

Fiscal Federalism

Teaching Material

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Course Introduction

The concept of federalism, though USA origin, has got a great acclamation by many states contemporarily due to its manifold purposes: conflict resolution, convenience of administration and local empowerment as well as political, economical and social benefits. Ethiopia through the 1995 FDRE Constitution, joined the world states of federation. However, it is not immune from potential dangers of fragmentation and conflicts which may weigh less or otherwise than the benefits from one state to other.

Fiscal federalism constitutes the core and difficult area of federalism which measures the degree of division of powers among the constituent units of federations for the financial power is an engine of every activity. It is tough area for natural resources are limited and endowed unevenly from place to place and constitutional redistribution is not fairly accepted by all concerned. In a geographical area of more than one level of government, allocation of revenue sources and expenditure responsibilities are elementary subject matters of fiscal federalism. Invariably, in all federations the allocation revenue sources follows the allocation of expenditure responsibilities which in turn signifies the division of powers and functions. The federations' system of divisions of powers and functions easily reflects in fiscal federalism. Other elements of fiscal federalism are the extensions of the two main subjects that as unavoidable problems and their solution. These are fiscal imbalances which are caused by the gap between allocation of expenditure and allocation of revenue sources both vertically between the states and the center and horizontally among the states. These problems quest constitutional methods of solution. Some of the schemes involve fiscal transfer from one level of government to the other, mostly from the center to the states. In addition, the whole machinery of fiscal federalism is geared by some specific institutions which are this effect.

This course material discusses fiscal federalism mainly Ethiopian Constitution's fiscal arrangement by exploring each subject matter under separate chapter. Accordingly, it has five chapters and course summary and conclusion with future concerns of fiscal federalism. To this end, chapter one provides conceptual underpinnings of federalism in general and fiscal federalism in particular and other related issues. While chapter two and chapter three deal with allocation of expenditure responsibilities and revenue sources respectively, chapter four is

devoted for the discussion of intergovernmental fiscal imbalances and fiscal transfer. Lastly, chapter five explains institutional frameworks and it is followed by summary and conclusion of the course.

Course Objectives

General objectives

Generally, upon the completion of this course, students are expected:

- ☞ to acquire the basic knowledge of the conceptual underpinnings and institutions of fiscal federalism;
- ☞ to acquaint themselves with problem solving skills in fiscal federalism; and
- ☞ to enhance their personal competence to engage in different fiscal institutions of the country in their future career.

Specifically, students will be able to:

- understand the method and objectives of dividing power between the levels of governments in general and under the Ethiopian constitution in particular;
- identify the issues of public finance and federalism enshrined in FDRE Constitution,
- explain the principles of sharing of revenues and expenditures among the States and Federal governments,
- appreciate the base, assessment type and methods of implementations of sources and spending the finances of both Federal and State Governments, and
- solve theoretical and pragmatic problems of fiscal federalism or fiscal decentralization among inter-states and between the Federal and State governments.

Tools of the Material

1. How is the Material Organized?

The Material consists of five chapters devoted to various aspects of fiscal federalism and breakdown to many sub-topics under each chapter. An attempt has been made to write each chapter as a self-contained entirety. Each begins with a brief introduction of the place occupied by its particular subject matter in the overall structure of the Material. In addition, each chapter contains cross-references to other chapters where appropriate. Consequently, the material can be used following the logical and importance sequence throughout the first chapter to the last. However, it is also possible to enter directly into the subject matter of a particular chapter of interest, or to combine any number of chapters.

2. Format of the Material

Each chapter has been written in the same format, which is explained below;

Chapter Outline

- Each chapter begins with a short introduction and chapter objective and ends with summary of the subject matter covered.
- A series of in-text questions and activities are given for students at the middle of and the last of each lesson that help the reader to conceptualize the important issues discussed in it. These questions also give an impression of the chapter's scope and purpose.
- Each chapter addresses the fundamental principles of fiscal federalism in its lessons that are of particular relevance to the subject matter of that chapter.
- Chapter one and three have additional, illustrative notes clarifying the subject matter or concepts of each chapter.
- Activities are meant to help readers assess their acquired levels of knowledge and understanding of the subject matter of each lesson. Instructors can use the questions under each heading and in-text questions for group discussions, exercises, or in any other form that suits their particular needs.
- Lessons, activities and in-text questions are structured under the perception of attaining Knowledge, Understanding and Application.

3. Who can use the material?

The material has been by those responsible lawyers for the students and education of members of law faculty in mind. Its contents should enable them;

1. to prepare theoretical concepts on one or more of the topics contained in the chapters, in order to impart the attitude, skill and knowledge of fiscal federalism required for adequate training performance by law faculties;
2. to conceptualize new techniques and tactics – and to adapt those that already exist – in order to equip law students with the skills necessary to ensure their adequate future performance;
3. subsequently, to incorporate principles of fiscal federalism in new training uniform curriculum at the theoretical level (knowledge/ understanding) and practical level (Skill/application) in order to secure continuity of education and training in this field.

However, it has not been the complied exclusively for the purpose of theoretical instruction to students and members of faculty. Its contents may prove equally valid and useful to members of other institution where they perform law enforcement function (e.g. legislative and executive).

CHAPTER ONE

FEDERALISM AND FISCAL FEDERALISM IN GENERAL

Introduction

The subject of fiscal federalism is an extension and basic element of the concept of federalism. It deals basically with the division of revenue raising power and expenditure responsibilities to multiple layers of governments formed by federalism. Political power division among the constituent units of federation without the enabling force; financial power correlated to political power division, ends as nightmare. Hence, theoretically fiscal decentralization in federal system follows the scope and elements of devolution of power and functions. Therefore, the student can only appreciate fiscal federalism through the broad concept of federalism and the constitutional arrangements of each federation. To this end, this chapter is structured to consist of introductory concepts of the course. It has three major sections underling with general overview on federalism, some economic aspects in federal system and fiscal federalism orderly. Students are recommended to follow the logical flow of the concepts accordingly.

Chapter Objectives

At the end of this chapter, the students will be able, among other things, to:

- identify the forms of state structures and their difference in the world and in their country,
- understand the basic principles and the rationales of federalism,
- analyze the methods and objectives of power division between the multiple level of governments in general and under FDRE Constitution in particular,
- identify the effects of foreign and interstate commerce in the rubric of federal finance,
- explain the nexus between the free-market economic policy and fiscal federalism,
- define public finance and decentralization of finance in federal system,
- state the main subject matters, merit and demerit of fiscal federalism, and
- trace the evolution and development of financial decentralization in Ethiopia.

1.1. Federalism: General Overview

Students Dear you have learnt about state structure in your course on federalism. Fiscal federalism or fiscal decentralization is the subject solemnly coiled to state structure called federalism. Therefore, it is worthwhile to refresh your memory of state structure.

State structure is the system by which states of the world design their basic elements; population, territory, government and sovereignty in the form as to which their people necessitate and benefit.

The core issues of the state structure are whether the essential elements of the state: territory, population, sovereignty and government are divided or undivided one, or if some aspects of them are united while the substantial parts are disintegrated. Accordingly, there are three form of state structure.

? What is meant by state structure? What are the three forms of state structure?

1.1.1. Forms of State Structure

The three forms of state structure in which the history of the world experiences; are unitarism, federalism and confederalism. Let us briefly discuss them orderly.

A) Unitarism

Unitarism is a form of state structure that is characterized by centralization of power and indivisibility of sovereignty. In unitary government, there is only one source of authority whatever local territorial units exist. Local units are merely agencies of the central government established for its convenience for local administration. They owe their legal existence to it. Hence, their power and arrangement increased or diminished or their legal existence ended by the unilateral will and action of the central government. However, some variants of unitarism have autonomous regions endowed with regional autonomy. Such kind of internal territorial division seems federal system and sometimes referred to as quasi-federalism. Most of the world sates structured themselves in unitarism. Britain, France, the Netherlands, Romania, China,

Egypt, etc. are some examples of unitarist states. Pure unitarism is becoming an abstract concept, for the modern central governments in the real world often have great difficulty of controlling the activities of local administration, even in officially unitary system.

B) Federalism

Federalism is a form of state structure by which power of a state is formally (constitutionally) divided among different level of government, each of which is legally supreme over its own sphere. It is the direct opposite of unitarism. It provides for an actual division of power between two or more nearly independent government each of which is against particularism and centralism authority over the same people. Federalism is a political union of different unit; a critical; more elaborated issues of federalism will be dealt in the next sub topic.

C) Confederalism

Confederalism is voluntary association of independent states. It is an association of states, which rests upon the common agreement of its members expressed in an elaborate document. Confederations are formed for common advantage without affecting internal freedom, structure, lawmaking and enforcing processes, external relations of the states confederating. It also differs from an alliance in that it has fixed issues through which the common will of its members may be expressed. It also differs from the league (union) in a greater variety of objectives designed to be achieved. These objectives include external security, promotion of cultural and economic unity, and operation of postal service.

Historically confederations are often provided to the first of second step toward the establishment of a national state usually as federal union. The federal form of state in Switzerland, Germany and USA were preceded by confederations. The common wealth of nations, which was formed in 1972, is an example of confederation born as a result of the decentralization and eventual disintegration of empire, UK and former Britain colonies. In contemporary world, there are modern forms of confederations, but such arrangements are different from the older ones. Modern arrangements are established around common defense, economic alliance and politico- religious alliance. Northern Atlantic Treaty Organization NATO,

Common Market of East and Southern Africa- COMESA, and Economic Community of Western African States- ECOWAS, The Arab League are some of the examples to be mentioned.

1.1.2. Conceptual Underpinnings of Federalism

Under this sub topic the meaning and the basic elements of federal state structure will be explored. In turn, this would enable the student to reconceptualize federalism in a nutshell.

A) Meaning

Although federalism has been defined in many ways for our purpose a limited meaning suffice. Federalism is a form of state structure in which the basic elements of state: territory, population, government and sovereignty are divided vertically to form independent political entities that enables each to make final decision independently of the others. The ability to make decision, however, is not absolute; one may be influenced by another in various ways. Nonetheless, federal system gives each level the ability to make some decisions without the approval (formal or informal) of the other. Such kind of state structure may come either from the disintegration of a unitary state or from integration of independent states. A comprehensive approach to this effect, is given by Friedrich and states federalism as:

“a process by which a number of separate political units be they states or any other kind of association, enter into arrangements for governing themselves jointly regarding joint needs and interests. Or reversely, the process through which a hitherto unitary political organization becomes federalized to the point where separate and distinct political communities arise and become politically organized.”

B) Basic Elements of Federalism

There are numerous and varying points to be raised in relation to federalism based on the structural difference of federations, among these the following underpinnings are the common essentials of federations.

- 1. The existence of at least two levels of governments:** the federal setup comprises at least two set of governments. These are, as different nomenclature are employed in different countries; federal/central/or union/national government which retains power concerns with the interest of the federation as a nation or the interest of two or more federating units and State, or regional or sub-national or provincial governments which have power pertinent to specific to them. In some federation, there exists third lower level of government, commonly known as local government but of various type in different federations; district, or municipal or communes etc. These levels of government possess a range of powers and function; legislative, executive and judiciary that the other cannot encroach.
- 2. Supreme written constitution:** in federation, the federal written constitution stipulates formal framework of federation and division of authority between each tire of government. The essence of existence, responsibilities and power of each of governments should very well be defined in written constitution. Accordingly, every government derives its power and function from the federal constitution; without written constitution there is no federation. Therefore, written constitution governs the relationship between the federal government and the states and among the states each other. It is the supreme law of the land, and every citizen and official should obey the constitution. The constitution shall be consulted in the event of any controversy in the federation. It is thought that, *inter alia*; these elements are basic and common to all federation in the world.

1.1.3. Rationales for Federalism

Many arguments for federalism have traditionally been put in terms of promoting various forms of liberty in the form of non-domination, immunity or enhanced opportunity sets. When considering reasons offered for federalism, many appear to be in favor of decentralization with one requiring constitutional entrenchment for spilt authority. Here it is explored that the political, economic and social factors that federalism opts are incomparable justifications.

1) Political Factors

A great democracy must either sacrifice self-government to unitary or preserve it by federalism. Some of these political benefits are:

First and foremost, federations may foster peace, secure from war and fear of war. State can join federation to become gently powerful enough to dissuade external aggression, and /or to prevent aggressive and preemptive wars among themselves. The confederation of American states moved to a federation largely attributed to these effects.

Secondly, federal arrangements may protect individuals against political authorities by constraining both central and state sovereignty, placing limited power with them. And by entrusting the center with authority to intervene in sub-units (states), the federal arrangement can protect minorities, human rights against state authorities. On the other side, sub-units may cheek central authorities and prevent undue action of contrary to the will of the citizenry or minorities.

Thirdly federalism gives regional and local interests a constitutionally guaranteed political voice, and increases the opportunities of citizenry participation in public decision making, though deliberation and offices in both-sub unit and central bodies.

2) Economic Factors

Federalism has been repeatedly praised for serving as an optimum utilization of resources and as effective system for distribution of functions between the levels of government. Fiscal and financial arrangements in federal system create an opportunity for effective use of the resources, labour, capital and land of the country. Federation can promote economic prosperity by removing internal barriers to trade through economics of scale, by establishing and maintaining inter-state trade arrangement, or become a sufficient large global player to affect international trade regimes.

It also facilitates efficient preference maximization more generally, as formalized on economic and fiscal federalism. It allows optimal matching of authority to create public

goods to specific affected subsets of the populations. If individuals' preference vary systematically by territory according to external or internal parameter such as geography or shared tastes and values, federal arrangement allows local variation are favorable to individual's preferences. Local-decision makers may also have a better group of affected preferences and alternatives, making for better services than would be provided by central government that tends to ignore local preference variation. Grants power to population subset that preferences regarding public services may also increase efficiencies by allowing these subsets to create such "internalities" at cost borne by them.

Federal arrangements promote mobility and hence territorial clustering of individuals with similar preferences, and allow sub-units authority to experiment and complete for individual who are free to move where their preference are best met.

3) Social Factors

The coexistence accommodation of several nations in one state (country) is a test, as well the best of its freedom of cultures; thereby the right to speak and to write in and develop language and to promote its culture and preserve its history. The entitlement and enjoyment of such right also entails the proliferation of resourcefulness' creativity in artistic, technology and ultimately development. The combination of different nations in one state (country) is a necessary condition of civilized life as combination of individuals in a society. Federal arrangement makes such social welfares possible.

1.1.4. Constitutional Division of Power

The primary quest for federalism is to divide the state's /country's whole power among the federating units to benefit at most extent the citizens in defined manner. The constitution is the prime evidence and the hand print of the framers left to the people as to items and pattern of power devolution. As mentioned above, the state power in the present philosophy of democracy and the principle of separation of power is divided among three branches (organs) of government, which are created for such effect namely; the legislative, judiciary and executive which revolve around law making, interpreting and enforcement (implementing) respectively.

Hence, power in its modern definition is not mighty but law. Therefore, two kinds of division of power; horizontal power division and vertical power division will be discussed as follows.

A) Horizontal Power Division

The concept of horizontal power division originated from the philosophy of separation of power of French political enlightenment thinker Baron De Montesquieu. Inspired by the UK parliamentary struggle against the monarchy for sharing of power of his time, Montesquieu described division of political power among an executive, a legislative, and a judiciary.

The model was first developed by ancient Greeks in their constitution that governed their city-states more than 2,500 years ago. However, the idea first came in to widespread use by the Roman republic. Under this model the government is divided into branches or estates, and each branch of the government has separate and independent power and area of responsibility. The well developed division of power is into the Executive, the Legislative and the Judiciary. The division of power among the three branches sometimes termed as tripartite system, protects democracy and for stalls tyrannical Monarchy, totalitarian and dictatorships and anarchism.

In the modern democracy, systems of governance, which is the subject of both federations and unitary states, is a continuum of variants exist that between “presidential government and parliamentary government”. A clear separation of power is said to be coined to presidential system, whereas, “fusion of power” is an inherent feature of parliamentary ones. “Mixed system” fall somewhere in between, usually near the mid point.

The point of difference lies on the formation of the three branches of Government. Where the three institutions are formed independently, for instance, as the US presidential system operates, results in separation of power. Where the three institutions (branches) of government get birth from one womb; parliament, as the UK parliamentary system is, it results with “fusion of power”. A mixture of the two; “mixed system” is experienced by the current France’s Fifth Republic. The basic principle common to all is that horizontal division of government power into three; legislative, executive and judiciary branches. Hence, the

FDRE constitution made a provision to this effect under Art 50(2) saying “the federal government and the states shall have legislative, executive and judicial powers.” In addition, the detail powers and formation of each branches of the government are provided by the constitution. The purpose of the course limits the topic to deal with each arrangement.

B) Vertical Power Division

The concept of horizontal division of power is the very constituent in the development of democracy whatever the state structure may be. Vertical power division, however, is the main principle to federal state arrangement. In its whole spectrum, vertical power division sometimes called assignment of power, deals with the distribution of powers contained in democratic government: legislative, executive and judiciary between various tiers of government in federal state structure. It consists of the manner of division and the items of powers divided by the constitution of different federal democracies.

In federations, this division of powers is the primary task of the federal constitution. Accordingly the Constitution of India made very different scheme of center- state distribution of powers and functions. Thus, it employed the distribution under three entitled lists: the union list; list containing subjects over which the federal government exercises exclusive power, state list; list containing subjects over which the states exercise exclusive power and the concurrent list; list containing subjects over which both the federal government and the states can exercise concurrently, and the residual powers are left in the hands of the union.

The US Constitution adopted a simple method of center-state distribution of powers, that the exclusive powers are expressed for federal government and the residual powers are reserved to the states, however implied powers are also reserved to the federal government where ‘necessary and proper’ for executing the exclusively enumerated power.

The Canadian Constitution differs by allocating the exclusive power to the provinces (states) and reserving residual power for the center. More or less, the German Basic Law (constitution) is akin to the Indian scheme but most of the federal government laws are left for the execution to the Lander (states). The Australian constitution follows the US trend.

In the Ethiopian federal system, the Constitution follows an approach of enumerating exclusive power of federal governments and reserving residual powers to the states. To this effect, Art. 52(1) states; “all powers not given expressly to the Federal Government alone or concurrently to the federal government and the states are reserved to the states”. It also provides a limited list of exclusive power of the states (Art.52 (2)). The heading titles of Arts. 80 and 98 of the Constitution also provide the concurrent power. In principle, the FDRE constitution follows the US model by enumerating the power of the federal government and allocating the residual powers to the states; but it also incorporates some features from India and Canada by listing some powers for the states.

The itemizations of powers divided and assigned under the subject of various tiers of government vary from one federation to the other. The Constitution of India in the seventh schedule made 97 subjects of power under Union List. Among these, the core are defence force; foreign affairs, citizenship, naturalization and emigration, rail, air and marine transport, foreign and inter state commerce, currency, coinage, legal tender and foreign exchange, banking and insurance, telecommunication, postal and telegraph, service patent, copy rights, trade-marks, establishing standard weights and measures, natural resources, revenue sources assigned to the union , etc. It also empowers 66 subjects to the states under State List II, some of these are: public order, police force, administration of justice, prison administration, local government, public health and sanitation, agriculture, communication with their territory, preservation of natural resources, land administration, trade and commerce in their territory, state employee and their payment, etc. In addition, the Concurrent List III contains 47 subjects over which, both the center and states are concerned. Some of the major are: criminal, civil and family laws and their procedures, contracts of partnerships, agency and carriage, economic and social planning; commercial and industrial monopolies; social security, social insurances and employment and unemployment. Inquiries and spastics for the purpose of any matter are specified under the list of I and II, price control, etc.

Under the US Constitution, inter-state commerce, defense, and foreign relations by ‘necessary and proper clause’ to raise revenue in peace and in war, to raise and spend revenue

for general welfare, to enact Law of Naturalization and uniform law on Bankruptcies, to coin money, regulate the value thereof and foreign coin and fix the standards of weights and measures and to establish post offices and ports and roads are exclusively enumerated power of the federal government. Subject to their reserve power states are performing useful functions; like education, public health, highway, law and order etc.

Under the federal arrangement of Ethiopia (2.6.1. provides the detail), the FDRE Constitution Art 51 entrusts the federal government with power subject to national defense, international or foreign relations, citizenship, immigration and naturalization; interstate commerce, postal and telecommunication services, weights and measures, domestic currency coinage and foreign currency usage, banking, patents and copyrights, levying taxes and collecting duties on revenue sources assigned to federal government, air, rail and water transports and highways linking two or more states, enacting labour, electoral, procedural, criminal, and commercial codes. The FDRE constitution Art 52 (2), states that the states have enumerated power and functions. These include; enacting and executing the state constitutions. To establish state police, to maintain public peace and order, levying and collecting taxes and duties on revenue sources reserved to the state, administration of land and other natural resource. The states also have power over areas of education, health and agriculture. These should simply be understood as guiding principles that are directed by the constitution for their open-ended residual powers.

In general the federal government powers can be summarized into four main areas. The first group comprises those powers which by their very nature are considered to be the concern of the federation as single entity. National defence, international or foreign relations, citizenship, immigration and naturalization, and other powers inherently intrinsic to these powers are the main elements to be mentioned in this category.

The second area concerns several commercial powers that are essential for facilitating local as well as international trade. In this group, we can find powers including interstate commerce, postal and telecommunication services, weight and measures, domestic currency coinage and foreign currency usage, and banking, insurance, patents and copyright.

The third area enables central government to implement powers mentioned in the first and the second category. This includes powers over rail, air, water and road adjoining two or more states transports.

The fourth group comprises legislation dealing with various aspects of social and political issues. Under this category, legislations concerning electoral laws, criminal laws and procedures as well as enforcement of laws of political rights such as press, demonstration and registration of political parties are the main areas of power.

? What is the nexus between vertical power division and fiscal federalism? Is vertical division of importance for fiscal federalism?

Students, it is worthy to note that the need to render functions and exercise including the army (sword) is subject to competence in collecting revenue and responsibility of expenditure (pocket wallet). Having praised vertical power division among various tiers of federation in most areas of powers but not in revenues and expenditures would end nominal or paper design federation. Therefore, most constitutions of federations have the division of public sector functions and finances – fiscal federalism that makes each level of government functional and meaningful. However, the allocation of resources and assigning responsibilities of expenditure has not yet a simple task of federations that can be derivated in some clear cut postulate or theorem as the other areas are. Hence, as an element area of distribution, as affirmation and as enabling force of federalism, fiscal federalism has got prominence in the doctrines of federalism.

Activity 1

Answer the following questions on the basis of the above discussion.

1. Most of countries of the world are unitary states while some are federal states; therefore, what are the courses to be followed in changing a state from a unitary to federal system? Discuss the preference of one state structure from the other?
2. Compare and contrast the method and items of constitutional power division of the following federations USA, India and Ethiopia,

3. If a federal constitution is well defined as to the devolution of powers between the federal and state governments, but ambiguous in allocation of revenue sources and expenditure responsibilities, what would be the relationship between different level of governments? What is the impact of financial decentralization on federalism?

1.2. Economic Policy and Commerce in Federation

1.2.1. Foreign and Interstate Commerce in Federation

Under federal constitutional allocation of powers and functions foreign and interstate commerce are the mandate of the federal government. For instance, the US Commerce Clause has been the subject of intense constitutional and political disagreement centering on the extent to which federal legislation may govern economic activity connected to interstate commerce but occurring within a state. In the debate of American federalism, the proponents of federal intervention have argued that the Clause should be interpreted broadly to permit everything related to commerce. The proponents were victorious for a long time, as the Supreme Court continually expanded the authority. In addition, US Supreme Court repeatedly decided that interstate commerce affairs are reserved to Congress and the Clause should be construed to include among other interstate navigation and meatpacking industry. The foreign commerce relation is not subject to interpretation but since it falls under the general power, foreign affairs are clearly assigned to the federal government. Art.1.Sec.10 of the same tied the above issues by stipulating that no state shall enter into treaty, alliance or without the consent of the Congress enter into any agreement of compact with another state or with foreign powers.

In our country, the FDRE Constitution under Article 51 lists the powers and functions of the Federal Government. Sub article 12 settles the matter by employing interstate and foreign commerce under the exclusive regulation of the Federal Government. However, the practice evidences that states are arranging foreign loan agreement under the supervision of the federal government.

Foreign and interstate commerce have immense impact on financial power of the federation. Economic disparity among states might be enhanced if this power is given to the states, and the flow of capital and the taxes collected and expenditure thereof may create competition and

imbalance among the states that adversely affect the relationship of the states and ultimately deviate from the purpose of federalism.

? What is the link between foreign, interstate commerce and fiscal federalism?

1.2.2. Economic Policy and Federalism

In the history of the world, states experience three types of economic policies: a free market economic policy or in its original name; laissez-faire, a command economic policy, and in between the two there exists a mixed economic policy. However, in today's actual world there is no pure command or free-market economy, rather a kind of mixture of the two; mixed economy is common. The adherents of free market economy are the capitalist states such as USA, Canada, and India, whereas, the adherents of command economic policy are communist countries such as the former USSR, North Korea and China. The social market economy of German, Britain, Cuba and Syria are some of the states to be mentioned for mixed economy. The modern trend of US also goes to mixed economy. The mixed economy is most commonly associated with social democratic forms of government; welfare state (see 2.4. below)

A market economy is an economic system in which the production and distribution of goods and services take place through the mechanism of free markets guided by a free price system. In a free market economy, businesses and consumers decide on their own volition about what they will purchase and produce, and in which decisions about the allocation of those resources are without government intervention. In free market economy, there is greater reluctance to entrust the state with wide powers, particularly spending powers; there is more skepticism about the state's ability to manage the economy; and much less faith is put in demand management as a means of stabilizing employment. More emphasis is put on action of a different kind: ensuring greater competition, providing incentives to innovation and enterprise, making the domestic economy more attractive to foreign investment, and above all, making efforts to improve the education and capabilities of the workforce. The unifying creed of demand management has thus given way to a series of measures on the side of supply. In theory, this means that the producer gets to decide what to produce, how much to produce, what to charge customers for those goods, and privatization is the basic element. Like decentralization, privatization enables the people to

economic scale. Hence, the transfer of power where the private sector is involved in service provision that was previously managed by public sector is the manifestation of decentralization.

In a communist or command economy, economic policy is more peremptory and government intervention to control the allocation of resources between different uses is carried much further. Economic policy becomes a matter of planning from the centre rather than leaving it to individual producers and consumers to express their preferences through the market in response to price signals, and nationalization is the basic element.

A mixed economy is an economic system that incorporates aspects of more than one economic system. This usually means an economy that contains both privately-owned and state-owned enterprises or that combines elements of capitalism and socialism, or a mix of market economy and planned economy characteristics.

In 1974 the imperial rule of monarchy of Ethiopia was overthrown by a military coup. The military leadership set up the Provisional Military Administrative Council, known as the Dergue, to govern the country. The Dergue declared Ethiopia a socialist state with a command economic policy and set about nationalizing all agricultural land and most industry. Realizing the then strong opposition and the unsuccessful economic performance, the Dergue forced to launch a mixed economic policy at its last ages.

The free market and liberalized economy has been launched and there is an attractive on going process toward the policy in Ethiopia under the coming in to power of FDRE. Substantial means of production such as capital, land and man power however are still in the hands of the government. This may be attributed to either the weakness of the private sector for lack of capital or for fear of risk involved, or the inherent nature of revolutionary democracy. Therefore, land, huge capital centered public service enterprises such as power production and supply, telecommunication, postal services, water supply, transport (land, air and water), are substantially under the government ownership and monopoly. More precisely, Ethiopia, a developing country, adheres free market economy, where economic transaction is not much more complicated specially where the country launch the Agricultural Development -led-Industrialization Strategy (ADLI), the government plays a supportive role to the private sector for the growth of the whole. Therefore, the present government of Ethiopia has taking an applaud

process of privatization; leave its hands from many enterprises which was nationalized by the previous government that can be rendered by private sectors. It follows that, even though, free market economy is officially declared, in practice a kind of mixed economy is operating.

