economic growth of the country to alleviate and eventually eradicate poverty.

BIBLIOGRAPHY

Books

Aronson, J.R. (1985) Public finance. McGraw-Hall Co, USA.

Batiz, F.L. and Batiz, L.A. (1994) International finance and open economy macroeconomics. Macmillan Publishing Company, New York.

Biggs, M. Nattrass, N. and Kahn, B. (1997) Macroeconomics. Cape Town and Johannesburg, David Philip.

Bjorksten, N., and Brool, A.M. (2002) Exchange rate strategies for small open developed economies such as New Zealand. The Reserve Bank of New Zealand, 65(14).

Bond, P., (2001) Against global apartheid: South Africa meets the World Bank, IMF, and International Finance. Cape Town: University of Cape Town.

Caiden, N. and Wildavsky, A. (1990) Planning and budgeting in poor countries. Transaction Publishers, New Brunswick (U.S.A.) and London (U.K.).

Dornbusch, R., Fischer, S., Mohr, P., and Rogers, C. (1996) Macroeconomics. Lexicon Publishers, Johannesburg.

Durrheim, K. (1999) Research in practice: Applied methods for social sciences. University of Cape Town Press, Rondebosch.

Government of the State of Eritrea (1994) Macroeconomic policy, Asmara.

Gwartney, J. D and Stroup, R.L (1990) Macroeconomics: Private and public choice. USA, Harcourt Brace Jovanovich.

Hockley, G. C. (1992) Fiscal policy: An introduction, London and New York, Routledge.

Hyde, A.C. ((1992) Government budget: Theory, process, and politics. Brooks/Cole Publishing Company, Pacific Grove, California.

Lee, R.M. (1993) Doing research on sensitive topics. Sage Publications, London.

Little et al (1993) Boom, crisis, and adjustment: The macroeconomic experience of developing countries. Oxford University Press, Inc. New York.

Martinez-Vazquez, J.M. and Alm, J. (2003) Public finance in developing and transitional countries. Edward Elgar Publishing Limited, UK.

McConnell, C., R. and Brue, S. L. (1990) Economics: principles, problems and policies. New York; McGraw-Hill.

Mohr, P. and Fourie, L. ((2000) Economics for South African students (2nd ed). Western Cape, NBD.

Mohr, P., Fourie, L. and Associates (2000) Economics for South African Students. Van Schaik Publishers, 1064 Arcadia Street, Hatfield, Pretoria.

Musgrave, R.A. and Musgrave, P.B. (1980) Public finance in theory and practice. McGraw Hill, New York, 1980

Ott, A.F. (1993). Public sector budgets: A comparative study. Edward Elgar Publishing Limited, England.

Parkin, M. and King, D. (1995) Economics, Addison Wesley

Premchand, A. (1989) Government budgeting and expenditure controls: Theory and practice. International Monetary Fund, Washington, D.C.

Premchand, A. (1993) Public expenditure management. International Monetary Fund, Washington, D.C.

Rosen, H. S., (1992) Public Finance. USA: Richard D. Irwin, Inc.

Sahn, D.E. (1996) Economic reform and poor in Africa. Oxford University Press, New York.

Todaro, M.P (1997) Economic Development. London and New York, Longman

Zerizghi, F. W. (2003) Implementing output-based budgeting under the medium-term expenditure framework (MTEF) approach.

Report

Eritrea-Demobilisation and Reintegration Program (2001) World Bank Document.

International Monetary Fund (IMF) (2000) Eritrea: Statistical Appendix.

Ministry of Information (2002) ERITREA: A Country Handbook, Asmara, Vision Africa.

Ministry of Local Government of Eritrea: Urban and Council Affairs Division (1995). An assessment of the urban centers. Asmara.

Research report

Klipin, J. (2001). How police managers learn best: The views of managers in the South African Police Service.

Webliography

Ahmed, Habib, Miller, and Stephen, M. (2000) Contemporary economic policy: Crowding-out and crowding-in effect of the components of government expenditure, 18(1). From: http://web22.epnet.com

Ames, B., Brown, W., Devarajan, S. and Izquierdo, A. (2001) Macroeconomic policy and poverty reduction. From: http://www.imf.org

Braconier, H. and Holden, S. (1999) The public budget balance: Fiscal indicators and cyclical sensitivity. From: http://www.konj.se

Budget Guide 2001-02. From: http://www.treasury.nsw.gov.au

Burgess, Robin, Stern, and Nicholas (1993) Taxation and development. Journal of economic literature, 31(2). From: http://web7.epnet.com

Burton, D., R. (no date) Policy analysis: Reforming the federal tax policy process. From: http://www.cato.org

Buskirk, R., V. (2001) Energy efficiency, renewable energy and development: Building national energy sector capital. From: http://www.punchdown.org

Dejenie, M. (2003) 5th Urban and city management course for Africa. From: http://www.worldbank.org

Eritrea commercial guide (2002). From: http://www.usatrade.gov

Ertirean economy (2002). From: http://africa.inafrica.com

Eritrea economy in dire straits. From: http://www.geocities.com

Eritrean government policies impede donor efforts to help Eritrea's people. From: http://www.geocities.com

Esipisu, M. (1998) Ethiopia conflict seen threatening Eritrean budget. From: http://www.geocities.com

Fall, C.I. (2002) Eritrea: 1996-98 country strategy paper. From: http://www.afdb.org

Government. From: http://countrydata.bvdep.com

Klein, D. (2001) The damage which rapid increase of government expenditure causes to economic growth. From: http://www.bankisrael.gov.il

International Monetary Fund (2003) IMF concludes 2003 article IV consultation with Eritrea, 19th Street, NW Washington, D.C. 20431 USA. From: http://www.imf.org

McConnell C. (1984) Economics principles, problems, and policies. McGraw-Hill.inc. From: http://www. Shaebia.com

Ministry of Finance (1999) Macro environment of Eritrea. From: http://www2.unesco.org

Mnyanda, L., (2003) IMF supports exchange controls policy. From http://allafrica.com

Negash, M. (2001) Investment laws in Eritrea. From: http://www.ucis.unc.edu

Objectives of government policy. From: http://www.revisionguru.co.uk

Olekalns, N. (2000). The macroeconomic implications of current fiscal policy. From: http://www.economics.unimelb.edu.au

Patashnik, E.M. (1999) Governance: ideas, inheritances, and the dynamic of budgetary change. An International Journal of Policy, 12(2). From: http://web24.epnet.com

Policy tools-government expenditure. From: http://www.bized.ac.uk

Saxton, J. and Garfield, R. (1995) Government spending and economic growth. From: http://www.house.gov

Schuhmann, R.A. (2003) Principles and processes of government budgeting. From: http://uwadmnweb.uwyo.edu

Shatz. H.J., and Tarr. D.G. Exchange rate overvaluation and trade protection: Lessons from experience. Form: http://www1.worldbank.org

The Eritrea currency through the ages. From: http://home.planet.nl

Tsegaye, S. (2002) Opening decision making to society via participatory budgeting. From: http://www.worldbank.org

Udenrigsministeriet (2000) Eritrea - Eritrea's Political and Economic Situation. From: http://www.um.dk

UK general economy policy advisors. From: http://www.bized.ac.uk

USAID Congressional Presentation FY 1997. From: http://www.usaid.gov

U.S. Census Bureau, Governments Division (2001). Federal state and local government: Government finance and expenditure classification manual. From: http://www.census.gov

US Department of Commerce (1998). Economic Trends. From: http://strategis.ic.gc.ca

U.S. Embassy Asmara, (1998) Eritrea's economy: Challenging. From: http://www.geocities.com