

## **Abstract**

Although the effect of fiscal drag is well studied in the industrialized world, empirical evidence from developing economies remains limited. Against this backdrop, this thesis applies micro and macro-economic approaches to examine the impact of the tax burden imposed by inflation on households and the macroeconomy, respectively. On the one hand, Chapter three looks at the size and effect of fiscal drag on income distribution and work incentives focusing on Ethiopia, Mozambique, South Africa, Tanzania, Uganda, and Zambia. On the other hand, chapter four examines the economy-wide effect of fiscal drag in Ethiopia. CGE based simulation introduces a 9.1 percent increase in the average income tax rate due to the failure of the tax system to update the tax parameters with monetary values for inflation. Further, the study considered unemployment in agricultural labour, and four critical conclusions are drawn from our empirical investigation. First, fiscal drag reduces consumption expenditure by urban non-poor households but fosters consumption outlays by the urban poor, rural poor, and rural non-poor households. The effect of a fall in saving rate on consumption spending outweighs the impact due to the initial increase in the income tax rate for the three household categories. Second, an inflation-driven increase in income tax rates decreases income for urban households while increasing the income of rural counterparts. Third, fiscal drag slightly increases economic growth, household consumption, and export but reduces imports. Fourth, the upsurge in revenue from direct tax due to fiscal drag more than offsets the fall in government revenue from indirect taxes. Addressing fiscal drag becomes very crucial considering the soaring inflation due to the war between Ukraine and Russia.