In free market economy, the intervention of government should be in limited areas; for instance, public utility service, defense, and infrastructures. Thus, the FDRE Constitution provides two functions. These are: i) Enabling function and ii) Regulatory function. The enabling function empowers the government to do what the private sector could not achieve, namely public utilities, defense, police protection, education, and transport action that make up a bigger part of our economy and Mining, Electrical power production, water constructions and telecommunication.

A very serious problem has resulted from the government's increased role in providing services. The government is spending a great deal of money than it taking in. The difference between what the government spends and what it takes in is called a budget deficit. Therefore, the government must borrow money with interest. Huge deficits are dangerous to the growth and well-being of our economy.

The Regulatory function prescribes the conditions which have to be complied with to obtain fair business practice that there after have to be observed to protect creditors, consumers and the public against the dangers inherent in such business practice. The Regulatory function of the government includes antitrust law, consumer protection law, fair employment and fiscal policies.

It is generally taken for granted that a country represents a single market economy with which labour, or capital, or goods move freely. However, in federal countries and especially those with less respect for market economy, each level of government may introduce an economic policy that led to more *de facto* fragmentation of the national economic policy. Residency or other requirements may restrict the movement of labour; and various transparent or hidden obstacles to the movement of goods and capital. It has been reported that in some of the federations, goods cannot always be moved from one region to another without going through domestic "frontiers" and *de facto* "customs". In the same fashion, there are various impediments to market activities that originate either in form of regulations or taxation. For instance, tax computation in United

States, Brazil, India, and Russia contributes to misallocation of capital. It is not only free market policy but its uniform application in different level of governments that tries to resolve the negative significance of resource allocation and growth in fiscal federalism.

The relationship between a type of economic policy and a form of state structure is that, while nationalization of public enterprises is a means of centralization of power of unitary state, or at least resembles to the effect, privatization is the common denominator for both free market economy and federalism; even some scholars put it as one method of power decentralization. In addition, privatization of government-owned enterprises should also take in to consideration of federal arrangement; the mere existence of an enterprise in the territory of the state may not give the right to tax and administer it. The more critical issue is the ethnic based federalism of Ethiopia, equitable distribution of wealth is another assignment of the central government. Therefore, economic equalization of the states is one of the subject matter of fiscal federalism.

Activity 2

1. In most federations, the central/federal governments has the power of foreign and interstate commerce and to tax and administer them, however if such power is assigned to states, what would be the adverse effect of such assignment to federalism in general and fiscal federalism in particular?
2. The principles of economic policy govern the role and relationship of private sector and public sector in the economic pokily of the country whereas federalism deals with intergovernmental relation; discuss the relationship of the two concepts.
3. Find any public or private enterprise in your vicinity that is taxed and administrated by the federal government; why the federal government taxed and administrated it? Why not the state/ city administration in which your institution is situated?

1.3. Fiscal Federalism

Introductory Remarks

The concept of Fiscal policy is not originated in our dates; it goes back to the struggle of the English Barons (lords) and parliament against their kings in early 13th and 17th centuries respectively. Amongst the main subject for the issuance of Magna Carta in 1215 and the English

Bill of Rights of 1628 was to curtail the kings attempt to levy taxes without the consent of the barons and the parliament which was an uncommon tradition to English feudal culture. Hence, financial policies are the most indicative litmus of democracy. In federal system, where power including finance devolved in various governments, democracy and justice as to the financial distribution are expected in the stipulated of the constitution.

Today, fiscal decentralization is becoming an important issue of the world. Many developing countries are experimenting with it as a means of improving their governance and economic growth; for instance, Canada's fiscal decentralization was tied up with Quebec issue of secession, Eastern Europe countries used Fiscal Federalism as one of the means to resolve their political and economic mess; Germany reviewed its earlier fiscal decentralization as the focal point to deal with the Unification issue. In the EU, US and many countries, fiscal decentralization is acquiring greater prominence in public governance.

Tax system in its variants was experienced in feduo-socio economic regimes of Ethiopia. With the introduction of socialist ideology, mainly by the Dergue ,a remarkable changes were also seen in the tax system. The transitional government succeeded the Dergue with the reforms on tax system oriented to free market economy in 1991. The 1995 FDRE Constitution came with the adoption of Federalism in which tax powers, among other things, are divided between the federal and state governments.

Therefore, this part of chapter one mainly consists of: important concepts, merit and demerit of Fiscal decentralization as well as its evolution and development in Ethiopia. However, a slight exposition of the acclamation of public Finance in federalism is necessitated before the other.

1.3.1. Public Finance in Federalism

The concept of public finance joined with the notion of federalism by a thin chain but both are the subject of a country. While the former focuses on the financing of government be it federal or other, the later deals with federal form of state structure. Federation, as state framework, is permanent than recurring nature of public finance. This may also be attributed to the inherent difference between the concept of state and government.

? Students can you discuss and enumerate the points that underline the difference of state and government? Is public finance state matter or government matter?

Public finance, therefore, deals with the financial operations or finances of the government. The financing of the government is a matter of worldwide concern. Authorities, all over the world have a number of public projects, such as social security, protection and other services of public utilities like electricity, water supply, railways, heavy electrical and atomic energy, etc. and to provide social amenities in the form of education, health and sanitation facilities and public utilities.

The government raises revenue from various tax and non-tax sources and borrowing from individuals, corporations and friendly foreign countries to incur huge expenditures in order to materialize the aforementioned functions and utilities.

To understand it very well, the concept of public finance is postulated in defining clauses by different scholars of the subject. To see some:

Hugh Dalton defines;

“Public finance is concerned with the income and expenditure of public authorities and with the adjustment of one to another.”

Prof. Buchanan puts:

“The Government, considered as a unit, may be defined as the subject of study of public finance. More specifically, public finance studies the economic activity of Government as unit.”

Bastbale

In the wording of Bastbale, “Public finance deals with expenditure and income of public authorities of the State and their mutual relation as also with the financial administration and control.”

Up until the modern economists broadened the scope of public finance, the subject matter of public finance was confined with only income from internal sources and spending to domestic affairs. When foreign relation of states of the world became the sign of welfare state in the eye of international community, foreign borrowing and grants have become additional elements of revenue. On the other hand, public debt has become, by the same fashion, in the ambit of expenditure. However, the recent trend treated public debt separately among other matters. Accordingly, the whole spectrum of public finance is branched in to five categories of financial activities of the government: (1) Public Revenue, (2) Public Expenditure, (3) Public Debt, (4) Financial Administration and Control; and (5) Economic Stability and Growth.

Since federalism creates at least dual governments: central and regional and devolution of powers and functions to the same. As financial power is the basic element of governments’ power, compared to unitary state the nature of public finance in federal system is changed by devolution of its subject matters to different tiers of governments. Hence, public finance in federations deals with federal finances; the finances of the central government and state governments. Elaborating the concept of federal finance further consists of sharing of revenue sources and expenditure responsibilities and their inherent issues among various levels of governments in federation, which means in other word, fiscal federalism which we will deal in the subsequent topics.

? What is the difference and similarity between Fiscal Decentralization and Fiscal Federalism?

1.3.2. Important Concepts of Fiscal Federalism

Decentralization is a broad term employed to signify distribution or allocation of power compared to centralization. It is not only the phenomenon of federal states but also unitary states. If power and functions are decentralized to several tiers of governments, in federal arrangements or to sub regions in unitary states (which do not qualify the principle of federalism), there is a need for fiscal decentralization in order to carry out their responsibilities. For instance, China, a unitary state, has a fiscal system divided in to five levels of administrations: (1) Central (2) Provincial; (3) Prefecture; (4) County, and (5) Township. In addition, Britain has two types of internal administrative arrangements from the center: administrative regions and autonomous regions. The autonomous regions (sometimes termed as quasi-federalism) have more decentralized powers than the administrative regions. Hence, high degree of fiscal decentralization is also scored thereof. In some cases of unitary sates, the trend of decentralization advances than federal states do formally.

The question that follows is not only about the degree to which power is distributed or devolved, but also in whose prerogative power is such devolution undertaken. In unitary states, whatever power is decentralized, the center can restructure and recentralize the power as it deems necessary at any time. However, decentralization in federalism is non-centralization, not subject to the will and whim of federating units. Each level of government is supreme in its power including financial matters formally granted by the federal constitution.

Therefore, fiscal decentralization is a general concept that encompasses decentralization of financial resources and power of spending in both unitary and federal form of states. On the other hand, the fiscal decentralization of federal states assigned by federal constitution is termed as 'fiscal federalism'. Accordingly, fiscal federalism encompasses principles of fiscal relations between federal and state governments, which are the command over resources by various level of governments and the direction and size of intergovernmental fiscal flows. This includes the division of tax power and the means through which resources are adjusted to match expenditure responsibilities for the federal and state governments.

The major issues of fiscal federalism are summarized as:

- allocation of expenditure responsibilities, which deals with the issue of which item of power of spending should be carried by which level of government;
- allocation of revenue raising power; which deals with the issue of which types of taxes should be levied and non tax revenues should be assumed in which jurisdiction by which level of governments;
- the fiscal imbalance between the tiers of government and disparities between them in executing their respective responsibilities; vertical and horizontal imbalances; and
- the intergovernmental financial transfer; which deals with the issue of financial flows between the federal and the states and among the states; vertical transfer and horizontal transfer in order to adjust the imbalance and keep a viable federal system.

Generally, the study of fiscal federalism focuses on allocation of expenditure responsibilities, the revenue raising power and adjusting vertical and horizontal imbalances between the federal and the states and among the states respectively through intergovernmental fiscal transfer.

? Discuss the four major subject matters of fiscal federalism

1.3.3. Fiscal Federalism: merits and demerits

A) Merits of Fiscal Decentralization

The merit of fiscal decentralization is the extension of social, economic and political advantages of federalism. Some of the peculiar advantages of fiscal federalism will be dealt as follows:

- i) **Optimum utilization of resources and development growth:** - the federal constitution assigns the federal and the state governments to determine their revenue sources and area of expenditures. And the fiscal decentralization of the same permits the local state and federal administrative agencies to collect revenues and spend them. In doing so, it makes an effective and proper system to design and implement the methods of financial

operations. Therefore, it also enables to curb the peoples' developmental encumbers expeditiously in a manner that satisfy the beneficiaries. This, in turn, results in the over whole development of the country.

- ii) Job opportunity to professionals and workers:** - the decentralization of fiscal power to different tiers of administration and the need to keep the financial machineries consistence with the dynamics of the area through time and technology quests numerous professionals and skillful workers. To cope up with local needs, the diversities of peoples such as working languages of the federal and the states where ethnic federalism is implemented based on language demands of specific professionals. This urges the governments to train professionals and workers and acquaint them with the required skills accordingly. Ultimately, fiscal decentralization generates large public employment because of the need to have more labour in lower level administration than central financial administration and because of the more limited ability to exploit economies of scale, and thereby contributes its part to development.
- iii) Decrease central bureaucracy and corruption:** - the power division in federalism enhances the local decisions in their financial matters in a manner that satisfy the need of the locality and prevents decision making from becoming overloaded in the central government. Thus, it avoids inefficiency and bureaucracy and bureaucratic chaos.

The other benefit of decentralization of finance is the fact that it helps to avoid financial mismanagement, corruption and lack of accountability. Budget auditing and reporting at different level and inter different level are some of the mechanisms to achieve these effects. Fore instance, As per Article 2(14) of the Council of Ministers' Regulation on Financial Administration the Federal Government No. 17/1997, the budget evaluation begins at the institutional level by the internal auditor. The finance laws require the internal auditor to produce a monthly report stating the monthly revenue and expenditure of the institution and this report is sent to the finance office of the level of administrating (Article 57 of the financial regulation). At the federal level, all public bodies which execute the federal fund should account monthly, quarterly, semi-annually and annually to the Ministry of Finance.

The federal government through Ministry of Finance and Auditor General also has the power to conduct an audit of the federal offices and the state governments concerning the

use of subsidy grants they have received from the federal government pursuant to Article 95 of the FDRE Constitution. All state government institutions have to be audited by internal and external auditors. And their findings have to be published.

The report and its publication enable the mass to know the financial administration either through their representatives or by themselves. Ultimately, it creates transparency of issues resulted in decline of financial mismanagement, corruption and lack of accountability.

B) Demerit of Fiscal Federalism

There are inherent problems and demerits of fiscal decentralization which resulted from the devolution of revenue raising and expenditures responsibilities among different levels of governments and institutions. The followings are some to be mentioned.

- i) **Imbalance and competition:** - the very nature of federalism is devolution of power and functions among different levels of governments. Hence, the devolution mainly concerns financial power. The federating units by no means exist identical in population size, natural resources, development, etc. Thus, these natural diversities and the difficulty to frame universally applicable decentralization formula creates financial gap among the member of the federation. For instance, in highly decentralized federations such as Nigeria, Indonesia, and Russia, problems often arise because of the regions attempt to claim for their own exclusive use of revenue from the natural resources found in their territory. This leads to political unrest and creates problems for the income redistribution role of the government. Attributed to the above reasons, there exists vertical imbalance between the federal and states governments and horizontal imbalance among different states in the federation. The science of fiscal federalism intrinsically has the room called financial transfer through grant-in-aid and revenue sharing to curb the imbalances but federalism yet cannot avoid imbalances.

The other chronic disease of fiscal federalism is competition among states. Because of devolution of power and function and autonomy to exercise thereof, states are free to specialize in production of any public services and goods. In most federation, states try to produce the same services and goods which the other state is specialized without due consideration given to the comparative advantages of producing in the state or importing it

from the other states. Such phenomenon is conspicuously aggravated by ethnocentric administration of the states in ethnic-based federalism. Competition results in duplication of service and goods which is surplus to the whole country and costs to the non-specialized states. Competition among the states in this case ultimately results in the phenomenon known as “race to bottom”

- ii) Mobility and Migration of workers and professionals:** - the other disadvantage of fiscal federalism is mobility and migration of professional and skillful persons due to disparity of payment for the same professions in different states and in between the federal or states governments. The richer governments tend to pay better salary and provide wage increment according to the pace of their development where as the poor strive to satisfy public services than individual payment in their financial performance and development strategies. Hence, disparity of salary payment for the same professionals is inevitable and therefore it may result in migration and accumulation of the same professionals and experts to a state or the federal governments which pays better relative to other states. However, having the required expertise or skill or profession does not suffice to work in one state or in the federal government where the working languages of the federal and each state is not the same like Ethiopia. Thus, language requirement in addition to profession minimize the migration of the same professionals to the region of better payment. Ethno-linguistic based federalism like Ethiopia solves the problem to some extent.
- iii) Spillover effects:** - in expenditure and revenue assessment after budget allocation of a fiscal year spillover effects may be shown. Spillover effect is meant to indicate services which are provided by one federating units either of the federal or a state or even a local administration in the region/state but used by people of other regions which are not perceived as the target of the budget. Township administrations which are surrounded by less developed rural areas owing to center of service providing institution and faster rate of urbanization are prone to these effects. More developed part of regions adjacent to less developed part of other regions also face the same problem. The spillover effects which are caused by the “flow” from one region to another would be in one direction, while in other places it would be in opposite directions and such phenomenon is termed as offsetting effects.

The State of Harari people and Dire Dawa Administration Council are the best instances of spillover effects in Ethiopia. They are exceptional to this effect for several reasons

1. They are wholly surrounded by other regions and therefore are particularly exposed to this effect;
2. They are large centers, with a commensurately extensive range of public services, relative to rural and smaller centers in the neighboring regions; and
3. For their small size in terms of population, the spillover effect can happen relatively more than other regions.

According to the FDRE New Federal Budget Formula, it is assumed that 15 per cent of the expenditures of the two regions on health and education are with respect to non-residents.

? State the merits and demerits of fiscal federalism and their effect in the federation

1.3.4. Evolution and Development of Fiscal Decentralization in Ethiopia

Fiscal decentralism should not be seen alienated from decentralization of power. In the regimes of centralization, it is hard to find fiscal decentralization. In light of decentralization, the state called Ethiopia has been experiencing of uniform governments and ruling systems which were mostly associated with the personal expertise kings, rulers or Emperors. Hence, up until the advent of federalism with the state, in the long historical canopy of feudal centralization, there were some fractures of that the spirit of decentralized as twilights which are the so-called *defacto*-federalism.

The issue of decentralization in Ethiopian history goes back to the Axumite kingdom. The Axumites were identified by the vast area of control over the trade routes and port of Adulis. The dates' system of control of such a vast area was considered as centralization but the historical evidences like the 'inscription of king Ezana', the then king, shows that the Axumites established a decentralized system having small states conquered under central authorities. There was a relation that existed between the conquered states and central authority in terms of the payment of tributes and military service. Accordingly, the states were empowered to collect tributes from the subjects and to transfer some amount of it (in which method of determination and the kinds of the tribute was not clear and fixed) to the central authority, whereas the military

service to protect the empire was the duty of the central authority. Such pattern of central power and autonomous regions or kingdoms was continued during the Zagwe and Solomonic dynasties until the 19th and 20th centuries where the strong centralization came into the state by emperors Minilik and Haile Selassie I and continued by the Dergue regime.

In Medieval period history of Ethiopia, the relationship between the center and the regions, widely known as the provinces and kingdoms of the south and southeastern part of the country, were some of the instants. In this time, the title *Negus* meaning king or *Ras* meaning head who had loyalty allegiance to the center given to provincial leader and '*Neguse Negest*' meaning king of kings to the center was also another implication to decentralization of the time. The influential provinces were Gonder, Tigre, Gojjam, Showa and Wollo, some times claiming the throne for themselves. The autonomous Kingdoms were Kaffa, Wolayta, Harar and Afar. Having cognizant of the existence of provincial autonomy and the kingdoms one of the writers concluded: 'Ethiopia, the oldest continually existing polity in Africa, has almost always been relatively decentralized at many stage in its long history.

The lesson we fetch from the above decentralization in relation to fiscal federalism is the system of devolution of financial power and the condition to keep it viable. The regional lords submitted themselves by paying taxes and tributes to the center and laying no claim to the throne provided that the center recognized and did not obstruct the regional autonomy and kept its power strength to defend external aggressions and internal conflicts in the empire. This was the transitional division of power between the center and region in Ethiopia.

The above description demonstrates the existence of decentralization in unitary states through powers attributed to the emperor and by recognizing provincial/regional autonomy, i.e. a dual power structure. This implies that the monarchy had not absolute power but was limited by the provincial *Negus*.

The other historical venture is the 1952 federation of Ethiopia and Eritrea. The northern coastal part of Ethiopia, Eritrea after several intrusions of foreign powers was finally colonized by Italy from 1896-1941. Italian colonization of the region was begun after its intention to control the whole Ethiopia had aborted in 1896 at the battle of Adwa. Italy was expelled from both Ethiopia

and Eritrea in 1941 after the second defeat of its second attempt from 1935-1941. Ethiopia claimed Eritrea to rejoin with the motherland. Because of a long diplomatic battle in the UN, Eritrea rejoined Ethiopia in a federal arrangement. On September 11, 1952 the federation of Eritrea with Ethiopia became effectlue under Imperial Proclamation No.124/1952. According to the articles of the proclamation and the UN resolution, the federal government retained jurisdiction over defence, foreign affairs, monetary and fiscal policy, communications, commerce, and the ports. The regional government of Eritrea, on the other hand, retained control in all matters not assigned to the federal government, which were basically taxation, budgeting and policing within territory.

The 1952 federation only governed the relation between Eritrea and the rest of Ethiopia to compromise the questions of the Eritrea's independence and unconditional union with motherland. However, the Ethiopian–Eritrean federation was short lasted; it was dissolved in 1962. And Eritrea after then was made integral part of Ethiopia like other parts of the country until 1993 where the independence of Eritrea was effected. Therefore, the then federation has little importance to our date of federalism and to fiscal federalism.

After the demise of the military government of the Dergue in may 28, 1991 the triumphant groups formed the Transitional Government of Ethiopia (TGE). Among other issues, the decentralization of power among different nations and nationalities and peoples was inspired as a novel solution for the long lasting ethnic based problems in the country. Having due consideration to this issue, the Charter, adopted as the provisional constitutional instrument, came up with three-tiered administrative system which underline the decentralization of administrative and fiscal authorities. Accordingly, it decentralized the country to fourteen regions with powers of central, regional, and local (wereda) levels of administration.

The principle of fiscal decentralization had got prominent place in TGE as enunciated by the Charter and further elaborated under proclamation Nos. 7/1992 and 33/199 which provided for the division of expenditure and revenue-raising responsibilities between the center and the regions. And the later also provided the principles that govern all forms of inter-governmental financial relations. The TGE with its federal-like structure lasted for four years from July 1991 to August 1995.

The 1995 Constitution officially declared the ‘Federal Democratic Republic of Ethiopia (FDRE)’. According to the Constitution, the FDRE comprises of nine states and federal capital. It deals with a federal structure which comprises of the federal government and the member states where each has equal powers and rights as set forth in the Constitution.

The fiscal aspects in turn followed the decentralization of the executive, legislative and judiciary in the federation as one and main element of power. Hence, the FDER Constitution in its provisions from Arts.94 to 100 provided the decentralization of financial power between the federal and states governments and the detail deliberation of these provisions will be the subject of the next chapters.

Activity 3

1. Ethiopia was a unitary state for a long period of time before 1991. The country introduces decentralization step by step from TGE to FDRE. Therefore, the financial operation and administration of the country also has been changed. Write the nature and the changes of financial operation administration in the history of Ethiopia. Basically before 1995, during TGE and FDRE.
2. There are one merit and one demerit of fiscal federalism in relation to employment and employees. identify them. Explain whether they contradict each other or not. Why? Discuss in group.
3. Trace the historical emergence and development of financial decentralization in Ethiopia.

Additional Reading on Fiscal Federalism

Fiscal federalism

Richard M. Bird (University of Toronto)

The analysis of the problems that give rise to, and arise from, the existence of more than one level of government within the same geographical area.

As originally developed by Musgrave (1995) and Oates (1972), the “theory of fiscal federalism” concerns the division of public-sector function and finances in a logical way among multiple layers of government (king 1984). Much of the literature of fiscal federalism consists of

relatively unrelated treatments of such issue as the “decentralization theorem” (Oates 1991), models for the assignment of powers (McLure 1993), discussion of inter- governmental spillovers and inter-governmental grants (Break1980), fiscal mobility and migration (Wildasin 1991), and vertical fiscal imbalance and dependence (Hunter 1997). The theoretical discussion of local public goods that has taken place in the context of the Tiebout model (Wildasin 1986) is not part of “fiscal federalism” as defined here because it is concerned only with governmental relations at the same jurisdictional level. A more general and relevant, theoretical framework to approach some of these problems might be the theory of overlapping clubs (Cornes and Sandler 1996), but as yet this has been little developed(Casella and Frey 1992)

Initially, stabilization and distribution were considered to be essentially “central” functions, with the only role for “sub central” (state and local) governments arising in the allocative sphere. From this perspective, the main analytical task of fiscal federalism is to define the appropriate functions and finances of local governments as efficiently as possible, that is, in such a way as to maximize community welfare (often represented for analytical convenience by the Median Voter Theorem). In a territorial variant of the Benefit Principle, it was suggested at an early stage that each jurisdiction could be most efficiently mapped in terms of the spatial dimension of the service it provided. Thus, there would be “local public goods,” “state public goods,” and “national public goods” with the presumed beneficiaries each financing their provision in appropriate way (Olson 1996). In practice, the overlapping and multidimensional nature of most public-sector activities makes it difficult to apply this approach very rigorously, particularly because few lower-level governments have sufficient own-source of revenue to finance the service logically assigned to them.

Given the greater interjurisdictional mobility of the base of the income tax relative to that of the consumption tax, and of the latter relative to that of the property tax (and the efficiency problems arising from tax exportation, when not precisely offset by benefit spillovers), most analysts suggest that the local public sector should be financed basically by the user charges and “local” taxes, especially the property taxes, and states by consumption taxes, with the income tax being left largely to the central (federal) government(Musgrave 1983). But this division of revenue means that state and local governments are likely to end up with greater expenditure responsibilities than can be financed from their own revenues. An important element of fiscal

federalism from the beginning has thus been recognition of the probable need for intergovernmental grants to close the revenue gap. Considerable attention has been devoted to the appropriate design of such grants (Wilde 1971; Ahmed 1997), as well as to empirical analysis of their effects on local spending patterns (Gramlich 1977; Rubinfeld 1987).

The theory of fiscal federalism applies as well, or badly, to local services units in metropolitan areas as to the state of federation. In principle, however, there are important analytical and policy differences, not only between local-metropolitan problems and federal-state problems but even between “tight” federations such as Germany and “loose” federations such as Canada, with the United States some where in between (Bird 1986). These differences arise in part from the differing nature and rigidity of the constraints imposed by political institutions. The question has attracted considerable attention in recent years, in part because of the emergence of nascent federal institutions in the European Union. However, fiscal federalism has little to say as yet about dynamics of institutional change in emerging (or disintegrating) federations. Moreover, it offers little guidance in dealing with such important real-world intergovernmental finance problems as appropriate size and scope of operation of local and intermediate-level governments in the newly emerging countries of the former Soviet bloc (Bird, Ebel, and Wallich 1995), where, for example, the potential impact on stabilization (Gramlich 1987) is the major concern.

In contrast, much good work has been done within this analytical framework on some of the problems arising from the common metropolitan area and situation of divided political jurisdictions within an economically integrated region. A structure that puts people’s place of work and residence in separate political jurisdictions, while making the latter primarily responsible for the most important local expenditure and education, has obvious implications for both efficiency and distribution (Wildasin 1986), as has been much explored in the literature on education finance. There is still much to be done, however, to satisfactorily explain local redistributive policies (Treich 1981); through, for example, education; and their impact on migration and other important economic variables (Wildasin 1991).

Much has been written about the virtues of decentralized government, from both a political and an economic perspective (Tullock 1994), but most of these supposed virtues can, in the conventional fiscal federalism framework, be achieved as well by regional based central officials

as by locally elected politicians. Perhaps some of the answer lie in the new “supply-side” theories of government (Breton 1996) that are beginning to be developed in the broad “public choice” framework (Mueller 1992), because there is considerable similarity between the assumption underlying public choice theory and federalist theory (Ostrom 1971). As yet, however, little progress has been made with respect to articulating these arguments in either normative or positive terms in the conventional fiscal federalism analysis, other than as a simple assertions.

Nonetheless, some important lessons have emerged from the fiscal federalism literature (Inman and Rubinfeld 1997). In particular, considerable progress has been made with respect to the appropriate assignment of tasks and finances in multilevel governments, especially with respect to the design and effects of intergovernmental grants (Wildasin 1997). While there is considerable variation in detail from state to state; let alone across countries; on the whole the observed assignment of functions to local and state governments accords broadly with the dictates of theory, with local governments being broadly responsible for “place-specific” services such as streets, water and sewerage works, refuse disposal, and fire and police services. In addition, in the United States, local governments are generally responsible for providing primary and secondary education, although as rule with substantial fiscal assistance from state governments; in other countries, education is often provided primarily by intermediate-level (state) governments and sometimes even by central governments. A common pattern everywhere is for one level of government to be involved in delivering a certain service while other levels are involved to varying degrees in financing and regulating it (Ter-Minasian 1997). Work on understanding the desirability and effects of alternative institutional structure of providing particular services is still in its infancy though.

Local governments rely heavily on property taxes for revenue, while state governments rely on a mixture of sales and income taxes, and the federal government mainly on income (payroll) taxes. The division of revenue differs in other countries although almost everywhere local governments get property taxes and central governments most income taxes, in some countries local income taxes; like national sales taxes; are much more important than in United States (Owens and Panella 1991). Such taxes are invariably “piggybacked” on national taxes; that is, they take the form of surcharges. Only Switzerland comes closer to matching the diversity of the state and

local income and sale taxes found in the United States. Most other countries, whether formally federal or not have much more territorially uniform fiscal system. Although there is clearly vertical competition between levels of government for revenue, most attention has been paid in the literature to horizontal tax competition, perhaps because as rule local governments have access only to those revenue sources that higher-level governments do not want for themselves.

Local governments almost invariably depend in part, and sometimes very heavily, upon transfer from upper-level governments to finance the services for which they are responsible. The appropriate level and design of such transfer has been an important concern of fiscal federalism literature. Some argue, for example, that a system of unconditional fiscal equalization grants is an essential component of an efficient (and equitable) fiscal federal system (Boadway and Flatters 1982). Others assert that there is no place for such transfer (Oakland 1994). The theoretical literatures suggest that the only clear efficiency case for intergovernmental payments is to compensate local governments for benefit spillovers to ensure that they provide the optimal amount of public service in question. In practice, however, virtually no examples of open-ended conditional matching grants called for by this theory are to be found in any country (Ahmed, 1997). On the contrary, most countries (other than the United States) have some system of unconditional transfer intended to equalize some concept of fiscal capacity. Moreover, most conditional matching grants are limited in amount and probably best interpreted in a principal-agent framework (Ferris and Winkler 1991), that is, as equivalent of mandated functions being paid for, in large part, by transfer but with some local payment being called for. The latter is to ensure that local fiscal effort is maintained and also that, at the margin, local politicians remain electorally accountable for their actions to their constituent, as well as to the granting authority.

At the policy level, the Advisory Commission on Intergovernmental Relations (ACIR) (1990) carried out pioneering studies on fiscal disparities (sometimes referred to as “horizontal imbalance”), fiscal capacity, and fiscal effort. Curiously, this work has had its greatest policy impact in other federal countries such as Canada, where since 1967 a version of the ACIR’s “representative tax system concepts” had formed the basis of the federal provincial equalization system; which itself was based in large part on a system developed in Australia in the 1930s (and since extended from revenue to expenditure equalization). Similarly, system of federal-state transfer, often based on formulas and usually unconditional in nature; are characteristics of most

federal countries (Shah 1994). Apart from the brief experience with a small “revenue-sharing” system in the 1970s (Juster 1977), the United States is unique among federal countries in that it has never had a system of federal-state equalization transfer; although there are, of course, many federal-state conditional transfers, as well as some experience with fiscal equalization at the state and local levels.

Summary

This chapter is the starting point to the present course material on fiscal federalism. It tried to introduce basic thoughts that are directly or indirectly associated to the rubric of the course at hand. The fundamental idea to this chapter is to identify the concept of fiscal federalism from its partners. Federalism has got the first of place in yielding fiscal decentralization. From its root, federalism is one form of state structure compared to unitary and confederation. The concept under each structure and federalism with its definition, basic elements, advantages and the constitutional division of power form the first part of this chapter.

The second part of this chapter is intended for the discussion of foreign and interstate commerce and different economic policies. It deals about the relation of each topic of the discussion with and their impact on fiscal federalism.

Lastly, fiscal federalism with its relation to the concept of public finance, merits and demerits and the evolution and development of fiscal federalism in Ethiopia and the additional reading close the chapter.

The contents of the topics are summarized as follows: as mentioned above, the first part deals with state structures; unitary, federation and confederation. Unitarism focus on centralization of power and particularization of government to a single body while other administration bodies are meant as agent of the center. In contrast, federalism underline the decentralization of nation power to multiple non-centralized governments; federal, state and local. Confederation is a different structure that maintains the sovereignty of the independent member states. The unit only serves their common benefits such as, economic integrity, military strength, promotion of common culture, etc. it is less durable; the members can with draw at any time.

The powers of foreign and interstate affairs are entrusted to the federal government in most federations. In light of fiscal federalism, it basically serves to equalization of the states which have unequal potential to exercise these powers. The market economic policy and fiscal federalism have the same effect to the subjects of the country. That is both empower individuals

to exercise power in their own affairs. Privatization is the form of both political and economic powers decentralization.

Fiscal federalism is the decentralized public finance of federation. While the concept of public finance shows the finances of any government, either in federal or in unitary setup, fiscal decentralization is the degree of distribution of financial power in any country setup. However, the non-recentralized decentralization of public finance in federal arrangement is referred to as fiscal federalism. Theory of fiscal federalism focuses on division of expenditure responsibilities, the revenue raising power and adjusting vertical and horizontal imbalances between the federal and the states and among the states respectively through intergovernmental fiscal transfer. It has advantages and disadvantages. Some of the advantages are optimum utilization of resources and development growth, creating employment opportunity and limiting central bureaucracy and corruption. Whereas, financial imbalances and competition among the federating units, mobility and migration of workers and professionals to the place of better payment which is resulted from financial gap of the federating units and spillover effects of services from the region of their higher concentration to the regions of less concentration without legitimate recognition are some of the downsides of fiscal federalism.

The evolution of decentralization in Ethiopia dates back to the ancient Axumite Kingdom of the 1000 BC. It was continued through the Zagwe and Solomonic dynasties of the medieval period. However the modern history of Ethiopia opened by strong centralization of power and continued up until 1991 where the first road of decentralization to formal federalism of 1995 was started. The financial aspect of the country followed the course as well.

CHAPTER TWO

ALLOCATION OF PUBLIC EXPENDITURE RESPONSIBILITIES

Introduction

Students; you have learnt the general overview about federalism and fiscal federalism in chapter one. Public expenditure, mainly the power of spending depends on the revenue of the government. The concept of public expenditure has a prominent place in the study of public finance. All the subjects of government finance whether it is the power of spending or the power of collecting abridge to the end of expenditure to satisfy the public services. It basically consists of determination of the area of investment; functions through legislation and the spending of the resources. In practice, a state breathes on the circulation of revenues in its body. Even friendly relationship of states in the world opens with grants and loans which is the result of their internal revenue to enable the state to perform its duties. Therefore, the healthy condition of public expenditure signifies the proper function of the state. However, the task of acquiring sufficient resource to perform the state duties in the way that satisfies the subjects is not easy. The challenge amplifies where there is existence of more than one level of government within the same geographical area. In federations, since the multiple tiers of governments broaden the function of the state and the tension between them to function better according to their public different needs seek the precise constitutional allocation expenditures. Hence, the main subject of this chapter is the constitutional division of expenditure responsibilities in Ethiopia. For better comprehension of the main idea, the substance of public expenditure; its meaning and type, and other federations approach in allocation of expenditure sources are also discussed. Students are recommended to follow the logical flow of the concepts and exercise the activities and in-text questions accordingly.

Chapter Objectives

At the end of this chapter, the students will be able, among other things, to:

- understand the concept and meaning of public expenditure,
- identify the basic principles and objectives of public expenditure,.
- internalize main areas of expenditure responsibility: capital and recurrent,
- learn lessons from USA and Germany experiences of allocation of function and expenditure responsibility,
- get the methods of allocation expenditure between the multiple level of governments in general and under FDRE Constitution in particular, and
- acquaint themselves with the constitutional allocation of power and expenditure responsibilities and budgeting process.

2.1. Meaning of Public Expenditure

? Students, what do you think after the phrase ‘public expenditure’?

The concept of public expenditure has a wider meaning that is highly associated with the function of government than any subject of public finance; in addition, the allocation of expenditures in federal form of state structure amplifies the problem to postulate the concept in a clause. In broader sense, public expenditure signifies the functions of government whereas, narrowly, it implies government’s identifying and prioritizing areas of spending and implementing those identified projects in particular fiscal year.

Public expenditure is not only the most important but also the central part of the study of public finance. It is incurred by the government for the attainment of public good. Every government has to maintain law and order, armed forces for providing protection, public parks, schools, health etc. of the people. Government has to perform certain other welfare measures like maternity protection, arranging for cheap food, cloth and low-cost housing for the poor and so on. All these multifarious activities which are increasing every year require huge fund. Public expenditure, thus occupies the same important place in the study of public finance that consumption occupies in the study of economics.

In economics, public expenditure is the value of goods and services bought by the State and its articulations. It plays four main roles: current effective demand; coordinated impulse on the economy, which can be used for stabilization, business cycle inversion, and growth purposes; public endowment of goods for everybody and positive externalities to economy and society, the more so through its capital component. It plays these economic roles through economic variables: GDP, consumption, prices, employment, etc. Public expenditure has an immediate impact on GDP. An increase of public expenditure raises GDP by the same amount, other things equal. Moreover, since income is an important determinant of consumption, that increase of income will be followed by a rise in consumption: a positive feedback loop has been triggered between consumption and income, exactly as in the case of shocks in export, investment or autonomous consumption.

The full extent of this mechanism will depend, however, on the reactions of the other economic agents. Firms have to decide whether to increase production or prices in response to demand.

Moreover, if consumers interpret the increase in public expenditure as a fall in their disposable income (i.e. after-tax income), consumption may fall accordingly.

Public expenditure is also told to crowd-out investment, possibly through an interest rate increase, further leading, in a floating exchange rate regime, to a currency appreciation. Exports would then be displaced as well. Automatic stabilizers may be at work, as with the case of support schemes for unemployment: in this case, higher unemployment and disappointing GDP growth would lead to higher public expenditure through unemployment benefits and financial support to firms.

In more microeconomic terms, public expenditure may be directed to consumer goods and thus substitute families' expenditure, as with the case of health drugs. By contrast, in other cases, as with education, public expenditure may trigger further consumption (books and all the other goods whose consumption depend on culture levels).

Public Expenditure is incurred by public authorities – Central, State and Local Governments – either for the satisfaction of collective needs of the citizens or for promoting their economic and social welfare. They can finance expenditures through taxes, public debt, money emission, and international aid.

2.2. Objectives and Principles of Public Expenditure

a) Objectives of Public Expenditure

Dalton divided the aims of public expenditure in broader two parts *i.e.* the functions of government.

- (i) Security of life against the external aggression and internal disorder and injustice.
- (ii) Development or upgradation of social life in the community.

These functions can be broken down in to more detailed functions as:

1. the public authority works in many ways for the benefit of the people. These include the generalized services like public health and education. The whole society is benefited by these functions of the State.
2. secondly, through public expenditure, the government influences directly or indirectly, the industrial and commercial system of the nation thereby helps towards the economic and social development of the society.
3. thirdly, in modern times, the responsibilities of the government are increasing every year. For the economic development of the country, the government has started, on its own accord, industries and commercial businesses. This sector of the economy which is under the direct control of State has come to be known as public sector. Expenditure on this sector is increasing rapidly every year. In an underdeveloped economy, this aim of public expenditure has attained great significance.
4. Fourthly, Dalton points out that the public expenditure should be carried on up to that limit where the marginal benefit arising from different branches of expenditure are equal. These marginal benefits must be equal to the marginal sacrifice incurred by the public.
5. Public spending should be designed to optimize the level of investment in such a way as to maintain full employment – with growth.
6. Public Spending may be incurred at an increasing rate in the backward region to uplift their economy.

b) Principles of Public Expenditure

In economic literature, the expression “Canons of public expenditure” is used for the fundamental rules or principles governing the spending policy of the government. The following canons of public expenditure have been laid down by many scholars on the subject:

- (1) **Canon of Benefit:** - this canon suggests that every public spending must ultimately be used for the cause of social benefit i.e. for the general well-being of the common people. In other words, the State spending should confer benefits on the entire community at large than on an individual group or section. It means public funds should be spending in such directions which pursue common interest and promote general welfare.

- (2) **Canon of Economy:-** It implies that public expenditure should be incurred carefully and economically. Economy here means that wasteful and extravagant expenditure should be a voided at all levels. Public expenditure must be productive and efficient. Hence, it must be incurred only on very essential items of common benefit – without duplication in a way that involves minimum cost. An efficient system of financial administration is therefore, very essential in any country.

- (3) **Canon of Sanction:** this canon suggests that no public spending should be made without the approval of proper authority. Only obtaining prior sanction is not sufficient. It must be properly inspected and examined whether the sanctioned amount of money spent on the purpose for which it is sanctioned by the highest authority and accounts properly audited.

- (4) **Canon of Surplus:** this canon suggest that saving is a virtue even for the government, so an ideal budget is one which contains an element of surplus by keeping public expenditure below public revenue. In other words, public authorities should aim at surplus of income over expenditure and they should avoid deficits. Frequent and huge deficits lead to uncontrollable financial situation with dire consequences of inflation. Therefore every government should attempt to balance its income and expenditure.

- (5) **Canon of Elasticity:-** this canon requires that the expenditure policy of the State should be such that changes must be possible in the expenses according to the changes in requirements and circumstances. In other words, there should be scope for changes in public expenditure according to the requirements of the country.
- (6) **Canon of Productivity:-** this canon or principle implies that the expenditure policy of the Government should be such that would encourage production in a country. That means a large part of public expenditure must be allocated for development purposes.
- (7) **Canon of Equality:-** one of the foremost aims of public expenditure is also to ensure the just and equitable distribution of income by conferring benefits on the poorer section of the community. This canon of equitable distribution is more significant for the countries where the gap between the highest income and the lowest income groups is very wide. Developing countries like Ethiopia, have given this aim a significant and particular importance in the economic activities of the State and in their fiscal policies.

2.3. Main areas of Expenditure Responsibility: capital and recurrent

Technically, in the structure of a budget, most governments classify expenditure into two.

- (i) Recurrent expenditure, and
- (ii) Capital expenditure.

All sorts of administrative costs such as salary, and defence expenditure and debt services are called recurrent expenditure. They are also referred to as non-developmental expenditure. They are intended for continuing the existing flow of goods and services and maintaining the capital of the country intact. On the other hand, capital expenditures contribute to increased productive capacity of the nation and therefore, are known as development expenditure. Expenditures on construction of dams, public works, state enterprises, agricultural and industrial development etc., are instances of capital expenditure.

Though public expenditure is a means of maintaining the capital of the country intact, it is not merely a financial mechanism, it is rather a means of securing social objectives. Socialism can be

realized only through progressive taxation and their distribution afterwards. Therefore, public expenditure is that expenditure incurred by the public authorities i.e. Central, State and Local governments, to satisfy those common wants which the people in their individual capacity are unable to satisfy efficiency wants.

The federal Government of Ethiopia, for instance in 2006 Fiscal Year, a total expenditure of 45.2 per cent was spent to capital expenditure and 26.8 per cent for recurrent expenditure while 28 per cent had gone to budget grant to regions. In subsequent fiscal years, relative increment has been experienced with a minor variation of the percentage share.

Activity 1

1. State the principles and objectives of public expenditure by contextualizing them with Ethiopia.
2. Ethiopia is following free market economy and it has also rendering public sector functions. The concept public sector varies among economic policies discussed in chapter one. What are the limits of government involvement as public sector in industries and commercial businesses under free market economy and the practice in Ethiopia?
3. The principles of expenditure like canons of benefit and equality seem incompatible with fiscal federalism especially in ethnic federalism like that of Ethiopia, for the revenue raising and expenditure responsibility are decentralized among tiers of governments. How these principles can be achieved in federations in general and in Ethiopia in particular?
4. Discuss the relation between public expenditure and economic variables like GDP, investment, employment, consumption, exchange rate, export and demand.

2.4. Roles of Each Layer of Governments

Public expenditure is determined by political will of the leading forces in the state: their priorities, their desired state model, and their interpretation of current economic and political phase. Past choices have relevant impact on public expenditure because of inertia and instrumentalism. Bureaucracy may play an important decision role for the actual expenditure.

Sometimes considered as a completely exogenous variable, the public expenditure would thus be fully in the hand of political decision-makers without dependency from the economic context. With its prioritized structure and its peculiar decision-making processes, public expenditure substantiates the prevailing kind of State. In democracy, public expenditure is an expression of people's will, managed through political parties and institutions. At the same time, public expenditure is characterized by a high degree of inertia and law-dependency, which tempers the will of the current majority.

In particular, as a very sketched framework, one may distinguish at least three general models of state to which public expenditure corresponds: There are:

1. the **minimal state**, where only justice, public order, foreign policy and some other basic functions should be carried out by the state, relying on private initiative for the others;
2. the **welfare state**, where the State cares about the people's well-being directly, also through expenditure in schooling, health, support for the poor, the old, the disadvantaged,
3. the **developmental state**, where the State takes the responsibility of fostering economic development, also through expenditure in infrastructure, support for firms, export and production in general.

Both the welfare and developmental state include the items of the minimal state. Military expenditure and special policies are common traits of the three models, maybe in different proportions. Comparing function shares in public expenditure, one can get insights in the kind of state under analysis. Needless to say, the State does not exert its influence on economy and society through public expenditure only, but also for example through laws.

In Ethiopia, the fiscal years from 2002-2006, six functional areas, *i.e.* Agriculture, Rural Water Supply, Rural Road, Education, Health, Administration and General Services are identified as the major sectors of regional expenditures. This is evidenced by the largest share (over 90 per cent) that these sector account from the total regional expenditures.

On the contrast, the federal government expenditures are summarized by the 2007 and 2008 federal fiscal budget proclamation under the heading of recurrent budget, capital budget and

subsidy. Accordingly, administration and general service, economic service, social service and other expenditures are the major branches of federal capital and recurrent expenditures. Administration and general service comprises the expenses organ of the state, justice and public order, national defence and general service. Economic service consists of agriculture and rural development, water resources, industry and trade, mining and energy, transport and communication and construction. Social service comprises education and training, information and communication, culture and sport, health, labour and social affairs and prevention and rehabilitation. Lastly, under other expenditure heading transfer, regional subsidy, public debts, provisions and others are arranged.

In 2007 fiscal year regional subsidy (14 bill.), construction (5.98 bill.), agriculture and rural development (4.59 bill.), education and training (4.56 bill.), national defence (3.5 bill.), public debts (2.32 bill.), health (1.81 bill.) and transfer (1.35 bill.) constitute above one billion Birr of federal government expenditure. In 2008 fiscal year federal budget the same items of expenditure has constituted the major area of federal expenditures with a grater increment in amount ranging from 18 mill. in transfer to 3.18 bill. in regional subsidy.

2.4.1. Allocation of Expenditure Responsibilities

In the study of the system of the division of expenditure responsibilities in a federal system, there should be careful consideration of the following points. First, it intertwines with the system of distribution of powers between the federation and the states. In this regard, the constitutional techniques for the allocation of powers in general and the scope of the powers allocated to each tier of government in particular results the functions of each tiers of governments, then follows the need to implement those assigned function through policies which, in turn requires expenditures. The 'division' of expenditure responsibilities is also called the 'assignment' of expenditure responsibilities in much of the literature.

The distribution of expenditure responsibilities in a federal system corresponds with the division of legislative as well as executive powers between the tiers of government. Legislative costs are insignificant compared to administrative costs. However,

legislative power is essential to understand the extent of a government's expenditure responsibility.

The actual division of expenditure responsibility deals mainly with the interrelated aspects of the division of legislative and executive powers. Central to this issue is which responsibilities or authorities are divided between the levels of government. In some federations, like the USA, the legislative, executive, judicial and financial powers are divided between the federal government and the states, and then the expenditure responsibility becomes coextensive with the legislative responsibility of each level of government. In other federations, like Germany, the legislative power is mainly entrusted to the federal government while the executive power is mainly reserved to the states. (We will discuss both of these in the next subtopics).

Activity 2

1. Discuss the models of states categorized by their nature of public expenditure What are their basic features?
2. To which state kind the Ethiopian expenditures responsibility activity implies?
3. Preparation of budget needs the participation of political bodies and the citizenry, grass root democracy, similarly basis on bottom-up participation in any decision. Thus, if a state expenditure program and preference is made through hierarchical political decision-making, how the people's needs are to be heard during each financial year?
4. In federal system, powers and functions of the state are divided among the levels of governments, does division of expenditure responsibility always consistent with the division of powers and functions in federal system? Why? Why not?

2.5. The Constitutional Methods for the Division of Expenditure Responsibility: the USA and Germany Experiences

In this sub topic, the material discusses about the experiences of some of the federation, selection is made to USA and Germany. Why the selection is made to USA and Germany than other federation is the question that follows.

- ? Discuss the peculiar features of USA and German constitutional allocation of power between the center and the regions and what lesson Ethiopia's systems can learn?

The selection to the above named federations has some ramifications. The US federation, for its pioneer and complex of federalism and the constitutional base of individualism and liberalism totally far from the spirit of FDRE constitution albeit, the mechanism of allocation is to some extent similar. The German experience is the best identified to its moderate lubrication the tension of highly ethicized federalism, which is common in other federations like Switzerland, Canada, Belgium, etc. Thus, the two selected federations teach the Ethiopian system lessons to harmonize the individual rights and group rights which are enshrined in the FDRE Constitution. In addition, the allocation of power and function which seek expenditure has also the same benefit.

2.5.1. USA Experience

The USA is a three-tier federation consisting of central government, states and local governments of various types. There are at least three unique features of fiscal system of the USA. First, it is one of the countries where fiscal federalism has had a long history and the fiscal framework is deeply embodied in the federalist spirit of the constitution. Second, it is the most diversified and complex system. For one thing, the state fiscal system is very diverse, and so is the degree of fiscal decentralization. For another, the structure of local government in various parts of the country, and hence, there is a great deal of variety in the pattern of the local government among different states. These combined with the lack of a clear assignment of fiscal

responsibilities among the various levels of governments, has led to the introduction of very complex and diversified system of change from time to time, the efficiency costs of which are large and can only be afforded by an advanced nation like the USA.

The third and the most striking features of the US fiscal federalism, in spite of its high complexity and diversity, is that there has been much stability. On the one hand, the fiscal structure has been the most flexible by any standards. This can be evidenced by the expanding role of inter-governmental transfers and the reassignments of fiscal responsibilities over times. As such, the Constitution provided neither assignment of particular expenditure functions to the various levels of governments nor did it prescribe what taxes should be used by them. It also refrained from setting specific limits to the expenditure functions of the federal government since the “general welfare” could be interpreted in extremely broad sense such that it would give much discretionary power to the federal government

Although the Federal government of the USA is referred to as the government of specified or enumerated powers since the powers of the federation have been specifically mentioned in the constitution, the wording of some of the provisions has not escaped from being the sources of controversy between the federation and the states. Accordingly, one such case has led to the development of implied powers. Implied powers are not specifically mentioned in the constitution, but they are necessarily interconnected with those specifically mentioned powers of the federal government and are enforced by judicial review. The source of implied power is Article I Section 8 of the US constitution which empowers congress to make all laws which shall be ‘necessary and proper’ for executing the enumerated powers.

The law based on implied power is valid if it articulates any provision, article or section of the Constitution and thereby promotes the general welfare of society. It implies that specific power could not have been exercised without the implied power. Further, the Supreme Court of the United States has given power implied in any enumerated to congress for the reason that implied power is not expressly reserved for the states. The ‘commerce clause’ is also another ground extending the power of congress in any issue related to interstate commerce.

The big items of US federal expenditure include social insurance, defence and interest. The big

items of state expenditures are education, welfare, social security, and transportation. By far, the dominant function at local level is education. Defense is entirely and social security is largely federal. Expenditures on welfare and transportation are made at state level, while education and policy are largely local functions. By including the general welfare as a legitimate objectives of federal finance, the constitution refrain from setting specific limits to the federal government's expenditure function. Interpretation of the term general welfare was left to the Congress and the courts, and it has come to be interpreted in any extremely broad sense. The general welfare is understood to cover not general objectives, such as national defense or the administration of justice, but also highly selective programs aimed at particular regions or population groups, such as aid to Appalachia, grant-in-aid, and transfer payments.

Although states in general have wider freedom in designing fiscal measures, a series of cases have challenged the system for funding the public schools. The bulk of the funds for public elementary and secondary education come from the local property tax. Since the property tax base varies among school district, children in low-base districts may be disadvantaged. Starting in 1971 in with the decision of California's Supreme Court in *Serrano v Priest*, a number of state court and lower federal courts have found the existing scheme for funding the public schools unconstitutional. The California Supreme Court in *Serrano v Priest* held that the "right to education in public school is a fundamental interest which cannot be conditioned by wealth." Judicial opinions in these cases referred to both the equal protection of the US Constitution and to the pertinent provisions of the relevant state constitutions.

Those who hoped that the educational finance decisions would bring immediate change to the system for local government finance were disappointed by the US Supreme Court's 1972 decision in *San Antonio Independent School District v. Rodriguez*. The Court held that the Texas's system for funding its public school did not violate the equal protection clause of the Fourteenth Amendment of the US Constitution. Its opinion seems sufficiently broad to validate the existing finance system. However, the Supreme Court of New Jersey has held that New Jersey's scheme of public school finance was unconstitutional under the New Jersey constitution and a number of states have followed, while legislation continues after others after *Rodriguez*. Even though, the US Supreme Court has refused to lay down a strict rule, state constitutions are interpreted increasingly as calling for equal education opportunity and independence of

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education finance from the local property tax.

The expenditure implementation needs the program to be planned, legislated, and executed. Focus will be on federal operation, since they much the largest, but more or less similar patterns are followed by states and locals.

The central instrument of expenditure policy is the budget. The four steps involved in the budget cycle are (1) formulation of the president's budget by the executive branch, (2) appraisal of the president's budget by the congress and budget legislation, (3) the execution of this legislation by the executive branch and (4) auditing by the General Accounting Office (GAO). Each of the will be discussed hereunder.

The president, with the help of the office of Management and Budget (OMB), prepares the budget and presents it to Congress in January of each year. This budget covers the coming fiscal year, running from October 1 to September. The lengthy process of budget preparation begins with the setting of guidelines by the executive branch. In consultation with other agencies, such as the Treasury and the Council of Economic Advisers, implications of the budget plan for tax policy and stabilization are allowed for. The resulting guidelines then become the basis for budget requests by the various department of government. The requests are then scrutinized by OMB in a series of budget hearings and brought into in line with the President's wishes. The budget, thus, comes as close to being a statement of administration policy and an economic plan is possible in governmental system.

The second step in the US expenditure policy is the congressional budget process. The budget must be submitted to Congress by January of each year, where it is received by the Congressional budget Committee. This Committee is flanked by corresponding committees in the House and Senate, is responsible for expediting the congressional budget process. The corresponding Hose and Senate committees follow a common schedule, beginning with the preparation of a "concurrent resolution" on the budget. Each committee must report its version of the resolution to its house by April 15. This resolution is to set the overall level of expenditures for the coming fiscal years as well as to provide a breakdown among major functional categories and to determine the required level of revenue. By May 15, the legislative process on the resolution must be completed, including the conference to reconcile the difference between the

two resolutions. Then, trying to stay within the limits set by the budget resolution, Congress acts (or it is supposed to act) on the appropriation bills, finishing shortly after Labor Day. In the time remaining before the start of the new fiscal year on October 1, Congress passes a second concurrent resolution on the budget in which it reaffirms its earlier decisions or revises them. In the latter case, a reconciliation bill that carries out the dictates of the resolution- including cuts in appropriation bills already enacted- must be passed before the start of the new fiscal year.

To help congress follow this expeditious and exacting budget schedule, a Congressional Budget Office was established to provide Congress with technical and staff assistance thereby greatly strengthening the ability of Congress to analyze the administration's proposals and to design its own budget. Unlike the case in the parliamentary system, in which the legislature accepts the government's budget as a matter of course or the government falls, the President's budget is no more than a recommendation to Congress. Congress may legislate as it wishes, and the full impact of political forces comes into play. Much depends on the strength which the President's threatening to veto appropriation bills.

The third step is budget execution. After the budget is enacted and a department has received its appropriation and authority to spend, it may proceed to do so, but execution of the programs remains under the supervision of OMB. While expenditures must be in line with congressional legislation, the executive branch has some flexibility in timing. However, once legislated by Congress, programs cannot be dropped by executive decision.

The final step in the budget cycle is the accounting and auditing function. This function is performed by the General Accounting Office, an independent agency outside the Executive Office and responsible directly to Congress. In this way, Congress can ensure that the funds have been expended in line with congressional intent and that no irregularities occur.

2.5.2. Germany Experience

The German Basic Law (*Grundgesetz*) defines a strict federal system whose dominant elements and actors are the *Länder* (states) and their *Gemeinden* (local administration), not

the top administrative level, the *Bund* (center). The Constitution is one of “moderate separation” or “cooperative federalism”. The moderation is explained through three aspects. First, each level has its specific task and duties as well as some taxable source – but not the general right to tax – for fulfilling its duties. Second, some tasks as well as some revenue sources are not exclusively assigned to one level, but instead are shared by two or even three administrative levels. Thirdly, there is a legally fixed mechanism which allows for an inter-Lander and inter-*Gemeinden* equalization of fiscal and economic power.

The Basic Law not only provides exclusive powers for the central and the regional governments but also extensively provides the concurrent powers of both levels of government, in general leaving their execution to the *Länder*. In Germany, the issue is not of inconsistency, but rather the existence of conditions subject to which the federation or the states can exercise the concurrent power (the Basic Law, Articles 72 and 74). The states can legislate on the subjects listed under the concurrent legislation so long as and to the extent that the federation has not exercised its legislative power by enacting a law. The concurrent power, on the other hand, can only be exercised by the federation if it is essential for the establishment of equal living conditions or for maintaining legal and economic union throughout the federation. This means that, unlike exclusive power, all powers under the concurrent list are not transferred to the federation. They can be exercised by the federation only when uniform federal legislation is required. If an issue of constitutionality arises, the constitutional court adjudicates the issue.

Accordingly, the Basic Law of German powers and functions of each level of administration are demarcated. What follows is a list of the constitutive functions of the *Bund*. This will not be discussed here in great detail because it is self-explanatory. Moreover, these are functions that are assigned to the central administration. To name some, Burdens as consequence of the war, Foreign affairs: proof of nationality and passport and visa; Defense; Currency, coins (but not issuance of paper money: this is the task of the Central Bank); Safeguarding the social insurance system; Labour administration; Federal Police; only two specific troops, namely: border protection and anti-terror unit; Federal financial administration; Administration of federal property and Supervision of the administrative act of the *Länder*.

Secondly, other tasks are identified by the Constitution as the subject matters of the *Bund* which are fulfilled by *Lander*. These include administrative tasks in the fields of federal highways, federal waterways, air traffic, defense and taxes.

Thirdly, the *Landers* are also exclusively empowered with the following task: Police, Culture and education, Transport, Construction and maintenance of (non- federal) roads and waterways, Provision of water and energy, Administration of *Lander* property, Supervision of the *Gemeinden*. Behind these lists for the Lander is hidden an immense range of politically and economically important tasks. This can be concretized in greater detail most clearly at the level of the *Gemeinden*, where the tasks of the Lander are put into practice.

Lastly, *Gemeinden* has the following list and it includes the majority of single items which belong to the tasks of a normal German *Gemeinden*. Some are duties which are fulfilled by the *Gemeinden* on account of the *Lander* to which the *Gemeinden* belongs. Tasks of a typical *Gemeinden* includes administration of property of the *Gemeinden*, especially of its enterprises, Tax administration, Regional planning, Registration/Records, Social question, Security, Industry, trade and commerce/inspectorate, Transportation, Environmental protection, Culture, Education, Sports.

The list looks long and indeed includes very many and important items. But it should be noted that such a list in itself does not prove the federal character of the fiscal or – more generally – the political system. Many of the above listed items must be fulfilled at the local level in any political system. By the same token, the expenditure responsibility follows the allocation of functions for a reason able implementation of the functions by the levels of administration seeks funding.

Activity 3

1. State the peculiar features of US and German federalism?
2. Write down the divergent and convergent areas of allocation of power in US and German constitutions.

3. The US Constitution is so short and general and has long history of amendment experience, since the policies are variable, the expenditures responsibilities are made flexible from year to year; does this nature of expenditure responsibility contribute to the amendment of the Constitution?
4. The base of American system in legislations shows the separation of power and check-and-balance for every legislation pass through three organs: the president, the parliament and the judiciary. If a yearly expenditure legislation is processed and passed through these scheme, what benefit is expected from such legislation to the peoples that are guarded by the organs? Does political decision-making override the interest?
5. The Basic Law of Germany provides legislative power to the center and the executive power to states on the same subject matters identified and this allocation is termed as framework power sharing. What are the advantages and disadvantages of such scheme?
Clue: uniformity, disparity of states in performances, autonomy of the state etc.

2.6. Division of Expenditure Responsibility under FDRE Constitution

? What are the implications of expenditure responsibility in broader and narrower sense?

As we discussed in the above lesson (2.1), expenditure responsibility and its allocation in federation signifies the allocation of powers and functions for the expenditure broadly means running the functions assigned to respective level of governments. On the other hand, expenditure responsibility narrowly means budgeting finance in every year. Hence, we will discuss the two dimensions of expenditure responsibility in Ethiopia.

2.6.1. Allocation of powers and functions under FDRE Constitution

In the Ethiopian federal system, the Constitution follows an approach of listing the exclusive powers and functions of the federal government (Art.51). It also provides a limited list of exclusive powers for the states (Article 52(2)). It mentions the source and type of taxes for which the states may exercise exclusive power. In principle, the Ethiopian Constitution follows the

USA model by enumerating the powers of the centre and allocating the residual powers to the states, but it also incorporates some features from India and Canada by listing some powers for the states.

In general, according to the Constitution, we can divide the powers and functions of the central government into four groups. The first group comprises those powers which by their very nature are considered to be the common concern of all the constituent units of the federation. In all federations, they are assigned to the central government. In this category of power, we may find national defence, international or foreign relations, citizenship, immigration and naturalization, and other powers that are supplementary to the main powers in this category. The Ethiopian Constitution (Article 55(7)) explicitly empowers the center to organize national defence, public security and the federal police force.

In the second group, several commercial powers that are essential for facilitating as well as international trade can be mentioned (taxation is independently dealt with in the next chapter). In this group, we find the largest category of powers, including interstate commerce; postal and telecommunication services; weights and measures; domestic currency coinage and foreign currency usage; and banking, insurance, patents copyright. These powers are assigned to the federal government primarily for economic reasons and for practical convenience. In all federal countries the central government power over currency and legal tender, but they may differ on regulating banking by giving a concurrent power to the states. In Ethiopia, however the central government has the power over monetary and fiscal policy, local currency, the administration of the national bank and foreign exchange. Under the Ethiopian Constitution regulating insurance is not specifically mentioned as the power of the center. Impliedly, extended from the exclusive mentioned interstate trade, the center assumes it.

Under the Ethiopian Constitution, rail, air and water transports and major roads linking two or more states are within the competence of the federal government. The legislative power of the federal legislature also extends to the labour and commercial codes. The FDRE Constitution does not enumerate those issues covered under the labour code such as employment contracts, trade unions, industrial and labour disputes. Nor does it mention various legal concepts included under

the commercial code, such as partnerships and bankruptcy.

The third group comprises legislation dealing with various aspects of social and political issues. In Ethiopia, the federal legislature (HOPR) may legislate on matters concerning electoral laws and procedures, as well as the enforcement of political rights established by the constitution. Some of the issues that may fall under the latter are press law, demonstrations and the registration of political parties.

The fourth group comprises civil and criminal laws. The FDRE Constitution enactment of the penal code is a federal matter. The states, however, may enact legislation on matters that are not covered by the penal code. The power over civil laws (e.g. the law of family and succession) is left to the states. The centre may enact civil law when the House of Federation considers that it is essential for employing uniform law in order to establish and sustain one economic community. In Ethiopia, those cases categorized under the fourth group mainly entail law-making power at the centre while, in practice, reserving the regulating and adjudicating power to the states.

The Constitution provides the states with a legislature, an executive and judiciary which are constitutionally independent from the central government in matters assigned to them. However, it is important to note that when powers assigned to each level of government are not mutually exclusive, there may be a greater possibility of encroachment on the power assigned to the other. This is because it is practically impossible to bring about a total power separation between the two levels of government, although the interrelationship between them may vary from one programme to the other. Accordingly, the Ethiopian Constitution reserves residual power to the states. Article 52 provides all powers not given expressly to the federal government alone or concurrently to the federal government and the states are reserved to the states. With regard to the residual power of taxation, however, the Constitution has another saving clause that does not automatically allocate it to the states: it is to be decided by a joint meeting of both Federal Houses (Article 99). Moreover, the Constitution reserves major policy matters governing education, health, environment, science and technology and development strategies to the centre which may broaden the power of the federal government over residual matters (Articles 51 (2 and3), 89-92).

Under Article 52(2) of the Constitution, the states have enumerated powers and functions. These powers include the establishment of state police power, the maintenance of public peace and order, levying and collecting taxes and duties on revenue sources reserved to states, the administration of land and other natural resources based on federal laws, and the employment and working conditions of civil servants. The states also have power over such areas as education, health and agriculture although the federal government has the power to set national standards. In addition, the States have independent power with respect to matters not mentioned in the federal list. However, it should be noted that the states may not have legislative power over residual powers. The Constitution has two provisions which limit the residual power of the states. The first concerns the taxation power, and the second is with regard to enactment of civil laws (Article 98 and 55 respectively). The regions cannot immediately assume the power of taxation that is not specifically provided by the Constitution either the centre, the regions, or concurrently to both. It has to be determined by a joint session and a two-thirds majority vote in the HOF and HOPR is required. Similarly, the federal legislature may enact civil laws if the House of Federation deems it necessary.

In addition, the limits of power assigned and the relations between the central and regional governments in relation to education, public health, and other social services have not become clear. For instance, the Constitution in its Article 51(3) provides that '[the federal government] shall establish and implement national standards and basic policy criteria for public health, education, science, and technology as well as the protection and preservation of cultural and historical legacies'

In practice, there is a general policy at the federal level and regions also have policies in most cases replicating the federal policy. The Constitution under its Article 51(2) provides '[the federal government shall] formulate and implement the country's policies, strategies and plans in respect of overall economic, social and development matters.' At the same time, the regions have the power 'to formulate and execute economic, social and development policies, strategies and plans of the state' (Article 52(2, c)). The Constitution does not spell out the relevance of similar policies at the central and regional levels at the same time. Nor does it indicate any restriction imposed upon the regions to act in areas left by the centre or in areas authorized by the central

government like that of the German and the Swiss Constitutions. Such cases may lead to inconsistencies between the federal and regional laws or policies. But this overlap of power of the respective governments can be clarified when seen in relation to the contents of power of the respective governments. For instance, in Ethiopia tertiary education is a federal matter whereas primary education falls within the state jurisdiction. Thus, the repetition could be avoided if the federal policy addresses higher education and states' policy focus on the major parts of primary education. At present the policies are issued at the federal level after being discussed and approved by the meetings of the ruling party.

The FDRE Constitution does not explicitly mention framework legislation like that of the German Basic Law. However, we can argue for the application of the principle of framework legislation in the Ethiopian federal Constitution. For instance, the federal government has the power to establish national standards and basic policy criteria for public health, education as well as for the protection and preservation of cultural and historical legacies. The federal government is involved in setting standards and basic policies, but the states are the major actors in the provision of education, public health and the protection of cultural and historical legacies. This division of power requires general, structured federal legislation and detailed state/local laws.

Furthermore, both the federation and a state have the power to formulate social, economic, and development strategies and policies for the country and the state respectively. The Constitution does not expect conflicting policies to be applicable at the same time. There are several options for this provision to be applicable. If policies determined by the federation remain as framework legislation, a state may determine specific policies addressing local needs. Presently there are several policies which have been decided by the federation and the states have acceded to them, implying the need for the uniformity of policies and laws throughout the federation. In general, it seems that the importance of the framework legislation is more favorable in a federation where the centre mainly retains the legislative power whereas the states engage in implementing the state as well as the federal legislation, as is the case in Germany. However, as we can see from the FDRE Constitution, there is a need for framework legislation for setting uniform standards and policies whereas the details are left to the member states since the expenditure responsibilities lie with them.

In general, the most important characteristics of a federal system is the existence of two levels of government and the concomitant division of powers between them. This division of powers sets a limit upon each level of government to remain within the territory of power and not to encroach upon the power of the other. In this regard, the states' constitutions in Ethiopia should provide the legislative, executive and judicial powers concerning matters which are reserved for them. The listings in a state Constitution may, to the possible extent, help to clearly demarcate the powers of the tiers of government within the state, and to minimize power conflicts with the centre.

The constitutional framework governing the division of power between the two tiers of government, enable us to explore the mechanisms as to how the federal government and the states fulfill their expenditure responsibilities. In general, how far does the FDRE Constitution deal with the allocation of expenditure responsibilities to both tiers of government is the next question.

? What is the implication of constitutional power allocation on the allocation of expenditure responsibilities? Do they have connection?

Before addressing the above issues, it is perhaps proper to note that the expenditure responsibility may not necessarily follow the legislative competence. This is because the scope of the expenditure responsibility is dependent upon the extent of both the legislative and the executive powers assigned to each level of government.

According to the Constitution, each government has the power of legislation and execution on matters that fall under its respective jurisdiction. Each tier of government shall respect powers of the other. And both the federal government and the states have to cover the financial expenditures necessary to carry out all the responsibilities assigned to them by law (Article 94(1)). To this effect, the powers and functions of the federal government and the states are listed under Article 51 and 52 of the Constitution respectively. In addition to Article 51, the scope of the legislative and the executive power of the federal government

are indicated under Articles 55, 74 and 77. According to the last two provisions, the executive power of the federal government is vested in the Prime Minister and Council of Ministers to follow up and ensure the implementation of laws, policies, directives and other decisions adopted by the HOPR.

Accordingly, those matters not mentioned under 'the powers and functions of the federal government' (Article 51), but included under the jurisdiction of the federal legislature (Article 55), are to be administered by the federal government. Federal laws are, therefore, implemented through the federal executive unless otherwise provided by the Constitution.

But the Constitution has the drawback of assuming complete separation of powers, the possibility of duplicating authority and not considering the efficient use of limited financial resources through administrative cooperation. However, the reasons for adopting this method of division of powers is related to the motive of the constitutional assembly which emphasized the values on 'self rule' rather than 'shared rules' or cooperation, as can also be seen in other provisions as well.

The question may be raised as to whether the Constitution permits the central government to reserve legislative power for itself and to leave its administration to the states. This is possible when the Constitution itself provides for an exception, or when the federal government delegates its powers and functions to be administered by the states, as prescribed in Article 50 (9). For example, the federal government enacts law for the utilization and conservation of land and other natural resources, historical sites and objects, but its administration is reserved for the states." There are certain matters which refer to the legislative power only. For instance, the power to establish national standards concerning public health, education, science and technology is reserved for the centre though the provision of these services is left to the states (Article 51 (3)). In these cases, it has to be clear on what basis the states administer the federal laws, because this can have financial implications. If the states are delegated with the administration of federal powers and functions, the financial implications thereof must be dealt with accordingly.

However, with regard to the administration of federal laws by the states, the constitution is

not always clear. This is because under Article 55 of the federal legislature, the HOPR, has also the power to enact laws in areas or subject-matters that are not included under the powers and functions of the federal government listed under Article 51. For instance, the HOPR has the power to enact labour, commercial and penal codes, and even civil laws on subject-matters which the HOF refers to. The Constitution specifically mentions those subjects allocated to the federal legislature; the problem, however, is how and who is to execute them.. In practice, there are also matters that cannot be administered by the federal government unless the states are responsible for their administration. These are cases of criminal law and regulating the possession and bearing of arms. Of course, this may have the benefit of a uniform application of laws by leaving room for local administrations. But, which provision of the Constitution authorizes the administration of these laws by the states is not clear.

The replicated provisions (of Articles 51 and 55) listing matters that require federal legislation have aggravated the problem of identifying the expenditure responsibility of the central government. Compared to the wording of Article 51, the provision of Article 55 explicitly determines the law-making power of the federal legislature concerning the same subject matters. However, apparently there is repetition in the allocation responsibilities to the centre. As the contents of Article 51 indicate, there are administrative and legislative responsibilities belonging to the government. Thus, what is the difference between the powers of enacting law in matters listed under Article 51 and Article 55 specifying the legislative powers of the HOPR? For example, both provisions provide that the federal government enacts laws regulating the possession and bearing of fire arms, and laws governing political parties and elections, but only Article 55 mentions the legislative power over labour, commercial and penal matters. Does it mean that the federal government has no administrative power with regard to these powers? It seems that there is an intention to leave the administration of these laws to the state, For example, concerning interstate trade and commerce, a closer scrutiny of the relevant provisions implies that, under the general provisions of Article 51, the federal organs required to regulate interstate trade, whereas the federal legislature is specifically required to enact laws with the help of which interstate trade and commerce can be regulated. with this regard, the confusion as to the specific meanings of the two apparently varying provisions may be resolved.

The allocation of legislative power is also the executive power except in cases where administration of federal laws is left to the states. But, as can be seen above, the administration of federal laws by the states is not clear. In practice, there is also direct involvement of the centre in the regions. This is partly due to the capacity problem in most of the regions. As a result, the expenditure responsibility of the central government may not be limited to its legislative powers. There can be cases where the executive power of a state extends beyond the scope of its legislative power. In such a case, the major factor that influences the expenditure responsibilities of both tiers of government will be intergovernmental relations through the use of conditional grants, executive agreements or other cooperative mechanisms.

At this juncture, it can be inferred that the allocation of expenditure responsibilities is part of allocation powers and it follows the root of other assigned powers since it enables the implementation of them. In addition, the center legislative power on some subject matter to be implemented or administrated by the state increase the states expenditure responsibilities in addition to their own assigned functions.

2.6.2. Budget Processing

In a federal system, constitutionally recognized levels of government can formulate their own economic, social and development strategies and determine their expenditure preferences. This is because they are constitutionally recognized jurisdictions having the respective autonomy to impose tax and to spend on expenditure needs. It should be noted that both the autonomy and accountability principles are applicable to both levels of governments. This financial autonomy of both expenditure allocations and the budgetary processes in Ethiopia broadly follow government policies. For instance, the budget proclamations show that the greater share of the federal budget is being devoted to roads, agriculture, capacity building and grant subsidies to regions. According to the recently introduced 'Sustainable Development and poverty Reduction Programme' (SDPRP), the budget allocation is expected to intertwine with the political and economic processes of the strategies indicated in the document. Accordingly, it should focus on agriculture and food

security projects, capacity building in the public sector, decentralization towards wereda and municipal governance, education, health and roads. In this regard, regional autonomy will be limited. However, their discretion is broader in the process of allocating recurrent and capital budgets and in prioritizing other expenditures. But, regions may show immense variations in their performance capacities, and in the expenditure evaluation and control mechanisms. In the following sub-sections, we will deal with the budget preparation, implementation and evaluation process in the centre and regions.

a) Budget Preparation

The FDRE Constitution calls for the governments at all times to promote the participation of the people in the formulation of national development policies and programmes, and to support the initiative of the people in their development endeavours (Article 89(6)). The overall approach of the Constitution is to provide a meaningful devolution of power to the lower levels of administration. This is possible if adequate power is granted to the lowest units of government to enable the people to participate directly in the local administration (Article 50(4)). The need for devolution of power also entails the autonomy to decide on the budgetary allocation based on local expenditure needs. That is, reversing the strict observance of the hierarchical budgetary relationship.

The FDRE Constitution also requires that the states shall determine all financial expenditure necessary to carry out all responsibilities and functions assigned to them by law (Article 94 (1)). However, the expenditure performance of states is, among other things, dependent upon the ability to draw up and administer their budgets. The independent budgeting process actually began in most of the states in the 1993/94 fiscal year. To understand this budgeting process, we have to remind ourselves how state governments are organized at least for the purpose of the budgeting system. The State Council (legislature), the state administration and the judiciary are established at the state level. The state administration, the highest executive organ, consists of sector bureaus which are also organized at the zonal, wereda and keble level. The sector bureaus are the major actors in the states' budgeting and spending activities. The weredas have a 'wereda council' and a 'wereda administration'.

The budgeting process before the 2002/03 fiscal year involved the coordination of several channels which ultimately make up the state's budget. This coordination involved a 'bottom-up information flow before the final amount was determined at the regional level. The bottom-up process refers to the process in which the budget was consolidated at the regional level by taking into consideration the requests from the wereda and zone levels.

The budgeting process in general had two dimensions: the identification of priorities and goals and managing funds in order to fulfill these goals. In the process of identifying priorities and goals, the major activity was to gather the budget needs of each administrative office. All the information about their needs was finally consolidated at the regional level and is approved by the state council. Information includes a draft request indicating the plan, the amount, the activities and the budget ceiling. Information flow began at the wereda level, where the wereda sectoral offices plan and send the budget request to the bodies concerned. This information flow took directions: horizontal and vertical flows.

The vertical information flow had two channels: the flow from a sector office at lower level to the office at the higher level, and a flow of consolidated information from the wereda council to the zonal administration and from the zones (the aggregate of report of several weredas) to the regional council. For example, in the education sector information flow from the wereda education bureau to the zonal education bureau. Zonal education bureau then consolidate the information gathered from all wereda bureaus accountable to it and finally transfer it to the regional education bureau. In a similar fashion, the regional education bureau gather and collect dated information from all zonal education bureaus. Finally, each sector bureau at the regional level consolidate the information gathered, and specified the implementation of capital and recurrent budgets.

The horizontal information flow existed at three levels: the wereda, the zonal and the local levels. A horizontal information flow existed at the wereda level when all sector offices (and other government offices) prepare their plans and the budget request, and send them to the wereda council. This flow of Information was designed to be facilitated through a wereda development committee (within the council) mandated with the power to review,

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consolidate and adjust the plans, and to submit the budget request, together with its own proposal, to the wereda council for approval. However, horizontal information flow was not as effective as planned for the reason that the weredas had no financial autonomy to decide, and because of the shortage of skilled manpower. Even the planning office was not available in many weredas. Further, the wereda council did not have the minimum amount of manpower to prepare its own budget request, let alone to review the reports of the sector offices. In most cases, the requests of the sector offices were transferred to the zonal administration.

The final step was followed by the regional planning and economic development bureau to aggregate the entire budget request submitted by all zonal sector offices and other government agencies. Its duty was to evaluate the information in light of the zonal and regional economic development goals. The information gathered from sectoral offices and the budget request from the wereda council created the zonal budget divided into recurrent and capital budgets. Here the aggregates of the recurrent and capital budget requests made up the zonal developmental plan. The recurrent budget was then passed to the regional finance bureau, whereas the capital budget was sent to the regional planning bureau. The final regional budget was consolidated by two separate bureaus; on the one hand, the regional finance bureau consolidated the regional recurrent budgets, and on the other, the planning and economic development bureau consolidated the regional capital budgets.

There were some common features of the budgeting process in the regions. First, the amounts requested for a particular year were measured in light of the budget performance of the previous year. If there were underspending, a budget amount higher than the previous year had little chance of being approved, unless there were convincing reasons for the underspending and the strategies for a better performance in the new budget year. This approach was criticized due to last minute spending and financial embezzlement in many public institutions.

Second, priority was given to recurrent expenditures (salaries, supplies, administrative costs) rather than to capital expenditure. Most of the recurrent costs were permanent costs. It was also easy to verify, i.e., the spending in the previous year helped to determine the amount

requested for the next year. Normally, it was only after the recurrent budget has been set that the remaining amount is allocated for capital expenditure. This, of course, did not apply to the budget whose source was either foreign assistance or loans. The allocation of the fund from these sources was dependent upon the nature of the agreement (bilateral or multilateral), but mostly it goes towards capital expenditure.

Third, the regional budgeting process was and still mainly carried out to reallocate the funds that came from the federal government. Thus, the consolidated budgets of the regions depend on the amount of grants rather than the expenditure need of the level of government. The imbalance between the expenditure needs and the available fund resulted in budget cut-offs, or shifting finance from one sector to the other depending on the reason appreciated by the regional government. Normally, the state councils have the authority to evaluate whether the budget requests were in accordance with the general development strategy and the activity of the planned projects.

The post-2002/03 fiscal year budgetary procedures aim to reverse the trends of the previous years and focus on the autonomy of local governments (weredas). According to the new approach, in principle, the weredas receive general grants but the budgetary process which allocates recurrent and capital budgets is only approved at the wereda council. This approach intends to address the major drawbacks of the preceding period; weak local participation, the broader financial and administrative autonomy of zonal administrations, and the possible fragmentation of regional government.

b) Budget Implementation

Each administrative unit, either at the federal or regional level, is responsible for the management and execution of its own budget approved by the respective governments. This in principle grants autonomy to each federal, regional and sub-regional administrative unit over the execution of its capital and recurrent budget. But, this autonomy is firmly defined by the financial laws that regulate the proper execution of the budget (the Financial Administration Proc.No.75/1996 and Council of Ministers Regulation No.17/97). The laws require the head of every public body to ensure the proper implementation of the budget consistent with the

rules and regulations defined by the finance laws. The laws also require that the budget execution against planned expenditures at the federal level be reviewed by the Ministry of Finance and by the regional finance bureaus at the regional and wereda levels. This may entail a reallocation of the remaining amount if there is underspending during the budget year.

The disbursement of the recurrent budget normally takes place on a monthly basis from the authorized finance office and is collected from the banks. For payments from the federal government, the ministry itself makes the payment; at the regional level payments are made at the regional, zonal and wereda finance offices depending on the nature of the claim. The major actors within the respective regions are the sector offices that are organized with three tiers where the lower level is accountable to the higher one.

In principle, the budget implementation follows the decisions in the budgeting process. This budget allocation process itself shows how the sector offices implement the expenditure responsibilities of sub-regional levels. In general, the role of the sector offices was decided based on a general principle that if the function was essential for several weredas, then the budget could be implemented by the zonal sector offices. Similarly, if it became the concern of several zones, then the regional sector offices would better handle it. For example, in agricultural sector, regional agricultural sector bureaus are responsible for research and training centers whereas zones and weredas are responsible for expertise advice in agriculture and veterinary services to the needy at the rural areas. In health sector, the regional sector bureaus distribute medicine and health equipment and mobilize fund and resources to fight statewide epidemics like malaria. Zones and weredas administer hospitals and health centers respectively. However, in some matters, identifying and allocating powers in this manner may be complex and more difficult to identify. When it is difficult to identify the common concerns, there is a tendency to centralize power.

c) Budget Evaluating

The budget evaluation begins at the institutional level by the internal auditor. The finance laws require the internal auditor to produce a monthly report stating the monthly revenue

and expenditure of the institution and this report is sent to the finance office of the level of administration (Article 57 of the financial regulation). At the federal level, all public bodies which execute the federal fund should account monthly, quarterly, semi-annually and annually to the Ministry of Finance.

The state governments are also required to report to the Ministry of Finance corresponding to the financial reporting system of the federal government (Article 74 of the financial regulation). Accordingly, they are required to submit financial reports monthly, quarterly, semi-annually and annually to the finance ministry. The report should at least contain 'the details of their receipts and disbursements by revenue and expenditure source codes; their cash balances and levels of outstanding debt; and their performance against the objectives stated in their subsidy requests'(Article 74(4) of the financial regulation). In practice, however, the report does not contain the details as required by the financial regulation, and reports are not compiled in a timely fashion due to delays in reporting from lower levels of administration and a shortage of manpower within the finance bureaus. The federal government, through the Ministry of Finance and the Auditor General, also has the power to conduct an audit of the federal offices as well as the state governments concerning the use of subsidy grants they have received from the federal government. The available reports of the Auditor General, however, have revealed serious financial mismanagement.

Budget evaluation at the regional level has to be done formally every quarter on the basis of the activity reports submitted by each sector bureau. All state government institutions have to be audited by internal and external auditors. And the audit reports have to be published. The whole purpose of the evaluation process is to reassess (the approved budget) the progress achieved and the remaining activities. This helps to take timely action by the regional council or the finance bureau such as to study the problems encountered by the responsible office, or to reallocate the remaining amount of the budget.

At the federal as well as at the regional level, internal auditing is conducted more regularly (statistically) than the external one, but less effectively due to incapacity problems. But most of the projects financed by foreign assistance and foreign aid are regularly audited by external (non-governmental) auditing firms. According to the Auditor General, the federal and the state

Auditor Generals have a backlog of auditing cases due to lack of human as well as financial capacity. In many regions, there are several offices which have not been (externally) audited for at least five years. For instance, what the Federal Auditor General can do is to focus on selected federal or regional institutions based on his own judgments considering the financial capacity of institutions (e.g. the customs office), the trends of financial malpractices and serious complaints from the public.

Activity 4

1. What is the scheme of allocation of power under the FDRE Constitution?
2. Identify the legislative and executive powers assigned to each level of government in FDRE Constitution?
3. What lessons does Ethiopian federation learn from the US and Germany?
4. What is the link between the allocation of power and expenditure responsibility?
5. State the budgeting process in Ethiopia?
6. Identify the subject matters that seem subject to framework sharing power in FDRE constitution. What is their implication on the expenditure duties of the states?

Summary

This chapter contains one of the basic elements of fiscal federalism, that is allocation of public expenditure responsibilities. It tries to approach the subject from many dimensions. The economic notion and the constitutional appreciation of it are the main thread in the chapter. The experiences of other federation are also discussed besides to the FDRE Constitution. The practical budgeting process is also highlighted.

The notion of public expenditure bears two aspects: broadly associated with powers and functions of the government and narrowly signifies budgeting in every fiscal year. It has also direct impact on the over whole economic aspects of the state such as employment, GDP demands, etc. In order to ensure the need of the state, public expenditure shall be based on some objectives and principles. While keeping the security, justice, development and satisfaction of the public needs are some of the objectives, canons of benefit, economy, sanction, surplus, elasticity, productivity and equality. Public expenditure in general is classified as recurrent expenditure and capital expenditure.

The second part of the chapter deals with the allocation of public expenditure in federalism. Before discussing the allocation, it gives some highlight about the models of states in relation to their expenditure activities. Accordingly, the states in the world may be either minimal or welfare or developmental. In federation, the allocation of expenditure is in line with the allocation of powers and functions between the tiers of the governments. In this regard, the US Constitution does not clearly specify the allocation of expenditure responsibility. The ‘Warfare Clause’ and the ‘Commerce Clause’ are widely interpreted to arm the center expenditure responsibility, while the states are invariably free to their reserved areas. The moderate and corporate kind of the German federation, on the other hand, provides list of powers and functions of the levels of government. It also peculiarly provides the ‘framework’ system by which the center issue legislation on some subject matters and their implementation is left to the states. In Ethiopia, the FDRE Constitution, in principle, follows the method of listing the power of the center and reserving the rest to the state. However, it tries to guide the states power by using limited list. There also limitation on the reserved power of the state such as the power of

taxation. From the essence of practices the center issue standards and policies applicable in the country, while there is administration and implementation is left to the states.

The budget processing of every fiscal year is the very instrument of public expenditure. Accordingly, the budget preparation, the budget implementation and the budget evaluation allocated among the organs and the tiers of government show the allocation of expenditure responsibilities.

To sum up, the constitutional allocation of powers and functions is the best measurement of the allocation of expenditure responsibilities in federations.

CHAPTER THREE

ALLOCATION OF PUBLIC REVENUE SOURCES

Introduction

Students! you have learnt about public expenditure and its allocation in federal system in chapter two. Public expenditure, mainly the power of spending depends on the revenue of the government. The rhetoric of public revenue has a prominent place in the study of public finance. All the subjects of government finance whether it is the power of spending or the power of collecting abridge to the end of revenue. It basically consists of determination of the source of revenue through legislation and the collection. In practice, a state breathes on the circulation of revenues in its body. Even, friendly relationship of states in the world opens with grants and loans which is the result of their internal revenue. Therefore, the healthy condition of public revenue signifies the proper function of the state. However, the task of acquiring sufficient resource to perform the state duties in the way that satisfies the subjects is not easy. The challenge amplifies where there is existence of more than one level of government within the same geographical area. In federations, the multiple tiers of governments broaden the function of the state and the tension between them to acquire more sources seek the precise constitutional allocation scheme. Hence, the main subject of this chapter is the constitutional division of revenue-raising powers in Ethiopia. For the better comprehension of the main idea, the substance of public revenue in its meaning and type, and other federations approach in allocation of revenue sources are also discussed. Students are recommended to follow the logical flow of the concepts and exercise the activities and in text questions accordingly.

Chapter Objectives

At the end of this chapter, the students will be able, among other things, to,

- understand the concept and meaning of public revenue,
- identify the basic sources of government revenues,
- identify the purpose and types of taxes,

- analyze the methods and objectives of revenue division between the multiple level of governments in general and under FDRE Constitution in particular,
- Acquaint themselves with the constitutional allocation of power of taxation as federal taxation, state taxation, concurrent taxation, local taxation and residual taxation, and
- understand the intergovernmental limitation of taxation in Ethiopia.

3.1. Meaning of Public Revenue

Revenue is the force and instrument to ensure the effective performance of powers and functions of the government. In a federal system, it enables multiple tiers of governments to perform their constitutionally assigned powers and functions for the welfare of their respective subjects. Hence, proper division of revenue raising powers and responsibilities in line with the framework of the other constitutional divided powers and functions in the federation signifies the purpose of federalism.

The raising of public revenues follows from the necessity of incurring public expenditure. The huge amount of the expenditure of governments to perform their respective several functions for the welfare of the people requires financing through public revenue. Dalton has defined public finance in to two senses; broad and narrow senses. In wider sense, it includes all the income irrespective of the sources they are obtained from and receipts which the government happens to get during any period of time, which includes but not limited to, income from tax, price of goods and services supplied by public enterprises, revenue from administrative activities, such as fees, fines etc., and borrowings, gifts and grants. In narrow sense, however, it includes only those sources of income of the government which are described as “revenue sources.”

To sum up the meaning, the income of the government through all sources is called public income or public revenue. However, as aforementioned, Dalton has defined ‘public income’ in broad and narrow sense, i.e. in terms of ‘public receipts’ and ‘public revenue’. Public revenue includes income from taxes, prices of goods and services supplied by public enterprises, revenue from the administrative activities, such as fees, fines etc., and gifts and grants; while public receipts include all the incomes of the government which it maybe having during a given period

of time, i.e. public revenue plus income from all other sources such as public borrowing from individuals and banks and income from public enterprises.

? What is the conceptual meaning of public revenue? Is there any difference between public revenue and public receipts? Identify the variable element of public receipt in a given fiscal year.

3.2. Revenue Sources of a Government: General

In general the government of any state has invariably two important sources of public revenue: taxes and non-taxes. It is, therefore, the methods of public revenue and its volume have significant impact on production and distribution of wealth and income in the country. It has effects on the nature and amount of economic activities and employment. The subject matters of the public finance in general, in fact, is considered as the powerful instrument to bring about socio-economic changes in the economic life of the country. Hence, it is worthwhile to discuss the several forms of source of public revenue; taxes and non-taxes such as commercial revenues, administrative revenues, grants and gifts and capital receipts.

i) Tax revenue sources: - tax is a compulsory levy by public authority for public purpose without expectation of direct return or benefit to the tax-payer. It is also said to be a burden which is only imposed by the legislative power on persons or property to raise money for the public purpose. It is exacted not on the basis of direct *quid pro quo* relations. In addition, the payment of tax cannot be imposed except by law; hence the maxim 'no taxation without representation'.

Different scholars of the subject try to put tax as follows:

Bastable defined tax as compulsory contribution of the wealth of person or body or persons for the services of public power.

Prof. Seligman defined tax as "a compulsory contribution from the person to the government to defray the expense incurred in the common interest of all, without reference to special benefits conferred."

Taussing puts the essence of a tax, as distinguish from other charges by government, is the absence of a direct benefit (*quid pro quo*) between the tax-payer and the public authority.

Tax is one of the most important sources of revenue to every government. In earlier days, payment of taxes was optional. Discretions were given to the people to pay and to avail the benefit of social amenities in the form of education, health and sanction, utilities and recreation facilities. Naturally, everyone is interested in availing social facilities used to evaluate the benefits derived by him in exchange for the tax to be paid by him. But the option in the payment of tax created lot of problems for the governments in fulfilling their obligations to the society. And it was deemed unreasonable and difficult to discriminate the citizenry who opt tax from who did not in social services. Hence, in the modern times, the optional nature of the tax is withdrawn and the tax becomes a compulsory contribution by every citizen to their government to enable it to fulfill its commitments towards society. Taxes are of two kind: direct taxes and indirect taxes. Their detail discussion will be in the next topic.

? Students! can you relate the principle of absence of direct *quid pro quo* and social amenities in taxation?

ii) Non-taxes revenue sources: - this category of public revenue consists revenue under many headings but constitute little portion of the total public revenue compared to taxes. These sources are discussed hereunder.

Commercial Revenues: the revenues, we call “commercial” are received in the form of price paid to government for produced commodities and services. These are revenues which are derived by government from public enterprises by selling their goods and services. They are also termed as price, for they are collected in the form of price of goods and services provided by government. They include payment of postage, tolls, interest on funds borrowed from the government credit corporations; dividends and profits from public sector enterprises; currency, coinage and mint by the central/national bank and profit from their circulation; price paid for liquor in the government stores; water, telecommunication, electric distributed by the government, rail, air, road and water transport services and the like. In addition, governments earn revenue from the production of commodities like steel, oil, minerals, etc. However, the

surpluses from commercial undertakings are not considered as an important source of income in most of the countries of the world. Moreover, in a country which implements free-market economy accompanied by privatization, these sources of revenues are minimal, for the substantial volume of goods and services are provided by the private sector.

Administrative Revenues: the receipts of administrative revenues includes fees, licenses, fines, forfeitures, escheats, and special assessments. They are characterized by more or less as a free choice on the part of the payer as to whether or not he will pay, and more or less on direct benefit conferred upon the payer. The amount of payment does not necessarily, however, bear a close correlation either to the value of the benefit obtained by the payer or the cost incurred by the administration. Further, the peculiar characteristics of administrative revenues are generally arising as by-product of the administrative function of the government. Hence, they are known as “Administrative Revenues”. The meanings of administrative revenues are given at the last part of this chapter.

Gifts and Grants; gifts and grants form another category of public revenue. Gifts are voluntary contribution from private individuals or non-government donor to the government fund for specific purpose, such as, relief fund or defence fund during a war or an emergency. Such contributions are made by patriotic, charitably minded, public spirited or conscientious person during war, floods and droughts or an emergency. Gifts have no significant place in modern revenue system except during such above mentioned natural or man made catastrophes.

Grants are government financial aid in the performance of governmental function at another level. In federal countries, for instance, central government traditionally gives grants-in-aid to the state governments and the state government to local governments in order to enable them to do their functions successfully or for undertaking specific activities such as construction of highways, dams, etc. and their maintenance in the interest of uniformity and efficiency in the working. Hence, these grants may be either conditional or unconditional or either for specific or general purpose.

Sometimes, the government of one country receives a grant from another country, which is commonly called “foreign-aid”. It may be military aid, economic aid, technical aid, and so on.

Many advanced and well developed countries such as United States, Soviet Union, United Kingdom, Canada, Germany, etc. give grants to the poor countries for their economic development. Such grants are very useful revenue resource for the under-developed countries. But foreign grants are always uncertain and not always unconditional, and this often leads to international difficulties and entanglements. Moreover, it always follows political game of give-and-take. Hence, it is not advisable to depend on foreign aids. Compared to each other, the total gifts as distinguished from grants do not form a significant amount in the revenue system. Both grants and gifts are characterized by their voluntary and by the absence of any expectation of direct benefit to the donor.

Capital Receipts; capital receipts constitute revenue from market borrowings, i.e. loans which have a maturity of fixed time. Receipts of this account would be considered as market borrowings even when some of these loans are taken by the central bank or reserve bank of the country. The borrowings also include special bonds, for example, the central government usually issues borrowing through special bonds and treasury notes under voluntary disclosure scheme that mature in different fixed time. The second means of capital receipts is external loan. In federal arrangement, only the central government is authorized to raise loans from abroad; from friendly countries. The third means of capital receipts consists of loans and advances made by the central government to state governments and non-government parties. Small savings are also made in terms of savings which comprises of Post Office savings, bank deposits, etc. There are also another group consisting a variety of funds and the net effect of transactions occurring under the funds, accounts and deposits. Examples of such funds include deposit under various compulsory deposit schemes such as, provident funds, pension fund, reserve fund, etc.

? From non-tax revenues, one is not common to all states, it has also externalities that are imposed in the state and it is not the permanent source. Identify this revenue source.

3.3. Purpose and Types of Taxes

Tax, as a major source of government revenue, in any economic policy and whatever the state may be, plays several roles. Tax covers the substantial part of the purposes of the public revenue in governments. In a federal system, it is a means of financial power division among multiple tiers of government. Therefore, it enables the government to attain specific and general purposes.

3.3.1. Purposes of Taxes

The purposes of taxes in public governance relates in all lives and functions of the governments and ranges from social to political through economic aspects. However, it is difficult to discuss all, perhaps you had gone through it in the course tax law. Some of the peculiar ones are.

- i) **Financing government expenditure responsibilities:** together with other revenue sources tax is meant primarily to meet the expenditure of the state incurred in fulfilling its duties either in the form of social security or social amenities. Social welfare may be measured in terms of per capital expenditure incurred by the government on providing amenities in the form of education, health, sanitation, recreation facilities, etc. and social security consist of peace and order maintained by police, military and the judicial machinery. These functions of the state are increasing from time to time. Thus, it is the tax potentials that cover the ever increasing expenditures of the state.
- ii) **Income distribution:** tax serves as income distribution mechanism. The distribution of income and wealth among the members of a society is one of the functions of the government. The government performs this function through the mechanism of tax policy. For instance, companies are required to pay high rate of corporate taxes on their own behalf and the dividend received by shareholders from the companies are subject to income taxes. Excise tax, high custom duty in luxurious goods, surtax, capital gains tax and progressive rate of income tax are some other taxes to reduce the incidence of socio-economic inequality. In this way the sufficient portion of wealth is taken away through taxation by the government so that the rich may not become richer and the poor, poorer.
- iii) **Stabilizing economy:** tax also plays an important role in stabilizing the economy. Economic stability may be judged by the behavior of price. Unhealthy economic operation arises in price fluctuation due to disproportional output and consumption and through supply and

demand in the market. The instability of economy in the market is generally summarized as inflation, deflation and stagflation. As regards inflation, deflation and stagflation, taxes play an important role as they can reduce or stimulate consumption. Taxation, if applied properly, may take away the excessive capacity to pay the people, which means demand pull inflation. Thus a rise in the rates of existing taxes and the imposition of new taxes would check consumption, decrease the level effective demand and thereby stability of price. Tax exemption on production and on savings has also effect in sterilizing cost-push inflation. Enhancing the purchasing power of the people through reduction of personal tax burdens during depression (deflation) may have favorable effects on the level of economic activity and employment. The third kind of economic instability is stagflation some times referred to as Recession, which is caused by increase in price while demand is falling. Effective progressive taxation on the haves discourage their capacity to pay, encouraging production by tax holidays and reducing the rate of commodity taxes such as sale tax, excise duties, etc., remedy the stagflation.

iv) **Encourage investment:** in a market economy the government designs incentive schemes to maximize the use of private investment. Such incentives schemes can be achieved through taxation by introducing exemption, deduction and depreciation and by tax holidays to stimulate the private sector participation in the economy. Tax also plays a guiding role to the movement of private investment towards areas given priority within the economic policy; towards hardship and less developed areas.

3.3.2. Types of Taxes

Economists in general classify taxes into two major categories: (1) Direct taxes and (2) Indirect taxes, and sometimes taxes are, based on their source, also classified as tax in *persona* (individual) and tax in *rem* (property). According to Dalton, those taxes which are paid entirely by those persons on whom they are imposed are direct taxes. Direct taxes are those taxes which cannot be shifted to others. To quote the words of John Stuart Mill, “a direct tax is demanded from the very person who, it is intended or desired, should pay it”. Thus, if a tax is intended to be paid by the persons on whom it is imposed, it is a direct tax. More over, direct are taxes levied on permanent and recurring occasions. Usually, direct taxes are based on the receipts of income.

Hence, direct taxes are levied immediately on the property and income of persons. Income tax, profit tax, capital gain tax, property tax or wealth tax are direct taxes.

Whereas, indirect taxes are those taxes the burden of which may not necessarily be borne by the assessee. They can be shifted or passed to other persons' shoulder. They are taxes which are levied on commodities and services other than personal services like custom duties, excise duties, sales tax or value added tax (VAT). According to John Stuart Mill, "Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of the other". Thus, if a tax is intended to be collected from other persons by those persons on whom it is imposed, such tax is an indirect tax. In relation to assessment, indirect taxes are when income is spent i.e. on goods or services purchased. These taxes are levied on occasional and particular events. They affect the income and property of persons on expenditure through their consumption.

Generally, the principal taxes currently in Ethiopia are profit tax, turnover tax (TOT), value-added tax (VAT), excise tax, customs duty, withholding tax and income tax from employment. While VAT has replaced sales tax, TOT and withholding taxes have been introduced recently. Other taxes include corporate tax, dividend income tax, royalties and stamp duties.

The detail exploration of the above topics of concerning tax is the subject of the Tax Law course but they are here aim to reveal the substance to be dealt in the next topics; the division of revenue sources among the federal, states and local governments. Without this preparation in this way, the next topics may not be easily understandable.

Activity 1

1. Students, can you enumerate the impact of public revenue in the economic life of a state?
2. There are two broadly classified sources of government revenue. List as much as possible the specific revenue sources under each category.
3. Tax has peculiar natures and rationales compared to other non-tax revenue sources. What are these natures and rationales of taxation? Identify the rationale that needs beyond simple logic tit-for-tat.

4. In Ethiopia, by virtue of introduction of market economic policy and privatization, the income from public enterprises become minimal, however, it increases taxation from private owners. Can you argue in favor or disfavor of privatization in relation to public revenue?
5. Discuss the types and purposes of taxation What are the criterias to set a tax as indirect or direct? Mention specific taxes under direct and indirect taxes.

3.4. Methods of Division of Revenue Sources between Federal, State and Local Governments

Finance is the life blood of the economy of any modern state. In every federation, the problem of allocation of the sources of revenue is difficult since two different authorities are arising from the same body of taxpayers. The basis of distribution of finance differs from federation to federation. The theoretical discussion on the principle for the allocation of revenue sources particularly on taxation powers has been carried out by different economists. Deciding which revenue source can be assigned to which tier of government is the issue to be underlined here. In relation to taxation, the traditional normative view set out by Musgrave enumerates the principles which, according to him, can secure independent autonomy and efficient utilization of resources by the federal and states governments. Accordingly, he proposes:

1. taxes suitable for economic stabilization should be central; lower level taxes should be cyclical stable;
2. progressive redistributive taxes should be central;
3. personal taxes with progress rates should be levied by the jurisdictions which are most capable of implementing a tax on global base;
4. lower-level governments should tax bases with low mobility between jurisdiction;
5. tax bases distributed very unequally between jurisdictions should be centralized; and
6. benefit taxes and urban charges might be appropriately used at all levels.

Other economists like Roger Gordon, Von Hagen and Russell Mathews have provided different approaches pertaining to problems of taxation in general and specific taxes. As to Gordon and Hagen, the principle of tax assignment should be based on the theory of 'optimal taxation' after

identifying the problems that may arise from decentralizing taxation powers. Thus, addressing the externalities effects like inter-jurisdictional tax spillovers meets the objective of decentralizing of taxation. Gordon proposed that assigning taxes that cause externalities effect, for instance company tax, to the center, while addressing the financial cost of the units through revenue-sharing mechanisms from these taxes serve as allocation of taxes between the federal and state governments.

The other approach to the problem of division of taxation powers is viewed from the effectiveness of taxes. Mathews argues that the formulation of tax should be based on the assumption that tax avoidance and tax evasion of the general behavior of taxpayers rather than assigning taxes to predetermined level of governments for the reason of convince to levy and collect taxes. According to him, unless the behavior of the taxpayers is taken in to consideration it could be difficult to effectively address the issue of tax rate structure, the definition of tax base and assessment procedures. Therefore, in order to bring about equitable tax allocation between different tiers of the government in federal system, the evaluation of taxpayers' behavior to a particular tax should be taken as the principle. However, the condition to address the problems of taxes in externalities effect and effectiveness of implementation are not the basic principles of allocation of taxation in federation, because such problems also arise in unitary country. Hence, the principle of allocation of taxation in federation should take in to consideration as bases to formulate the basic principles.

Concluding the different perspective approaches, in general they give the central government those taxes that can help to redistribute income and to stabilize the economy, whereas those immobile taxes which primarily provide a benefit to the local governments are to be left to the sub-national governments. Specifically, they proposed taxes such as corporation income taxes and VAT to be assigned to the center. Whereas those taxes such as personal income taxes and retail sales taxes are to be left to the state. This classification is mainly based on the mobility/immobility nature of the tax bases. But, they are not hard and fast rules to be recognized in the constitutions forming different federations. Sometimes, immovable taxes may be assigned to the center, for instance, taxes on natural resources for they are unevenly distributed among the federating units and may substantially result in horizontal inequalities.

The main question follows that the practice of different federal constitutions does recognize the above norms propounded by economists. In general, the assignment of each and every tax may not conform to the normative theories stated above. Some may fit with the suggested while the others may not. This is because the actual system of constitutional dividing power of taxation is country specific although federations have similar general principles.

? In the above lesson you have read the professional approaches to allocate revenue between different levels of governments. However, some of them are not strictly linked to the federal system and they are to cope the problem of taxation. Identify those suggested methods that fit and unfit federalism.

3.4.1. Constitutional Methods for Division of Revenue Powers in Federation

The method of allocation of revenue in federal systems is theoretically intended to follow the division of the expenditure responsibilities in order to accomplish the power and function assigned to each level of governments. In this subtopic the approach of major federations will be exposed.

The allocation of the entire revenue sources either to the center or the states has different problems in the general federal system. If a constitution provides exclusive authority over all aspects of revenue to the states, they will be required to transfer part of their revenue to the central government through 'upward revenue sharing' system; others call it as 'reverse revenue sharing'. This approach creates the central dependency on the state and it does not facilitate the principal function of the central government, such as income distribution through taxation, stabilizing role and tax harmonization policies. In addition, the states become reluctant to participate in central government where particularly there is a considerable regional disparity. The country following this method is forced to embark on excessive negotiation between the center and the states concerning revenue sharing. Generally, this approach needs confederal framework or weak federal system of federation or a country having a strong tradition of close economic policy coordination.

On the other hand, if the entire revenue sources are retained by the center, the state governments become fully dependant on the revenue transfer mechanisms. This approach deviates from the basic principles of federalism; the devolution of powers and function among the federating units and autonomy of each level of governments. Therefore, the usual trend followed by most federations is to divide the revenue sources between the center and the state. But this method is not as simple as the concept. In general principle, there should be a framework in which each tire of government can raise its own finances without a conflict between them. In practice, however, the degree of tax autonomy in each level of government is enjoyed demonstrates wide variation in federations. This may be attributed to the different of methods of and allocation of revenue envisaged by the various constitutions.

? The assignment of all revenue sources exclusively either to the center or the states in federation creates some problems. Discuss the problems.

The methods employed by federations can be summarized into three: exclusive power of taxation, concurrent power of taxation and shared power of taxation. In the exclusive power of taxation, the constitution assigns several tax sources to the federal government and to the states separately, allowing each to have exclusive tax power within its sphere. It exists in the cases where each level of governments is constitutionally authorized to impose the same type of tax, but upon different subjects: things, businesses or category of persons.

Concurrent power exist when the constitution allows both levels of government to exercise the power to levy, collect and apportion in relation to some or all taxes. The federal and state governments have equal constitutional authority on to levy the same kind of tax with respect to the same category of persons, businesses or particular things. This approach entails the overlapping of specific types of taxes exercised by both level of jurisdiction, which may lead to competition and conflict between them. Shared power of taxation means the constitutional reservation of the power to levy taxes to the federal level, but it guarantees the states' right to some or all of the proceeds from specific taxes.

In light of the above three methods of division of revenue, the constitutional allocation of some of the federations will be seen as follows.

The US Constitution, having a long history of fiscal federalism does not assign tax instruments to different levels of governments. It offers rather concurrent power of taxation as a result of which more than one level of government may tax an activity or tax base, and the precise definition of the base may differ between levels. Other than taxes on international trade, which are exclusively reserved for the federal government, and property taxes for states and local governments, all other taxes are practically open to all levels of governments.

The Indian Constitution on the allocation of power of raising revenue between the Union and the states follows its general method of power division employed. Accordingly, the revenue sources distributed under the Union List, State List and Concurrent List and beyond the list residual revenue sources are left to the Union through the parliament legislation. Therefore, custom duties, taxes on incomes other than agricultural income, corporate tax, taxes on capital value of assets, taxes on the capital of the companies, etc are assigned to the Union. In addition to this tax sources, the Union has income from Railways, Airways, Post and Telecommunication, Property of the Union and other charges and fees. On the other hand, the states levy and collect taxes on land revenue, on agriculture income, on goods manufactured and produced on the state, etc. Taxes on mechanically propelled vehicles and stamp duties other than judicial stamp and other sources related to the concurrent powers are assigned to the concurrency of the Union and the states.

The tax allocation under the German Basic Law devolves in to threefold government; the Bund (center), the Lander (state) and the Gemeinden (local). Hence, the Bund is empowered on turnover tax, consumption tax on specific goods, income from the state monopoly, insurance tax and custom duties (before it transferred to the European Union). By the same list, the Lander has power of taxation on income and corporate tax, capital and land transfer tax, motor vehicle tax, property tax, inheritance tax, beer tax, lottery tax and fire protection tax. On the other hand, profit and equity taxes other than agriculture, real state tax, surcharge on land transfer, dog tax, ice cream tax, local alcohol tax, bar permission tax, tax on fishery and hunting and taxes on cinema and other entertainment are under the list assigned to the Gemeinden.

Other federations likewise follow different method of devolution of revenue sources among their constituent units of federation. The Ethiopian constitutional approach in allocating the revenue sources will be discussed hereunder.

Activity 2

1. In the above lesson we have discussed the methods of revenue division practiced by different federations. Which of them are logical to you? Which one do you think is advisable to Ethiopian federal system?
2. Compared to USA and India, the German Basic Law provides for local taxation power. What are the significances of local taxation in general from the concept of decentralization of power in federalism and from the merit of their performance of social welfare?
3. In the above topics you have acquainted yourself with the main sources of government revenue; taxes and non-tax and the professional suggestions, the general methods and the experience of some of the federations on allocation of revenue between multiple tiers of government. Assume that Ethiopia is a federation without constitutional division of revenue-raising powers between the federating units. Prepare in group a draft of allocation of revenue sources of each tax and non-taxes to the federal, states and local governments of Ethiopia with corresponding reason to each assignment. (Do not consult and refer the FDRE Constitution)

3.5. The Structure of Taxation Power in Ethiopia

The division of taxation power is a principal aspect of the Constitution that provides the legal framework of the Ethiopian federation. The FDRE Constitution divides the taxation power into three categories, namely ‘the federal power of taxation’, ‘the state power taxation’ and ‘the concurrent power of taxation’. It also prescribes the conditions by which the regional governments could acquire revenue through loans and grant subsidies. Here, the analysis of the assignment of tax powers will focus on the tax sources that constitute each category of power, and the manner in which the sources are divided makes each level between the three categories.

In Ethiopia, the federal Constitution declares that the federal government shall levy taxes and collect duties on sources reserved to it, and the state likewise exercise the same power with respect to sources that falls under their jurisdiction. Thus, the two tiers of government exercise their legislative and administrative powers within their respective taxation competence. Therefore, the revenue generated from the respective sources belongs exclusively to each level of the government. The power of taxation reserved to each level is subject to respect by the other. The FDRE Constitution does not explicitly limit the power of the state to change the tax rate in order to influence the tax base. However, it provides general directives on taxation in Article 100 in which they must consider exercising their taxation power. As per sub-Articles (1) and (2) of the same, both the states and the federal government have the obligation to ensure that any tax related to the source of revenue taxed; that tax should be determined up on proper consideration and tax imposed by them should not adversely affect their relationship. If any tax imposed by the state affects interstate commerce, the central government intervenes since the power is reserved to it. But, in practice, the tax legislations are uniform throughout the country. This is because of the fact that the states do not have the expertise to deal with the impact of imposing different tax rates.

The FDRE Constitution provides exclusive revenue sources under the title ‘federal power of taxation’, ‘state power of taxation’, ‘concurrent power of taxation’, and ‘undesignated power of taxation’ in the Articles 96, 97, 98 and 99 respectively. Although the titles refer to the ‘power of taxation’, strictly speaking they do not only deal with taxes. The lists also include other non-tax revenues like fees, charges, rents and other revenue sources. The Constitutional arrangement on division of revenue raising power in Ethiopia is mainly structured according to the categories of tax payers or particular things as a source of revenue. The exclusive domain of each government is not the tax base but the tax source. Hence, it does not result in taxing the same tax source by both levels of governments.

- ? The Ethiopian constitutional approach is to divide revenue sources based on the tax sources not on the tax bases, i.e. a specific tax, except custom duties, is not assigned to either of the governments exclusively. Rather, the category of the taxpayer and

the particular things on which different taxes are imposed are assigned to each level of government. Do you think this assignment corresponds with federalism in Ethiopia? Why? Why not?

3.5.1. Federal Power of Taxation

The FDRE Constitution under Article 96 enumerates the exclusive revenue sources of the federal government. Among them, revenue sources such as customs duties including import /export tax and other duties exclusively reserved to the federal government. However, other revenue sources from income tax, sales and excise tax, property taxes and charges and fees are assigned to tiers of governments. The federal government in this respect only differs in the category of the taxpayers or a particular thing from which the revenue is collected.

It seems universal in federations that customs duties are exclusively given to the federal government. There are many reasons in relation to international and national trades to this assignment of revenue. A country may have to fulfill international obligations by reducing tariffs or impose restrictions on unfair trading practices to protect the sudden influx of import of specific items (anti-dumping measures) and on contrabands, to control importation of prohibited items, etc. In addition in order to protect trade distortions within the country and for efficient tax administration the power of custom duties remain in the hand of federal government. The same is true in Ethiopia so that import and export duties, taxes and other charges on imports and exports are exclusively levied and collected by the federal government pursuant to Art.96(1) of FDRE Constitution. Tax on foreign trade is a major source of revenue in Ethiopia. However, in countries like Ethiopia, the nature and type of export items are few in number and they may also originate from specific regions. The major export items are coffee, skin and hides and some raw materials. The reservation of such resources and other natural resources to the federal government enables income redistribution and equalizations schemes effective.

The FDRE Constitution provides prominent place for income taxes as the source of revenue reserved to the federal government. Unlike customs duties, the constitution does not exclusively assign income tax to the federal or to the state governments. Accordingly, with regard to personal income from employment, exclusive federal taxation applies to the income of

employees of the federal government, of the public enterprises owned by the federal government and of international organizations (Art.96 (2) and (3)). The exclusive tax power of the federal government also extends to income from other sources than employment. Income or profits of the federal public enterprises are taxed by the federal government (Art.96 (3)). The federal government also exercises exclusive power over income arising from rail, air and sea transport and income from chance winning from national lotteries (Art.96 (4) and (5)). Income obtained from leasing its own property and houses are subject to federal taxation (Art.96 (6)). The accrual of tax from the employees of government-owned, however, is expected to shift from the federal government to the states as a result of the on going privatization program. But, this transfer will benefit Addis Ababa and the surrounding areas, for most of the enterprises reside there.

The area of sale and excise tax so far as they pertain to the sale and production or services of public enterprises owned by the federal government are exclusive power of the federal government (Art.96 (3)). In addition, the introduction of VAT broadens the federal taxation to the sale and production or services of individual traders.

The other areas of federal revenue assigned by the Constitution are fees and charges. The Ethiopian Constitution provides the federal government the power to determine and collect fees and charges relating to licenses issued by organs of the federal government (Art.96 (7)). It also empowers the federal government to levy and collect stamp duties provided that the organs of the federal government render the service (Art.96 (9)).

Beyond the devolution of tax power between the two tiers of governments, the federal government of Ethiopia assumes the revenue from public enterprises. As the World Bank report (World Bank, 'Ethiopia: Review of Public Finances' 200), the income of the federal government from taxes of its agent and enterprises accounts the third largest source of revenue. This consists of income from the National Bank, rent from government property, and residual surpluses from various public enterprises that the government monopolizes. The latter source includes enterprises such as banks, insurance companies, Telecommunication Corporation, the Electric Power Corporation, the Post Office, the Petroleum Corporation, sugar industries, and government farms.

3.5.2. State Power of Taxation

Unlike the federal government, the states have no exclusive tax bases assigned to them by the FDRE Constitution. The lists under Article 97 entitled 'state power of taxation' enumerates those tax bases shared from the federal tax competence based on different category of taxpayers or particular things. Therefore, except custom duties, all tax bases are also the source of state revenue. Hence, the states income taxes, sale and excise taxes, property taxes and fees and charges are discussed hereunder.

The Constitution assigns the power to levy and collect income taxes to both tiers of governments, in which each of them is conferred with exclusive power over specific sources. Accordingly, with respect to personal income from employment, income from employees of the states and from employees of private enterprises are subject to the exclusive authority of the states (Art.97 (1)).

The exclusive tax power of the states on income extends to other sources than employment (payroll tax). The income or profits of the public enterprises owned by the states are taxed by the states (Art.97 (7)). Profit or income from small business activities and sole proprietorships (the nature of the business activities determined by the Commercial Code and other relevant laws) is left to the states (Art.97 (4)). Income from individual farmers or cooperative association, income from water transport service provided within the boundary of the state and rental income from properties owned by the state are exclusively taxed by the state (Art.97 (3), (5) and (6)).

There are sales and excise taxes reserved to the states. The states can levy and collect excise and sale taxes against public enterprises owned by them (Art.97 (7)). In addition, the states can levy and collect these taxes from individual traders within their jurisdiction (Art.97 (4)). However, the exclusive power of the states is restricted in some cases since some individual traders are subject to federally administered VAT law.

The Ethiopian Constitution gives the states a power to levy property taxes upon houses which are privately owned, land which is used by *usufructuaries* and royalties from the use of forests (Art.97 (2), (6) and (10)). The states are also empowered to levy and collect taxes and royalties

on small-scale mining activities (Art.97 (8)). One of the most important property tax of the states could be revenue from land lease payment from investors, for the Constitution provides that land is publicly owned.

Similar to the federal list, the taxation powers listed for the state also have provisions authorizing the collection of fees and charges on license issued and services rendered by different organs of the state. Hence, the states are empowered to determine and collect fees and other charges for the service rendered by the state organs (Art.97 (9)).

The allocations of taxes have some rationales and differences from federation to federation. Solomon Negussie argues that the levying of tax from personal income is primarily for the purpose of providing local public goods and infrastructure. It follows, therefore, it is recommended to assign the levying of income tax from employees of federal public enterprises and NGOs to the states in order to enhance their revenue capacity and thereby to ensure the efficient provision of public goods. The Ethiopian Constitution assigns exclusive power to the federal government due to the general principle applied in federal countries that imposes a tax limitation on each level of government to tax income from the respective property and income of their employees. However, this should be reconsidered in cases where states retain a very limited tax power.

The other problem in relation to income taxes is that the Constitution does not mention all the sources of income and tax bases, nor does it contain a statement reserving such sources to either level of government. The federal Income Tax Proclamation, No. 286/2002, on the contrary, enumerates several taxes sources which are not mentioned in the Constitution. To mention some, Art. 3(6) of the same includes income from employment, from business activities, income derived by an entertainer, musician, or sports person from his personal activities; income from entrepreneurial activities, income from use and alienation of movable property, income from use of immovable, livestock and agriculture; dividend income, profit shared by business partners, income from interest, royalties, lease payment and other license fees.

According to the Federal Financial Administration Proclamation No. 57/1996, the tax system at the federal and regional level have to be harmonized and should have standardized tax base.

Therefore, based on the basic constitutional principle of tax allocation between the federal government and the states; tax on different category of taxpayers or particular things mostly of their jurisdiction, the states can introduce these tax bases. To this effect, without formally adopting separate legislations, the Amhara and the Oromia states' financial regulations have referred to the incorporation of federal taxes legislation.

In general, the fixed nature of real property makes it easier to administer by the subnational governments. But, there are exceptions. Mineral taxes and royalties are in most cases assigned to the center. This is because natural resources are unevenly distributed between the states. Thus, if taxation of minerals is assigned to local governments, it may aggravate horizontal imbalances.

It is generally agreed that for the sake of convenience stamp duties fees and other service charges shall be collected at the place where the service is rendered. If a license or a specific service is rendered to the beneficiary at the federal office or the state office, the federal or the state government will levy and collect the payment respectively.

? Sometimes the federal government seems a system devoid of territorial and personal jurisdiction; even Addis Ababa and Dire Dawa have their own self-administration while they are directly responsible to the federal government. On the other hand, the states have vast territorial and personal jurisdiction. In consistent with the mass of category of the taxpayers and things which it administers, the federal government collect huge amount of money that transfer to the states every fiscal year. What do you think is the reason?

3.5.3. Concurrent Power of Taxation

The constitutional acclamation of the concept of concurrent power differs from federation to federation. Constitutionally, however, the concurrency of power signifies that the center as well as each state has the right to enact laws concerning the subject-matter under its jurisdiction. As it is illustrated above, the USA presents a typical case of concurrent powers. In this case, both the federal and states are free to impose the same type of tax upon the same subject to taxation. As it appears in the German Basic Law, the Lander exercises legislative power on concurrent matters

only when the federation has not exercised its legislative powers. But in the Ethiopian case, the title ‘concurrent power of taxation’ may mislead readers since it is different from its application in other systems. At present, it gives the states only the power to share revenue from concurrent sources.

When the FDRE Constitution came into force, several issues arose regarding the exercise of the concurrent power of taxation which is the object of Article 98 of the Constitution. The said Article provides ‘The federal government and the states shall jointly levy and collect....’ The main issues raised are: how can both the federal and states jointly levy and collect taxes at the same time? Would it enable each state to enact its own tax on sources listed under concurrent power of taxation? Do all states benefit from these taxes irrespective of the place where the sources of the tax are located? The power of taxation comprises of two specific powers: the power to legislate tax laws or to levy, since the maxim ‘No taxation without representation’ and to collect the tax. Likewise, the concurrent power of taxation presupposes the above mentioned two powers to be decided by the federal and state governments concerned. In doing so, the problem of tax competition may arise between the federal government and states. As it is said, unwisely treated concurrent power is a source of conflict. And the FDRE Constitution prefers silence if conflict arises between the federal and state laws. The main issue is which law prevails. Therefore, the concurrency of laws on the same source of tax would not be effective.

On the other hand, the literal interpretation of the provision of Article 98 would mean that tax legislation would be enacted by a joint meeting of the federal and the state legislatures. Such a meeting would also be held between the federal and each state at different circumstances involving only one state. This may also be another difficulty in practice.

The concurrent power of taxation in general would have lead to inter-jurisdictional competition (federal-state, or state-state) or conflict concerning a better control of taxes. It might have as well created a serious inconvenience to the taxpayers, a greater possibility of tax evasion and inefficient administration which may have a direct consequence up on the law and limited revenue source of the country. In most cases, countries that do not have a developed tax administration system avoid this complicated approach by allocating the power to the central government only.

? Do you think Article 98 of FDRE needs amendment? What are the conceptual and practical problems within the Article? What changes do you suggest the Article have to incorporate in the amendment according to your understanding ?

For these reason, it is said that the Constitution has been “amended” whereby the power is delegated to the federal government. Accordingly, the provision has been interpreted in such a way that those tax sources listed under the concurrent power have to be levied and collected by the federal government and the proceeds are compulsorily shared with the states. As the result of this interpretation, the federal government has become fully empowered to levy and collect taxes on the mentioned sources and to retain the proceeds and dispose of them based on the decision of the HOF.

The spirit of interpretative clause has been taken from the proclamation, Definition of the Sharing of Revenue between the Central Government and the National/Regional Self-Governments Proclamation No.33/92 of the Transitional Government of Ethiopia. However, such interpretation would not be free from creating further problem. First, since the federal government is given the power to determine the tax bases and rates, the states are devoid of participation in setting tax bases and rates in the manner that satisfy them. Second, should the revenue sharing be divided according to specific formula or should it be included in the grant subsidy is the major issue.

The FDRE Constitution provides the source of concurrent taxes under Article 98. These sources are:

1. profit, sales, excise and personal income taxes on enterprises they jointly establish,
2. taxes on profits of companies and on dividends due to shareholders, and
3. taxes on incomes derived from large-scale mining and all petroleum and gas operations and royalties on such operations.

The above provision seems to refer to those enterprises to be established jointly after the incorporation of the federal system. However, the direction of the government’s policy is

towards market liberalization and its withdrawal from the market. Thus, the federal government is aggressively engaged in privatizing state-owned enterprises rather than establishing new public enterprises. So, practically speaking, insignificant revenue is being generated from profit, sales, excise and personal taxes on enterprises established by the federal and the states governments.

The second list of concurrent taxation is taxes on companies and their dividends. Taxes imposed upon companies are relatively mobile among several states. This mobility factor reflects the fact that their economic activities involve a multitude of factors from different jurisdictions. That is, factors of production (capital, labour, land) may be used from several states and products and sales are going back to these states. Thus, the power of taxation with a huge factor of mobility is suggested to be allocated to the concurrent power of the federal and states governments.

According to Article 98(2) of the Ethiopian Constitution, ‘the profit of companies and dividends due to shareholders’ are sources of concurrent taxes. The English version of this article only specifically refers to revenue from company profit tax and tax on dividends due to shareholders. The Amharic version includes sales tax, and since it prevails over the English version and it is consistent with the practice. Excise tax is not mentioned in both versions, but is actually levied on products or the sale of companies. The exclusion of excise taxes seems to be ‘a slip of pen’ as there are no reasons to exclude the imposition of excise taxes on some products locally produced or sold by private companies.

The allocation of company tax is basically seen from the mobility factor of the economic activities of the companies. Usually, they operate in more than one state. But in Ethiopia, it is not mobility that primarily distinguishes this issue. Rather it is the type of the enterprise that matters irrespective of its mobility. Except for sole proprietorship, private enterprises such as a partnership and private limited companies are taxed by the federal government. However, if these companies are not engaged in business in several regions (say in the case of laundry or a beauty salon), allocating them to the federal administration serves little purpose. Thus, it is prudent to assign such kinds of business to the regional administration although they might be registered as a PLC. This can help to augment the tax capacity of the states.

A case can also be made for distinguishing between different tax bases with respect to the activities of companies. Income tax on companies and businesses in general are payable on the total income earned. With respect to tax on dividends, countries' practices do vary; some directly assign to the states while others leave it to the central administration but distribute it to the states through a revenue-sharing mechanism. In Ethiopia, the central government levies such tax according to a flat rate of ten per cent.

In most federal systems, disparities concerning the fiscal capacities of states are also intertwined with their wealth in natural resources. Tax on natural resources is, therefore, not exclusively reserved to the states, because it may aggravate the gap between resource-rich and poor states. Thus, federal governments deal with the unequal distribution of natural resources through their revenue transfer mechanisms. In Ethiopia, too, issues concerning the equitable distribution of revenue generated from natural resources will be a challenging task when it plays a significant role in the national economy.

In Ethiopia, the revenue from taxation on income from large-scale mining and all petroleum and gas operations and on royalties collected from both operations are shared between the federal government and the regions. Thus the administration of incomes and royalties from all petroleum and gas operations is the task of the federal government. However, mining operations are qualified as large-scale and small-scale operations, where royalties, land rentals and income taxes from small-scale operations are left to the states. It is the Ministry of Mines and Energy, who designates a mining activity as large or small-scale.

At present royalties and income taxes from mining operations are not significant. But mining operations are a potentially large revenue yielding area which is contingent up on the exploration of minerals. Hence, there should be an appropriate revenue sharing mechanism that can address at least two contending interests. First, the states where the material/natural resource belongs may at times raise a sense of entitlement with secessionist rhetoric. On the other hand, the exploration activity may impose additional cost in the states such as on the environment or security (spillover effects). Thus, there will be a need to compensate these claims. Second, all the states and peoples of Ethiopia have a vested interest in the income generated from mining

operations, as the Constitution confers ownership rights on natural resources to the State and to the peoples of Ethiopia (Article 40(3)).

The whole argument refers to deciding what proportion of the income from the above revenue sources could go to the state or local governments where the resources are found. For instance, the oil-rich regions of south Nigeria initially argued to retain all the taxes and only pay royalties to the federal government. But, recently they argued for the increment of their share from 17 per cent to 50 per cent of the royalties from oil collected by the federal government. The above two contending issues remind us that the sharing of revenue from mining operations will require appropriate formula.

The other source of tax that need to be discussed is value added tax (VAT). Sale taxes such as VAT and turnover tax (TOT) are multi-stage taxes, whereas retail sales tax is a case of single-stage taxation. VAT was recently introduced in Ethiopia at the rate of 15 per cent of the value of the taxable transaction, after Value Added Tax Proclamation No.285/2002 came into force in 2003. VAT is paid by and collected from every person whose annual taxable activity exceeds 500,000 Ethiopian Birr and by everyone who engages in import activities, unless the taxable transaction otherwise involves a supply which is exempted under appropriate laws. The VAT replaced the sales tax on those taxable transactions. As a result of the new law, the power of levying and collecting the VAT is assigned to the federal government. Hence, the power of taxation of the states as with regard to VAT payers, sole proprietorship with taxable capacity exceeding 500,000 Eth. Birr belongs to the states, has been reassigned to the federal administration. But this tax administration is expected to respect the taxation power of states and the federal government is expected to transfer the revenue from the VAT to the respective state based on a derivative principle.

In general, the most important issue in concurrent taxation is how to share the total revenue between the federal government and the states and between the states.

3.5.4. Undesignated Power of Taxation

Article 99 of the Ethiopian constitution reads: ‘The House of Federation and the House of peoples’ Representatives shall, in a joint session, determine by a two-thirds majority vote on the exercise of powers of taxation which have not been specifically provided for in the constitution.’ An interesting aspect of this provision is the distinct method of power division it creates from residual power reserved to the states. As per Article 52 of the Constitution, all powers that are not exclusively given to the federal government alone or concurrently with the states are reserved for the states. The former provision is specific to taxation while the latter refers to the general allocation of all powers and functions of both tiers of government. Therefore, it implies that states necessarily have a residual power concerning matters other than taxation. With regard to exercising residual tax, either level of government can only acquire the power of taxation after a decision is reached by the joint meeting of the two Houses of the Federation.

It has to be noted that the joint session of both Houses is to determine which level of government can exercise the power of taxation. The Constitution allocates independent powers of taxation to the states and the federal government, and taxes shared by both levels of governments. The joint session therefore determines the residual tax to be shared by both levels of governments or to be assigned to either of them. Therefore the power over residual taxes is an exception to residual powers of the Constitution.

It may be easy to consider gift tax, inheritance tax or death duties which are found in some other countries as residual taxes under the FDRE Constitution. But the most significant factor concerning the scope of the residual power of taxation is the system which the Constitution follows in dividing taxation powers. It does not only allocate the type of taxes. The type of taxes is allocated in relation to taxpayer or in relation to the object upon which a tax is to be imposed. For example, it is not income tax that is given to the federal government, rather income from employees of the federal government or from enterprises owned by the federal government. Income from the business profits of rail and air transport goes to the center, while profit from state enterprises goes to a state. Thus, if the source of income or the payer of income tax is not found in the taxation powers of either government, an issue of residual tax could arise.

Sometimes, the issue of residual taxes may arise with regard to the problem in demarcating the precise scope of the constitutionally assigned tax powers. For example, Article 97(6) mentions the power of a state ‘to levy and collect taxes on income derived from private houses and other properties within a state.’ Does it include taxation on the transfer and alienation of these properties? Does the phrase ‘other properties,’ which is in the provision mentioned above, refer to intangible properties? If we answer these questions affirmatively, we may consider capital gains tax, royalty from the use of patent and copyright and income from deposit and from interest are not residual taxes. However, this does not seem to be the case for at least three reasons. First, these types of taxes are special type of taxes which require careful analysis of an economic impact and convenience of tax administration, and the general constitutional division of powers. For example, there must be a clear mandate to assign the power of levying tax from patent and copyright, while the power of patent inventions and copyright protection are given to the federal government. Thus, there must be a clear mandate to allocate this power to the states. Second, this will not be consistent with the style of the constitution which refers to specific type and source of taxes. Third, the Amharic version of Article 97(6) refers to income derived from renting houses and other movable properties.

The other instance of residual tax arises if a state imposes a tax other than profit and sales tax on individual traders within its territory (e.g. if a specific tax is imposed on the number of passenger and goods carried within a state), would this fall under the undesignated tax power? If it has an effect on interstate trade, or discriminates against those coming from other states, the federal government can intervene as the power of regulating interstate commerce is reserved to it alone.

Thus, it follows from the above analysis, capital gain tax, royalty from the use of patents and copyright, income from interstate on deposits, surtax and VAT can be argued to be undesignated taxes, despite the presence of some of them in the existing tax laws. A joint session of the Federal Houses was held for the allocation of the latter two types of taxes before the center levies them.

The Federal Houses in making decisions regarding the assignment of undesignated tax power should consider both the national and state interests. In addition, they have to take into consideration the principle laid down under Art.95 which says ‘the federal government and the

state shall share revenue, taking the federal arrangement into account'. The task of decision on undesignated taxes should be also accompanied by professional competence of the subject and the need for forum that consider the interest of the state in advance. The study on undesignated taxes should also consider the overall tax performance, changing economic condition, and the existing allocation of tax power.

? While Article 52(1) of the FDRE Constitution provides residual power to the states, Article 99 made a provision that the residual power of taxation should be assigned after the deliberation of the two houses jointly. Is there any inconsistency between the two provisions? Why? Why not?

3.5.5. Local Taxation

The federal constitutions primarily provide the distribution of revenue-raising powers between the center and the states. The division of revenue is one of the elements of the power division in the federation. Hence, the distribution of revenue-raising power follows the general power division method. For instance, the federation of Russia, German and Brazil have three tiers of government: center, state, local, and thereby the distribution of the revenue follows this arrangement. In the dual tier federation, decentralization of power further to the lower level governments left to the states in their own territory. However, the assignment of power to local governments may not be the concern of federal constitutions. For instance, the Constitutions of the United States, Australia and Canada deal only with the power of center and the states. Local governments may retain some of the revenue source assigned to the state.

However, there are some trends to constitutionally allocate taxation power to the local governments. For instance, the German Basic Law assigns taxation power to local governments, setting tax rates such as levying taxes on real property and trades. The Swiss Constitution also recognizes the taxation powers of the municipalities, and provides that they have power to levy direct and indirect taxes unless specifically reserved for the center. In India, it is through the 73rd and 74th amendments in 1992 that the Constitution recognized the assignment of revenue sources

to the local governments. In Nigeria, the Constitution recognizes local government, some revenue sources and their right to receive a share from the national as well as the state revenue.

In Ethiopia, the federal Constitution leaves the decentralization of power of the state to the lower level of governments to the respective states; but it gives emphasis to the importance of local governments having adequate power (Art.50(4)). Thus, the allocation of revenue sources to local government is a state matter. Most of the states are organized at zonal, wereda and kebele levels of administration below the state government. Accordingly, revenues are collected through the finance bureaus organized at the state, zonal and wereda levels where the latter collect taxes and they accrue to the state treasury. The weredas have had no autonomy to spend the revenue they collected. Also, the state governments have been determining the local budgets. Even though the 2001 amended Constitution of Oromia and SNNPR provide that the weredas shall have the power to utilize revenue sources other than those allocated and administered by the state government, all the revenue sources constitutionally assigned to the states are reserved to the state governments. The actual local tax power is expected to be determined by the respective state laws. The major obstacle to delimit local tax powers and which the states have expressed are wide local disparities in tax sources and local administrative capacities.

Normatively speaking, from among the type of taxes assigned to the states, those attached to real property can effectively be administered at the local level if the human resource capacity is put in place. Taxes on employment income, agriculture income and rural land use fees, rental income tax, charges and fees and tax on the sale of real property can be assigned to local governments. The local governments can also share the revenue they have collected with the state government according to a certain agreed percentage. Since the type of taxes assigned to the states mainly follow the taxpayer's category and the particular things, they can be administered effectively. The major problem witnessed in tax collecting capacity of weredas is the lack of skilled labour and uneven distribution of tax sources between the weredas.

Solomon recommended that more efforts should be exerted to maximize the administrative capacity of local governments and to secure their autonomy to administer and collect specific types of taxes. In principle, the establishment of local council and local governments is meant to enable them to implement their own expenditure responsibility by collecting certain local taxes.

If local taxes are identified, it will be easier to determine taxes to be shared by the local and regional governments. It is also important to determine what form of intergovernmental fiscal relations should be established in the regions. If revenue sources and the form of fiscal relationship at the local level are identified, the local governments will play a significant role in executing expenditure responsibilities, and in promoting good governance, local participation and efficiency.

3.5.6. Limitations on Powers of Taxation

In federal system of taxation powers allocation between the federal government and the states, there are three limitations of taxations imposed on each federating units. These are prohibition of federal discrimination tax laws, the prohibition of extraterritoriality of state taxes and intergovernmental tax immunity.

The first limitation imposed a prohibition on the federal government from dealing with tax between the states or other levels of government in a discriminatory manner. The limitation prohibits the imposition of different tax rates and tax privileges between the states. The significance of this limitation is that the people of different states should not be exposed to unfair treatment by the federal government on the pretext of the inequality of the states. It is also attributed to the equal constitutional status of the states. But, in some federations, like Ethiopia, asymmetry between the constituent units of a federation cannot be overlooked. The constitution of Ethiopia requires the governments to provide special assistance to those states which are least advanced in economic development. One of the measures taken with regard to taxation is to provide different tax holidays for income from different states. For instance, persons who invest by establishing new enterprises in states such as Gambela, Benishangul-Gumuz, Somali, and Afar are granted an exemption for a period of five years. However, in other states the same investments are encouraged only by three years exemption. This incentive is meant to attract investment in the above mentioned least developed states.

The second limitation is the prohibition of extraterritoriality of taxes imposed by the states. Such prohibition has some purposes. It prevents certain types of tax from shifting beyond the territorial boundaries of the states. This is because such taxes may impose burdens upon the

economic and trade activities of other state, or they may result in duplication of taxes. It also preserves the free flow of goods, services and capitals among the states. But, more important in the Ethiopian context, is that the states should not enact tax laws that discriminate among taxpayers on ethnic grounds. Therefore, those taxes, which by their nature are extra-territorial, can be assigned to the federal government.

The third limitation concerns the capacity of each tier of the federal government to tax each other. In the federal system, a question arises as to whether it is proper for one level of government to pay tax to the other. In principle, the two tiers of government having autonomous functions and taxing powers are deemed to operate in parallel so that one level of government cannot interfere with the power of the other. But in practice, it is hardly possible to avoid the possibility of intervening in the work of one with the other.

In Ethiopia, the directive on intergovernmental tax immunity is embodied in Article 100(3) of the Constitution. It reads: ‘Neither states nor the federal government shall levy and collect taxes on each other’s property unless it is a profit-making enterprise.’ However, the application of this provision and particularly the interpretation of the terms; ‘property’ and ‘profit-making enterprises’ should be consistent with the other provisions concerning allocation of power of taxation.

Activity 3

1. Whether the division of specific kinds of the taxes in Ethiopia has difference from its counterpart in other federations? Why? Why not?
2. Whether the Ethiopian approach makes each level of government self-sufficient in meeting the respective expenditure responsibilities? Why? Why not?
3. The allocation of income from natural resources like petroleum and its taxation assigned to the center as the general principle developed by federations creates some political unrest in Nigeria and Sudan currently. In Ethiopia, there are also political instabilities around Ogaden and Gombela because of the same reason. If such power over income of natural resources is given, it would result in horizontal imbalances among the states. What kind of solutions to you propose in revenue sharing of these natural resources?

4. Discuss the three kinds of tax limitations imposed upon the federal government and the states? Identify the one that is enshrined under FDRE Constitution?
5. The Ethiopian Constitution is based on the category of taxpayers and particular things to divide taxation power between the two tiers of governments. However, such category of taxpayers and particular things are devolved to the federal and the states as per the division of power and function under Articles 50, 51 and 52. So, Is the division of taxation under Articles 96, 97 and 98 redundancy and superfluous? Why? Why not?
6. Does uniform taxation in federations after powers and functions are divided contradict the autonomy of the states? Why? Why not? Why the states are not free to apply different tax rates and bases as they want since they are paying different wage for the same professionals (judges)?
7. The introduction of the federal VAT in Ethiopia replaced the constitutionally assigned sale taxes of the states. Is it unconstitutional? Why? Why not?

Summary

Chapter three deals with public revenue in general and the allocation of revenue-raising power among multiple tiers of governments of federal system in particular. The notion of public revenue consists of two powers. The power to legislate laws on some determined sources and the power to collect revenues accordingly. However, in federal system where powers of the state including the revenue-raising power is divided among multiple layers of governments, the task of public revenue associates with problems, at least creates some difficulties on the governments. Hence, the constitutional help in demarcation of the jurisdiction of each government in the area is an evitable solution.

Governments in general raise revenue from two basic resources. Taxes are the major and the substantial source of government revenue. The non-tax sources are the other sources of government revenue. The non-tax revenues accrue from administrative income such as fees and charges, fines and penalties, special assessments etc. In addition, price capital receipts and grants and gifts from domestic and foreign donors constitute the substantial part of non-tax revenues. Taxes with their category as direct and indirect play a vital role in government financing. They

finance the government expenditure responsibilities, stabilize economic fluctuation, distribute wealth of the state and encourage investment

Devolution of power of taxation by specific method is the basic task of federal constitutions. Accordingly, the FDRE Constitution derives specific methods of division of taxation between the federal government and the states. Hence, the category of tax payers and particular things pertaining to either of the governments by constitutional decentralization of power and functions are taken as the base of revenue power allocation. Therefore, except custom duties exclusively given to the federal government, all taxes are allotted to both governments in their own jurisdiction. The Constitution addresses the division by setting ‘federal power of taxation’, ‘state power of taxation’ and ‘concurrent power of taxation’. It also provides the residual taxation to be dealt by the joint meeting of the two houses.

In order to make clear the Ethiopian constitutional approach, the system of other federations such as USA, India and Germany have slightly been compared.

Meanings of Major Administrative Revenues

Fees: - as Pro. Seligman defined fee is a “payment to defray the cost of each recurring service undertaken by the government, primarily in the public interest, but conferring a measurable special advantage on the free-payer. Thus, a fee is a payment charged by the government to bear the cost of administrative services rendered primarily in the public interest, but conferring special benefits to the individuals. Hence, fees are to be paid only by those individuals who receive some special benefits from the services rendered by the government, e.g., a student has to pay fee for getting the benefit of education from government colleges.

Thus, fees can be distinguished from prices. Prices are always voluntary payment, but fees may be compulsory contributions though both are made for special services. An element of tax, i.e., *quid pro puo*, is also present in fee, while it is absent in prices. Fees are the by-products of the administrative activities of the government and not a payment for business activities undertaken by the government.

License fee: - though a license fee is similar in nature to that of a fee, but it can be distinguished from a fee, “a license fee is paid in those instances in which the government authority is invoked simply to confer a permission or a privilege rather to perform a service of a more tangible and definite sort.” The registration fee for motor vehicle, the payment for permits to operate automobiles, and the license fee for keeping a gun can be examples of such fees. In these cases, an individual is not forced to make payments, but if he wishes to use an automobile, he must pay the necessary fee. The nature of the benefit conferred up on the payer is to be found in the shape of legal practical benefit to use an automobile or to keep a gun.

The object of such a fee may sometimes be the regulation or control of various types of activities, e.g., licenses for guns are granted to responsible persons to maintain law and order. Similarly, licenses are granted for running liquor shops to control the scale of liquor. For the interest of public safety, automobile drivers are asked to obtain driving licenses, and these are granted only when an individual is fit for driving particular vehicle. Hence, the element of regulation or control is present in license fee, which distinguishes it from fee and taxes both.

Special Assessment: - Pro. Seligman, defined special assessment as, “a compulsory contribution, levied in proportion to the special benefit derived to defray the cost of a special improvement to property under-taken in the public interest. That is to say, when the government undertakes a certain activity of public improvements like construction of roads and bridge, provision of drainage, street-lighting, etc., they may confer the common benefit to the community as a whole and special benefit on those whose properties are nearby. As a result of the improvements, the values or rents of these properties may rise. The government, therefore, may impose some special levy to recover a part of the expenses incurred. Such special assessment is levied, generally in proportion of the increase in the value of property. In this respect it differs from a tax.

Fines and Penalties: - fines and penalties are not an important source of revenue. A fine refers to the punishment or penalty which is imposed for the infringement of law. It is meant to serve as a punishment for and a deterrent of crime.

Forfeitures: - forfeitures of basic surety or bonds refers to the penalties imposed by courts for the failure of individuals to appear in the courts, to complete contracts as stipulated, etc. Obviously, the sources of revenue are also of very little importance.

Escheat: - it refers to the claims of a government to the properties of a person who dies without having any legal heirs or without keeping a will. Thus, a bank balances and other properties of such a person will pass to the government. Under the rights of escheat, the government may also acquire unclaimed property of dissolved educational or other trusts, etc. This is not an important source or revenue.

CHAPTER FOUR

FISCAL IMBALANCES AND INTERGOVERNMENTAL REVENUE TRANSFER

Introduction

Students! you have learnt about allocation of public expenditure and revenue rising in federal system in the previous chapters. In this chapter, we will discuss two basic elements of fiscal federalism: fiscal imbalances and intergovernmental transfer. While public expenditure and revenue rising are common in public finance to all kinds of governments and states, fiscal imbalances and intergovernmental revenue transfers exclusively happen in fiscal federalism – public finance in federalism. These basically result from the devolution of financial power to different tiers of governments in federalism. Fiscal imbalance means a mismatch of revenue and expenditure in state or among the states. It is of two kinds: vertical imbalance and horizontal imbalance. Vertical imbalance is a mismatch between the expenditure responsibility and the revenue capacity of regional governments which opens a way to the center to interfere – creates vertical relationship between the states and the center. On the other hand horizontal imbalance is fiscal imbalance which is related to the fiscal disparity in providing equal public services among the states. It entails that individuals in different states have different access to the same public service. Hence, this creates horizontal comparison among the states.

The first part of this chapter explores the two imbalances highlighted above with their causes and implications. The second part of the same is devoted to cure the problem of fiscal imbalances, *i.e.* intergovernmental transfer. The concept of fiscal transfer concerns issues that address the states' financial constraints in executing their expenditure responsibilities and narrowing the gap between revenue capacity and expenditure need to ensure that state governments will be able to provide comparable public goods and services. These can be achieved, as illustrated hereunder, through transfer such as revenue

sharing, grant and interstate transfer. Ending with summary, the chapter has in-text questions and activities throughout the lessons.

Chapter Objectives

At the end of this chapter, the students will be able, among other things ,to;

- understand the concept and meaning of fiscal imbalances and intergovernmental fiscal transfer,
- identify the basic causes and implications of both vertical and horizontal fiscal imbalances,
- acquaint themselves with the impact of black economy and ethnicity in fiscal imbalances,
- identify the types of fiscal transfer;
- analyze the types and objectives of revenue transfer, and
- acquaint themselves with the methods and techniques of grant distribution formulas and their basic elements.

N.B. This Chapter is highly drawn from the book entitled “*Fiscal federalism in the Ethiopian Ethnic- based Federal system.*” By Solomon Negussie (Dr.).

4.1. Fiscal Imbalances in General: meaning

In federations powers of the government are subject to constitutional devolution among tiers of the governments. This includes financial power of governments to satisfy the public services through expenditure responsibility and revenue raising. Though this allocation scheme is designed with many considerations, it is not immune from creating disparity between responsibilities and resources. The fiscal mismatch between the expenditure responsibility and revenue sources is generally termed as fiscal imbalance. In accordance with the level of governments and their relations, there exists mismatch between revenues and expenditures that arise from fiscal relations between the center and sub-national governments and from fiscal relations among sub-national governments. While the former constitute vertical fiscal imbalances, the later does horizontal fiscal imbalances.

? What are the conditions that constitute fiscal imbalances? Identify the two fiscal imbalances.

4.1.1. Vertical Fiscal Imbalances

The issue of vertical imbalance is one of fiscal imbalance challenges of fiscal federalism that is encountered by either of the tiers or both governments. In most federal systems, there is a mismatch between the expenditure responsibility and the revenue capacity of regional governments. This imbalance between the revenue raising ability of sub-national governments and their expenditure responsibilities is usually called **vertical fiscal imbalance**. The problem of vertical imbalance is also evident in the Ethiopian fiscal arrangement. This vertical imbalance is primarily generated by constitutionally assigned expenditure and revenue responsibilities. That is, while tiers of government have significant expenditure responsibilities, the major revenue sources remain concentrated at the centre. In most federations, expansive and lucrative source of taxation lie within the center while the responsibility to provide for development, welfare and social activities like education, housing, health, agriculture etc. are primarily imposed on the states.

There are two methods which enable to examine vertical imbalance. These are basically based on the two aspects of public finance: the expenditure and the revenue. The first way is to measure what share of regional government expenditures are financed with its own revenue sources under the control of the region. The outcome of this reveals the share of regional government expenditures financed by revenue sources controlled by the region itself and the federal government. Then if the substantial share of regional government is covered by the center, vertical imbalance imperatively exists.

The second way to examine the imbalance is to measure the share of revenue generated by the regions as a percentage of the total national revenue raised by all tiers of government. This shows the capacity of the regional government in order to incur its expenditures compared to other states. The imbalance measured in these two ways demonstrates whether the states remain with limited revenue sources and with a small percentage of the total

revenue. For instance, the revenue generated by the states, including Addis Ababa City administration and Dire Dawa City council, accounts for only a maximum of 9.7 per cent of the total national revenue in 2007/08 fiscal year. The overall share of the states' revenue is considerably lower than their expenditure. For example, in the 2006 fiscal year the states own revenues (excluding Addis Ababa) covered only 18.7 per cent of their total expenditure. It is apparent that the remaining percentage of expenditure was covered by the finance transferred from the centre. Eventhough the revenue collected by the regions increased progressively from 1,736.5 million in 2000 to 1,620.6 billion in 2007, it is the central government which collects the major portion of the country's revenue. This is mainly because taxes collected from profits, residual surplus and indirect taxes from the federal government enterprises as well as import duties which constitute the lion's share of aggregate revenue sources are under the Federal Government.

4.1.2. Horizontal Imbalance

One of the objectives of the fiscal arrangement is to ensure that individuals residing in different regions or localities have equal access to public goods and services. However, the sub-national governments may not have equal fiscal capacity to provide public services although they are assigned with the same revenue sources. They usually have different capacities owing to the fact that single tax base may not generate the same amount of money in different places. This leads to another problem of fiscal imbalance which is related to the fiscal disparity between the states, usually referred to as **horizontal fiscal imbalance**. The problem of horizontal imbalance occurs when the revenue capacities of different sub-nationals vary so that they are not able to provide their citizens with services at the same level on the basis of comparable tax levels. This problem is related to the varying fiscal capacities of the individual member states of the federation.

In Ethiopia, all the regions have fiscal deficits and they also have widely divergent revenue-raising capacities. This disparity can primarily be attributed to the fact that regional governments at the same nominal level vary considerably in their skilled manpower, financial capacity, as well as in population size. Just two regions, Oromia and Amhara, account for 60 per cent of the total population and one third of the territory in the country,

while three regions (Harari, Gambela and Benishangul-Gumuz) do not have more than one per cent of the population. They also have variations with regard to management and administrative capacities as a result of relative variations in natural resources, infrastructure and the characteristics of urbanization. They also vary their economic environment for private as well as public investment. This asymmetry causes problems in measuring the imbalances between the jurisdictions.

Table 4.1. REGIONAL GOVERNMENT EXPENDITURE FINANCED FROM THEIR OWN REVENUE F.Y 2006.
(in Billion)

Region	Total Exp.	Own Revenue	% share of (2)	%share of total Regional revenue
	1	2	3	4
Tigray	695.7	194.9	28.0	12.0
Afar	332.0	38.0	11.4	2.3
Amhara	1899.7	380.3	20.0	23.5
Oromia	2958.3	624.3	21.1	38.5
Somali	506.2	31.0	6.1	1.9
Benishangul-Gumuz	229.0	22.1	9.7	1.4
SNNPR	1626.4	262.8	16.2	16.2
Gambela	156.2	12.4	7.9	0.77
Harar	119.0	20.5	17.2	1.3
Dire Dawa	153.9	34.3	22.3	2.1
Total/Average	8676.4	1620.6	18.7	100

Source: Ministry of Finance and Economic Development (MoFED), cf. The Federal Democratic Republic of Ethiopia, The New Federal Budget Grant Distribution Formula, May 2007.

A formal regional fiscal imbalance is measured as the ratio between regions revenue and the total revenue generated by the regions. The total revenue collected by the regions is

very much concentrated in a few regions. Just four states account for more than 80 per cent of the total revenue generated by the states. For instance, in 2006/2007 fiscal year Oromia's share of the total revenue raised by the regions was 38.5 per cent, but Gambela had only 0.77 per cent. They accounted for 21.1 and 7.9 per cent of their respective financial expenditures. The largest revenue item in these regions is employment income tax. Their capacity to effectively raise revenue from business-related taxes such as sales, excise, and business profit taxes is very much limited.

A better indication of the horizontal fiscal imbalance is given by the percentage of revenue raised by each region relative to the respective expenditure. The lowest percentage is recorded in the Gambela region. The variation in the revenue capacity is a reflection of the available revenue sources. The lowest percentage of revenue compared with their own expenditure implies that they have the least revenue-generating capacity. The data also show that Tigray and Dire Dawa generate the highest percentage of their own revenue compared with own expenditures, accounting for 28 and 22.3 per cent respectively. Amhara, SNNPR and Harari showed about 15 to 20 per cent, while Somali, Benishangul-Gumuz and Gambela regions were able to account for less than 10 per cent of their expenditure.

Although the percentages show frequent fluctuations, the ratios can be easily interpreted. First, the total expenditure is dependent on the amount of federal grants. When a region receives a higher amount of transfer, the revenue-expenditure ratio will be lower. Second, it reflects the administrative capacity of the regions. Those with the least executive capacity usually generate the lowest percentage of revenue. Third, taking the least revenue-generating capacity into account, Afar, Somali, Benishangul-Gumuz and Gambela are categorized as the least developed regions seeking a substantial amount of federal grants. On the other hand, Tigray, Amhara, Oromia and SNNPR are considered to be relatively developed and entitled to lower per capita federal grants. It is also said that there is a higher level of economic activity in these regions which has led to a larger revenue base. However, these regions also need the provision of goods and services for their large population size. Although these are the general categorizations, for a better understanding of the imbalances it is important to measure the revenue and expenditure disparities on a per capita basis.

4.1.2.1. Intrastate Imbalance

If we continue the comparison, the imbalance exists not only between the regions. There is also an imbalance between zones and local administrations within a region or in comparison with those in other regions. In other words, the horizontal fiscal imbalance refers not only to interstate but also intrastate imbalances between the sub-regional governments. In order to analyse the actual imbalances of revenue-generating capacity vis-a-vis the expenditure share there should be a clear assignment of sources and responsibilities. Although the powers and responsibilities of the sub-regional administrations are not constitutionally delimited, the zone and wereda administrations have, in practice, expenditure responsibilities. Hence, there exist horizontal imbalances among zone, weredas and even kebles. It suffices here to see the first two cases which are the major ones.

a) Zonal Level

If we see the Amhara region, zones vary in their contribution to the region's total revenue and in the percentage of revenue compared to their own expenditure. For instance, during the 2000/01 fiscal year, the smallest contribution was made by *Wag-HimYra* zone raising about 1.4 per cent of the total revenue and covering 16 percent of its own expenditure. The highest contribution came from the South Wollo zone raising about 16 per cent of the region's total revenue and covering 30 per cent of its annual expenditure.

In the Oromia region, a few zones within the region were major contributors to the region's revenue capacity. For example, the recurrent expenditures of East and West Harerge zones are completely covered from locally collected revenue sources. The economic dynamics in some of the zones indicate that most of the tax bases accrue to the regional and to the federal government (i.e. not local government). For instance, Eastern Oromia is an industrial zone and has a better possibility of attracting investment due to its better infrastructure. Some other zones have a potential natural resources and agricultural investment. However, most of the revenue from large investment accrues to the central government. If these economic potentials are exploited and properly regulated, it may be assumed that there will be significant contributions to the region, zone or to the local

government.

b) Wereda Level

Weredas also experience horizontal fiscal imbalances. Out of the 89 weredas in the SNNPR, 18 weredas together were able to generate more than half of the total business profit tax collected in the region. 45 weredas together generated less than 10 per cent of the total business profit tax. During the same fiscal year the weredas in the Tigray region varied tremendously in their revenue-generating capacity. Out of the total 34 weredas, two weredas together were able to generate a major portion of the sales tax collected in the region.

Activity 1

1. What do we mean by fiscal imbalance? Identify the two imbalances.
2. What is the difference between horizontal and vertical imbalances?
3. Articulate the difference and similarities of measures of both fiscal imbalances.
4. Horizontal imbalance has wider dimensions than vertical imbalance. Discuss the area of dimensions.
5. Students, you have learnt about types of federalism in the course federalism. Do you think fiscal imbalances among the tiers of governments demonstrate the type of federalism? How? If so, what kind of federalism is Ethiopia experiencing?

4.1.3. Causes and Implications of Imbalances

a) Causes of Imbalances

The cause of fiscal problem that the regions are facing has two aspects: revenue is low while expenditure needs are high. To begin with revenue, the dominant and lucrative sources of revenue are reserved for the federal government under its exclusive jurisdiction, or through the concurrent powers on the basis of which it has the ultimate power to levy and collect the taxes. The major sources of revenue, such as customs duties and other charges on imports and exports, which account for the lion's share of the total revenue

generated in the country, are placed under the exclusive jurisdiction of the federal government. The centre has also been levying and collecting other taxes levied upon companies which are concurrently assigned to the centre and the states.

On the other hand, tax sources which yield only a limited amount of revenue have been allocated to the states. The sources of revenue held by the states neither generate a substantial amount of taxes nor reveal signs of growth relative to the total revenue and their expenditure needs. This can be observed from the lower amount of revenue generated by the regions. The regional governments generate a small amount of tax from trade activities and indirect taxes such as sales tax. The regions' revenue receipts are mainly from those types of sources which are easier for the administration, such as employment income tax, pension contributions and charges and fees for services rendered by government office. For the regions, the source of tax which is easiest for the administration is personal income tax paid by government employees. The insufficient revenue of the states is not only the result of limited tax bases, but also of tax administration incapacity and taxpayers' unwillingness or inability to discharge their obligations.

On the expenditure side, the low level of development in the country leads to particularly high expenditure needs in the regions. If it was not for federal grants most regions could not even cover the salaries of the civil servants. That is a further reason why fiscal gap measurements show a considerable vertical imbalance.

As Ronald Watts propounds, the vertical imbalance continues and requires regular adjustment. This is because, according to him, no matter how carefully the original designers of the federation may attempt to match the revenue sources and expenditure responsibilities of each order of government, over time significance of different taxes (such as income taxes) changes and the costs of expenditure vary in unforeseen ways. Revenue from agricultural income tax and land use fees are evidences in Ethiopia. The revenue from these sources always vary because of famine which affects millions of people of the land frequently.

The vertical imbalance may also be attributed to the fact that the factors determining the assignment of expenditure and revenue-raising responsibilities are usually considered

independently. The underlying reason for assigning both powers to the sub-national governments is to bring a government closer to the people so that the governments better address the people's needs. But with regard to assigning taxation powers could be additional reasons which may lead to the growth of a vertical imbalance. There are at least two reasons: capacity in tax administration and the need to secure equitable distribution of finance among the regions. This is because, for example, for reasons efficient and effective tax administration some tax sources will be assigned to the center. Similarly revenue sources which are unevenly distributed between the regions concentrated in few regions could be retained by the centre. Unless they are retained, the centre and later on redistributed to the regions on equitable grounds, there could be which are a huge disparity between the regions. However, there will be a vertical imbalance between the expenditure responsibilities and the revenue raising capacities of the states which requires an effective transfer mechanism. Thus, when a greater portion of revenue accrues to the centre, the major task of the central government will be redistributing it equitably to the regions.

The levels of the vertical fiscal imbalances in some developed federal systems have demonstrated a lesser revenue capacity on the part of the states, while the centre collects funds in excess of its expenditure needs. When we analyze the Ethiopian federalism (the assignment of expenditures and the revenue-raising capacities) and its vertical imbalance, the vertical imbalance is not a result of an assignment of power that enables the central government to collect funds in excess of its expenditure needs. Although the amount of revenue that accrues to the federal and state treasuries varies tremendously, the federal revenue is not sufficient to cover the federal expenditure. The central government does not generate revenue in excess of its expenditure needs. It is only when we compare the capacity of the central and the regional governments that the vertical imbalance is evident from the flow of a large amount of taxes to the centre. If we see it in terms of fulfilling financial requirements, then neither the centre nor the regions cover their expenditure from domestic revenue sources. All the revenue generated by the federal government through tax and non-tax sources accounts for up to 65 percent of its total expenditure. The bulk of the expenditure needs are covered by finance flowing from domestic loans as well as foreign sources such as loans, aid, and counterpart funds. These sources account for up to 35-40 percent of the total national expenditure.

On the other hand, horizontal fiscal imbalance in the same fashion is caused by the revenue and expenditure aspects among the states, specifically, the variation of regions in terms of per capita revenue and per capita expenditure. This is calculated as the ratio of total revenue and expenditure to the total population of the region independently. In cash terms during the 1999/2000 fiscal year, the lowest amount of revenue raised per person was about 6 birr in Somali and the highest was about 85 birr in Dire Dawa respectively, excluding the Addis Ababa administration. The next highest per capital revenue was raised in the Harari region (65.8). The highest per capital revenue raised in Dire Dawa and Harari is a reflection of the higher level of economic activity as they are urban centers and have a smaller population size. Although Tigray, Amhara, Oromia and SNNPR are in the same group of relatively developed regions, the latter three regions, with large populations and territory, have lower per capita revenue and per capita expenditure than the middle-sized region of Tigray. This demonstrates, among others, that the average size does matter in the per capita distribution of revenue.

A number of reasons are provided for the root cause of horizontal imbalance. To mention some, difference in natural resource endowments that gives rise to variation in revenue sources; urban centered industrialization that pools investments and high dependency ratio of young, old and poor, or naturally difficult terrain or generally higher cost disability factor.

The data, on the other hand, demonstrate variations in the level of expenditure. Those regions with the largest revenue-raising capacity do not have the highest per capita expenditure. Rather, those regions with the least revenue capacity (also a smaller population size) have the largest per capital expenditure. This is due to the high revenue transfer from the centre, based on the fact that they have a higher public expenditure need owing to the relatively low level of development.

b) Implications of Imbalances

Whatever the causes may be, the vertical imbalance in Ethiopia provides evidence that the

centre dominates the fiscal power of the federation. The imbalance is also higher than in many other federal systems. As we have seen above, the sub-national revenue share in Ethiopia is a maximum of 9.7 per cent (2007/2008 F.Y), compared to India 28, Brazil 24.3, Germany 24.5, Australia 28.2 per cent and Nigeria 32.3 per cent. In this regard, the main issue will be what does this imbalance imply?

First, it could lead to problems of inefficiency. As it is argued, because the costs of public expenditure are not fully internalized by the regions and are supported by transfers from other parts of the country, there is a reduced incentive to provide public services in an efficient manner.

Second, a very low level of vertical imbalance generally implies that the states vigorously exercise their decision-making autonomy, as their revenue capacity matches their expenditure responsibilities to a great extent. In contrast, a higher degree of vertical imbalance implies that the states' autonomy is dependent on the transfer of revenue controlled by the center. When the states remain with a small amount of revenue compared to their expenditure needs, they will be prone to the influence of centre. However, the extent of the central influence will be dependent on the mode and extent of federal transfer which is discussed below. If the nature of transfer system emphasizes federal preferences or conditions, there will be too much influence on the autonomy of the regions. The practice in Ethiopia does not appear to reflect a challenge to secure regional autonomy, since the ruling party and its allies control both the federal and regional governments. However, this trend may change if strong opposition parties control both the federal and regional governments. In such a case, the degree of maintaining regional autonomy will be dependent on the nature of the revenue sharing and the transfer system. The revenue transfer system requires, at least, an independent and efficient financial institution, a check and balance mechanism (through the Upper House) and a transparent transfer formula. Otherwise the federal government may harass or restrict the states' autonomy through fiscal instruments.

Apart from focusing on revenue sources, reducing the existing imbalance itself requires far reaching administrative and political measures to tackle the problems. Some of these measures

could be the following: increasing efficiency in tax administration so that the regions can tap the full potential of the assigned taxes, promoting awareness among taxpayers to fulfill their obligation, securing financial accountability, fighting corruption, and engaging in effective intergovernmental cooperation. This also requires a political commitment to enhance the capacity of sub-national governments by refraining from acts which hinder the movement of skilled labour and capital.

? Students, can vertical imbalance be used as a weapon among the tiers of federal governments for political influence among each other? Discuss the worst case of such influence whether it happens in multi-party system or single-party system of parliament.

The horizontal revenue imbalance implies that the regions retain different capacities to generate revenue within the regions to cover costs of public expenditure. It also reflects the extent of support they need in the form of federal transfers, but before taking any corrective measures, the fiscal disparities between the regions should be effectively measured. Thus, there should be a method to measure both the actual (what is collected) and the potential revenue capacity.

The degree of financial imbalances can also be influenced by imbalances in the expenditure needs. The need for public services of different types can differ between states and the cost of providing them may also differ. As Watts emphasized, this is because of variations in population dispersion, social composition and age structure, and the cost of providing services affected by such factors as the scale of public administration and the physical and economic environment. The imbalance of expenditure needs between regions and local governments should be measured. Thus, the measurement focuses on the cost of the provision of basic services in the regions and the size of the population with similar expenditure needs due to remoteness or poverty or lack of public services.

The general understanding is that the least developed regions have been historically marginalized and, therefore, they have a higher expenditure need. However, this comparison is difficult because the total number of people living in extreme poverty in Oromia, Amhara and SNNPR is higher than the total size of the population living in the

remainder of the regions. Measuring the expenditure needs should also target the vulnerable population that lives in the so-called developed regions. As a whole, in the Ethiopian case, measuring the imbalances could be feasible if the existing asymmetry pertaining to demography and size is reduced by territorial reorganization. It is argued that efficiency and accountability is better promoted in regions with a relatively manageable size.

C) Extraneous Factors in Fiscal Imbalances: black market and ethnicity

? What is the concept of contraband or black economy? Is it helpful or harmful to ones' economy? What would be its fate when Ethiopia accedes to WTO?

One of the main challenges in measuring the horizontal imbalance between the states, between zones or between local governments is the impact of the black economy. This makes itself at local level. The black economy is related to unregulated business, cross-border trade and smuggling. In some places the smuggling of goods into and out of the country forms the major economic activity of the people. However, the expansion of contraband trade and the dumping of cheap foreign products on the local market have been major setbacks to the growth of the industrial sector in general. In general, contraband is rampant in many of the localities in the Somali, Harari, Benishangul-Gumuz and some Oromia zones, whereas at the moment regions like Amhara and Tigray have little opportunity to "benefit" from such a black economy. For instance, it has been reported that the country loses up to 400 million birr due to live animal smuggling in the eastern and southern part of the country. The impact of the black economy in the regions mentioned above cannot be ignored. Besides, its impact on the national economy, it can contribute to imbalances between Weredas, Zones or regions as the case may be. It can also influence the per capita income of the people in a specific zone or wereda. It has been recounted by the residents of Dire Dawa that economic movement in the city is hampered since the Federal government imposed serious customs control. They complain because the economic activity in the city is forced to move to neighboring Zones where administrative and customs controls are lax.

The fiscal issues are one of the objectives of the EPRDF: tackling the socioeconomic problems by treating all ethnic groups equally. As ethnicity is the basis of organizing regional or sub-regional levels of government, there is also a tendency to scrutinize the fiscal imbalances through the same principle of equality of ethnic groups irrespective of the level of government. A comparison of the financial packages of ethnic groups, however, will not address the real financial disparities between the levels of government. Of course, the ethnic groups vary in terms of several factors, ranging from the population and geographical size to the manpower and administrative capacity available. However, the fiscal imbalance can only be measured by comparing the revenue and expenditures across the territorially defined jurisdictions. Thus, the tendency to devolve power to the weredas making them the relevant budgetary unit which then makes it possible to measure the fiscal imbalances between them. Nevertheless, the difference at the local level is also a reflection of the disparity between the regions and it is likely that the disparity between the weredas would be the same. This is so because the disparity observed at the regional level is also a reflection of the disparities at the local level. Furthermore, tracing the exact degree of imbalances and the precise calculation of the share of revenue requires a careful analysis. Thus, a comparison between local governments is equally problematic as it reveals tremendous variations in financial capacity, expenditure demand and skilled labour. Thus, to effectively measure the local fiscal imbalance, it is important at least to reduce the territorial asymmetry between the regions.

In sum, measuring regional disparities is important in order to identify places that need a better provision of public goods and services. Reducing the fiscal imbalance is not only important for the purpose of equity, but also for forging solidarity between the regions, zones and the weredas. This will strengthen the effort to reduce the disparity in the level of public services across the regional or local jurisdictions.

Activity 2

1. List down the causes of vertical and horizontal imbalances and identify the legal and practice based cause
2. List down the implications of both fiscal imbalances Identify those of political and economic or social implications

3. The vertical imbalance of a region consistently was financed by the center with smooth political relationships between them owing to the same party was ruling both the center and the region, however, the current election results cause different political to parties assume in the two governments. The ideological difference between the two parties amplifies the policy and priority of expenditure differences. What are the expected political influences and economic implications to the population of the region?
4. The Ethiopian federalism craft construct ethnic based states, which have horizontal fiscal imbalances, do you think that highly ethnocentric thoughts has impact on the fiscal relation among the states? Do the basic values of multinational federalism help to lubricate the financial tension? Discuss them.

4.2. Inter-governmental Revenue Transfer: meaning

The outcome of the overall greater fiscal imbalances has led to the implementation of the transfer system that can be considered as the major revenue source of states in many federations. The transfer system in Ethiopian federation operates within its local context. Transfer in crude sense is a mechanism which involves a vertical flow from the center to lower governments or the vice versa and horizontally from wealthier regions to poorer regions in order to maintain fiscal stability that creates broad correspondence between revenue resource availability and expenditure functional responsibility.

4.2.1. Objective of Transfer

We have discussed the devolution of powers and responsibilities to sub-national governments to enable them to act independently on matters considered to be in the interest of their constituents. Other mechanisms, notably political and economic, have to be employed to accommodate diversities in conformity with local preferences or capacities to perform the responsibilities. This is considered to be one way of accommodating diversities and regional autonomy. Promoting diversities may result in disparities related to governmental financial capacities or individual incomes. In order to manage the income disparities while preserving diversities fiscal instruments, particularly intergovernmental revenue transfers, are vital.

Revenue transfer has the main objective of addressing the states' financial constraints in executing their expenditure responsibilities. But narrowing or closing (if possible) the fiscal gap between revenue capacity and expenditure need may not be sufficient to ensure that state governments will be able to provide comparable public goods and services. The revenue of the state governments may vary also between them, which affects their ability to provide (access to) services.

The process of adjusting the horizontal as well as vertical imbalances is known as '**fiscal equalization system**'. This process is required, for large differences in economic circumstances between regions are likely to threaten the cohesion of the federation, and to distort federal policy making and the operation of the internal market. However, the processes, extent and nature of transfer to reach the desired level of equalization vary widely across federations. For instance, in Australia, the process of adjusting the imbalances between the states takes into account not only of the difference in revenue capacity, but also of the difference in expenditure needs. Notwithstanding the great variety, the general assumption which is common to most federations concerning the objectives of equalizing revenue capacity of states is principally to address the vertical and horizontal imbalances.

Addressing financial disparities between governments is sought for equity reasons and promoting an economic union. The interest of an economic union at the same time necessitates an equitable revenue transfer system and collaboration between the constituent units of a federation. The system of revenue transfer is related to the economics of the responsibilities and revenue sources of government. This federal principle leads to a certain expectation that each state should have a broadly comparable level resource so that it can provide the same standard of public services such as education, health, social welfare, etc. However, the states end up with different capacities to provide public goods and services to their resident. This results in two main problems: different tax capacities and different expenditure needs. Consequently, as economists say, identical persons will be treated differently by the public sector according to the states in which they reside. Thus, in the process of revenue transfer, there is also a need to consider, to the extent possible, the equitable distribution of income between individuals.

The disparity in the capacity (of revenue raising and expenditures) of the states also raises the question as to how to balance their role in the interest of the economic development of the federation as a whole. Inefficiency in some constituent units can have an impact upon the capacity of the federal government, on the one hand, and on efficient execution of responsibilities by the states, on the other. This is because the disparity consequently requires the shifting of resources from efficient to inefficient states. The financial imbalance between the states requires an equitable transfer which can address two opposing interests: enhancing the ability of states with less reliance on their own source of revenue and promoting the role of the efficient ones in achieving the objective of equitable distribution without weakening the financial benefit derived from fiscal decentralization. Therefore, the other objective of revenue transfer is to reduce, if not to eliminate, financial imbalances and inefficiency across the states.

The other rationale of revenue transfer is to compensate for local spending which provides significant extra-territorial benefits or spill over but has unrecognizable local benefits, or increases the local burden due to the goods and services provided for the neighboring state or local territories. For example, local spending on schools and health centers could in fact mean the provision of services to people coming from neighboring local governments. Unless these external benefits that are given to the other communities are compensated, the quality of goods and services to the local community remains below standard or the local government will be forced to undertake additional costs. Thus, the revenue transfer system is expected to take this issue into consideration and aim at compensating the spillover effects of local costs.

A federal government may also transfer revenue for local spending on condition that it can be spent on specific services or targeted objectives. This type of conditional transfer will at the same time enable the implementation of federal policies at the state or local level. In addition, transfer serves to achieve political goals. If the decentralization in a federation target to keep some economically non-viable, culturally non-sustainable and non-dominant groups autonomous from the influence of majority or historically unjust marginalization, transfer makes it to place.

The attainment of the objectives of an equitable transfer of revenue might encounter several problems which should be handled with care. For instance, several economists warned that if the transfer solely aims to fill the budget deficit and if sub-national governments rely on the amount transferred, it can have a disincentive effect on efficient tax administration. Inefficient local taxation can also reduce accountability and responsibility towards local residents. Thus, transfers should, to the greatest extent possible, reduce the impact of inefficiency and unaccountability. Also transfers may undermine the autonomy of state or local governments if they involve federally set priorities or conditions. So, one should be careful not to create a loss of local or state autonomy.

Furthermore, the role of transfers should be purely for addressing the special problems of financial incapacity rather than benefiting states for political expediency. In this regard, there should be a clear legal mechanism and an unbiased institution to administer the system of revenue transfer so that it cannot be manipulated based on the outcome of an election. It should not be used to appease those states which may join a coalition in government or to penalize the rest.

Another factor especially relevant for countries like Ethiopia is the relationship between revenue transfer and economic development. The challenge here is to create a level playing field for the regions, that is to strike a proper balance between regional economic efficiency and competitiveness on the one hand, and the existence of political cohesion based on equity on the other. While reducing regional economic disparities promotes national unity and peace as an important prerequisite for national development, horizontal equalization must not be a disincentive to regional development activities.

4.2.2. Types of Transfer

Although the scheme for the allocation of centre-state taxing powers can be made with many considerations in mind, in most cases it does not create a balance between responsibilities and revenue sources at the state level. Most productive sources of taxation are in the hands of the centre. As a result of this, it is necessary to transfer a portion of the revenue to the states. Thus, most federal systems have sought to create a balance between

states' functions and financial resources through transfer mechanisms. While in some federations the power is entrenched through specific interpretations of the concurrent power of the centre and the states, in some other systems a wider transfer of authority is mandated by the constitution. As Roy Bahl remarks 'transfers are at the head of sub-national finances.' But designing a transfer system is difficult, not least because of the many goals that such systems might set out to achieve. One system cannot simultaneously achieve all of these ends and governments must decide which are the most important. In general, there are two instruments which are devised for the transfer of revenue from the centre to the regions: revenue sharing and equalization through the allocation of grants. Before discussing the situation in Ethiopia, it is important to gain an insight into the nature and the purposes of these instruments and the practice in other federal systems. First let us discuss revenue sharing, next we will discuss grants.

4.2.2.1. Revenue Sharing

The nature of revenue sharing heavily depends upon the constitutional division of revenue sources between the levels of government. In general there are two cases:

- i) in some cases, besides assigning independent revenue sources to the centre and the states, revenue sharing applies to specific sources the revenues of which are jointly owned by the federal government and the states;
- ii) in other cases, most or all revenue from federally assigned taxes are shared between the levels of government.

Revenue sharing becomes relevant when revenue sources are shared between the centre and the states, but administered by the former. Its principal purpose is geared towards increasing the revenue capacity of states in order to meet their expenditure assignments. This implies, on the one hand, recognizing the autonomy of sub-national government for a portion of centrally administered taxes and, on the other hand, retaining the merits of a uniform application and administration of such tax laws. According to Bahl and Linn, the merits of a uniform application of laws are several, such as effective tax administration, reducing adverse impacts on trade and investment, avoiding harmful tax competition, and treating taxpayers in the same manner. But the basic question that needs to be addressed is what

proportion of the revenue collected should be allotted to the states (vertical division)

There are two basic approaches which have been adopted by countries in order to provide an answer to the above question: the sharing of revenue on a tax-by-tax basis or the sharing of revenue pooled by the central government from all the taxes destined to be shared.

The first approach, *tax-by-tax sharing*, implies that the revenue collected by the central government from each tax base is divided between the centre and the regions using percentages set by the constitution or other pertinent legislation. The German financial equalization scheme is a case in point. The federation and the states have concurrent power concerning revenue from income tax, corporation tax (turnover tax) and VAT. The Basic Law of German provides that the federation and the Lander equally share the revenues from corporation taxes. The division of personal income tax, on the other hand, is different; the federation and the states take their equal shares of the personal income tax after the allocation to the localities has been determined. VAT is subject to different criteria where each state receives a different share since it is apportioned on a per capita basis resulting in a better share for the less efficient states.

The Indian Constitution, on the other hand, provides for a sharing of revenue, but without setting a percentage for the share of the centre and the states (Article 270). For instance, the revenue accruing from income taxes (other than corporate and agricultural income) is compulsorily shared on the basis of a percentage recommended by the Finance Commission and decided by the President. It is the Finance Commission which decides the net proceeds of taxes of each state (on a tax by tax basis) and the allocation of grants to states in need of assistance. Actually the Constitution had categorized the taxes shared on a compulsory basis or voluntarily by the centre until the 80th amendment in 2000. This amendment repealed the distinction between the two and broadened ambit of the sharable taxes to cover all central taxes except those listed in Articles 268, 269 and 271 and enabled states to share in the wider context.

The sharing of revenue on tax-by-tax basis can also be laid down by agreements reached through intergovernmental negotiations. In Switzerland, for instance, different percentages for tax-sharing schemes were implemented in 1992 for three revenue sources; 30 per cent of the federal tax on income and profits, 10 per cent of the withholding tax, 20 per cent of a tax on exemption

from military service was allocated to the cantons. The newly introduced revenue-sharing scheme in Ethiopia follows the first approach, sharing on a tax-by-tax basis.

One of the questions that can be raised is why different share percentages are applied to each type of tax. One reason could be the convenience of locating the source of tax. For example, it is difficult to trace the source state, as in the case of tax on companies which are highly mobile, a higher percentage could be assigned to the center. The cost of administration could also be considered in setting the percentage. It may be designed to partly address the horizontal disparity in addition to its primary goal of narrowing the vertical fiscal gap. Ter-Minassian recommends, when considerable disparities exist between the rich and the poor states a higher percentage share of the revenue should be allocated to the centre. The centre can then redistribute it to the states subject to certain agreed principles.

In the second approach, the *sharing of the entire pool of the tax* levied by the central government, a single formula may suffice. For instance, had Germany applied this method, revenue collected from corporate tax, personal income tax and VAT would have been added together and divided between the centre and the states based on a given percentage. The second approach for revenue sharing has been the major intergovernmental transfer mechanism in Nigeria where the total amount derived from the major tax sources that accrues to the federal account is divided between the centre, the states and the local governments.

In a revenue-sharing scheme (either on a tax-by-tax basis or on the basis of sharing the total tax pool), the actual proportion of tax to be allocated to the respective states is determined by either the *derivation* or the *redistributive* principle.

derivative principle is that each state receives a share based on the amount of revenue collected in that specific state. It is very much correlated with revenues that are collected by each state on tax sources allocated to them. Of course, it requires an arduous task to identify the amount of income generated by the state, for example, companies operating in each state. Depending on the type of tax bases, the amount of revenue generated in each state has to be identified. In addition, a different percentage of apportionment of revenue

can apply to each type of tax.

The other method of apportioning revenue is by means of a formula based on the *redistributive* principle. In this approach, Ter-Minassian explains, revenue from a specific tax base or from the entire pool retained by the centre will be apportioned to all states, irrespective of their capacity to generate the shared revenues. In this case, revenue sharing is very much like unconditional grants.

Several countries have adopted different criteria to apportion the revenue between the centre and the states. In Germany, for instance, VAT is apportioned on a per capita basis which results in a better share for those states with less per capita revenue. Its objective is essentially to redistribute income. In India, according to Govinda Rao, the formula comprises a combination of equity and efficiency criteria such as income per capital, population size, level of development and the state's own tax effort. In Nigeria, the share of the states and local governments from the Federal Account has to be allocated to each state and local government based on redistributive criteria. For example, one of the studies indicated that in 1992 a formula with the following variables was used equality of states, population size, geographic size, social development needs, and revenue raising efficiency. In general, several factors have to be considered and approved by the constituent units of a federation when a rule is determined for apportioning the revenue between the centre and the states and among the states themselves. Some of these factors could be the nature of the distribution of the tax base among the states, the amount of revenue collected from a specific tax base, the capacity of the central government, and the role of the centre in allocating grants to relatively poor regions.

In Ethiopia, according to the Constitution, developing a revenue-sharing scheme may involve two major issues: the sharing of joint taxes (to use the words of the Constitution, i.e., concurrent taxes Art.98), and the sharing of federal taxes for providing subsidy grants to the states (or for equalization purposes Art. 62(7) and 95).

Although the Constitution spells out the possibility of these two separate steps of revenue sharing, the sharing of joint taxes and sharing the federal revenue, the system which was in

place until the 2003/04 fiscal year addressed both issues with one instrument, i.e. through the provision of grants. For that purpose, revenue sharing refers to determining the share of the centre and the states is solely decided by the federal government instead of using certain agreed principles which are specific to concurrent taxes. All revenues from federal taxes, concurrent taxes, loans and aid were considered as a common pool. The federal Ministry of Finance, mainly considering the costs of federal expenditures, determined the shares of the central government and the regions. After deducting the share of the federal government the remaining amount was distributed among the regions based on a formula decided by the HOF.

The federal government has promulgated a new system for the sharing of revenue from concurrent tax sources, based on a principle recommended by both the centre and the regions and decided by the HOF. Before going through its allocation principle, let us first recall the constitutional provision on the sharing of joint taxes. The Constitution stipulates that the revenue derived from concurrent tax sources shall be divided between the centre and the regional governments as determined by the HOF taking the federal arrangement into account (Art.62(7) and 95). The sources of shared taxes are: profit, sales, excise and personal income taxes on enterprises which the centre and the regional governments jointly establish; on sales and excise taxes, and profits of companies; on dividends due to shareholders; income derived from large-scale mining and all petroleum and gas operations and royalties on such enterprises (Art.98).

How should the share of the federal government and the states (or a state) be determined? Should sharing be on a tax-by-tax basis or on the total amount generated from joint taxes? How should the share of each regional government be determined, should it be on a derivative principle or on an equalization principle?

A close reading of the provision shows that the sharing of revenue seems to follow a tax-by-tax approach. For instance, the sharing of profit from jointly established enterprises depends on the capital contribution made by each government. Some taxes such as employment income tax are easier to collect while in the case of others, such as sales and excise taxes from companies engaged in business in several states, it is difficult to identify the source of

the tax. Similarly, although the derivative principle seems to be applicable for the sharing of most tax sources, there are also taxes that may need further criteria, as it is sometimes difficult to trace the place of taxation. Some of the issues that should be scrutinized are related to the division of company profit tax and VAT.

The other basic issue would be how to determine the basis for the apportionment of revenue, since the Constitution does not set a percentage for the share of the centre and the sharing region. Therefore, what policy guidelines and criteria are used to determine the shares between the centre and the regions? Normally, the percentage can be determined considering factors such as how much the financial capacity of the centre is dependent on shared taxes, whether the division of shared taxes plays a role in income redistribution, and the need to reward efficient regions. A glance at the newly proposed principle for the sharing of revenue shows that a higher percentage is set for the central government on sources of revenue with a national character and considering the responsibility of the centre in carrying out the collection. The share of the regions focuses on sources which can promote efficiency in the levying and collection of taxes and on the source related to the consumption of local goods and services. Accordingly, the centre and the region share direct taxes equally, but a higher percentage of indirect taxes (70 percent) are allotted to the centre.

By applying the revenue-sharing scheme, the system replies to the ‘ownership’ of the source of revenue. It increases the revenue capacity of the sharing government and also promotes efficiency in the levying and collection of taxes. Furthermore, it encourages the states to consider the benefit from joint taxes and to cooperate for an efficient tax administration. However, its drawback emanates from the failure to consider the difficulty of identifying the exact amount of tax collected from companies engaged in trading in several states. Whether the division of royalties from mining, petroleum and gas operations will be feasible in the long run is also another issue. To date, earnings from royalties are less significant. But in the future the fifty per cent share could be challenged for the Constitution confers ownership rights in natural resources on state and on the peoples of Ethiopia in general and not on a specific region.

Table 4:2 Types and Sources of joint Revenue*

Types and sources of joint revenue		The share of the centre and the regions on a tax-by- tax basis from each type of tax in %	
		Share of the Centre	Share of the Regions
1	Revenue from Enterprises jointly established by the centre and region	N.A. (not available)	N.A. **
2	Revenue from companies		
	2.1. Profit taxes	50	50
	2.2. Service, sales (V AT) and excise taxes	70	30
	2.3. Tax on dividends	50	50
3	Revenue from large-scale mining and all petroleum and gas operations		
	3.1. Tax on profits	50	50
	3.2. Royalties	60	40

* The revenue-sharing scheme as reported by the Ministry of Revenue, December 2003.

** Since there are no enterprises jointly established, the sharing of direct or indirect taxes from this source is not currently applicable.

In a revenue sharing scheme, there are some arguments that should be considered before which method of distribution is adopted. For instance, some authors argue that revenue (sharing on a derivative basis perpetuates the resource disparities between the region (horizontal imbalance). Others also criticize the case of sharing revenue on tax-by-tax bases since the central government may give priority to those taxes from which it receives a greater share. However, if a central government gives a preference to some types of taxes, it is possible to solve the problem by applying a uniform percentage share to all shared taxes. Making sub-national governments active participants in the collection of shared taxes could be another solution. Revenue sharing is essentially based on efficiency in revenue generation, especially in cases where there is another transfer in the form of grants. So, a proper and transparent system of sharing revenue based on a tax-by-tax system addresses the efficiency considerations of the respective states. Furthermore, as Bahl and Linn noted, the revenue-sharing schemes either explicitly provided in the constitution or through other pertinent legislation should guarantee a specified share. According to them, this makes it different from grants where the grantor predominates the method of allocation and the amount of grants. Revenue sharing promotes partnership, enables the actual

share of the centre to be easily determined and, to some extent, reduces dependency. In general, it guarantees the states a certain percentage of annually collected shared taxes, it is unconditional and the states can utilize the taxes according to their local needs. In particular, the sharing of revenue on the basis of the derivative principle promotes transparency, helps to reduce resentments and contain secessionist tendencies by giving due consideration to the capacity of a region that contributes major revenue sources.

4.2.2.2. Grants

Apart from systems of revenue sharing, disparities between poorer and richer states are addressed through grants also known as 'equalizing transfers'. In principle, the objective of allocating such grants is to reduce the horizontal imbalance between the states. It also has the effect of reducing the vertical imbalances by increasing the revenue capacity of the states. Ehtisham Ahmad espouses that by equalizing the revenue capacity, it is anticipated that the states can provide comparable public services for their inhabitants. Each country may also have specific objectives which have to be met by using various grant instruments. The German Basic Law, for instance, stipulates the equalization of living standards as an objective of the system. Whatever the ultimate objective of the transfer of grants may be, its nature is intertwined with issues related to the division of revenue sources and expenditure responsibilities. Since the states surrender most of the productive tax sources to the centre, the transfer of grants secures a flow of revenue back to the states. But its impact on sub-national autonomy in making financial decisions depends on the choice and structure of the grant system. Therefore, let us first study the types and the nature of grants in general.

a) General Purpose (Unconditional) Grants

As the name indicates, general purpose grants are allocated to states to spend the money in any area of public purposes designated by them. It is characterized by the absence of significant restrictions on the use of funds, as it is at the region's discretion to spend the money for any preferred purposes. The choice of a general purpose grant not only maximizes the financial capacity, but also broadens the area of spending which may be considered essential by the states.

A general purpose grant is widely used as an instrument to equalize the revenue capacity of states. Thus, it should be equitably distributed between the sub-national governments. The main characteristics of general purpose grants is the incongruity between imposing the taxation burden on the federal government while benefiting the sub-national governments with the liberty of spending the money. This has led to an argument that such an 'asymmetry' between the political unpopularity of imposing taxes and the political popularity of spending money is said to taster fiscal irresponsibility. This asymmetry would be avoided, however, if the same government that takes the taxing decision also, in a symmetrical fashion, takes the spending decision. This argument is typical of the United States which favors conditional grants since the centre can control the recipient through the imperatives attached to the use of the funds. Nonetheless, if the allocation of grants is required to equalize the financial capacity of states, some form of general purpose grant is required.

b) Specific Purpose (Conditional) Grants; matching and non- matching

These grants are also referred to as categorical grants. They are aimed at spending in a specific sector supported by the central government. The grantor may require, for example, a state to use the funds for a specific activity in the education sector, such as the construction of post-secondary institutions or the purchasing of books, with a possibility of further specifications. As the conditions become more specific, the states will in effect be left with no option but of spending the money in the area specifically required by the centre. Wheare argues, the imposition of such conditions upon the use of grants has to be explicitly or tacitly mandated by the constitution, or the initiative has to come from the states where the state alone cannot finance projects without the assistance of the centre.

Ahmad and Craig claim that the objective of specific purpose grants is to impose conditions on the use of grants in order to maintain nationwide standards for the provision of services such as health and education. However, its objective may go further to address the problems associated with the provision of public goods in the less developed and asymmetrical societies by allocating funds to scarcely endowed areas. Further, it can also play a role in curbing financial embezzlement, inefficiency and corruption, as the federal government retains the power to set conditions, to control and audit the spending. This will

be consistent with the principles of financial responsibility and accountability to the taxpayer. Conditional grants may also be further classified as matching (cost-sharing) and non-matching

Non-matching grants: are conditional transfers from the federal to the state governments but without any matching requirement on the part of the latter. The states are not required to spend a portion of their income to match the funding by the central government.

Matching grants: are given on a basis when states commit themselves to sharing the costs in order to receive a grant for a particular programme. In practice it may be difficult to determine the exact share of a state and the central government, but the rationale for granting the money can provide some guidelines. Normally, the greater the degree of the federal interests in the project to be covered by the matching grant, the larger the federal share. The other issue would be whether the states should share the same percentage of the costs or whether the poor states should be favoured. As commented by R. Watts, in the USA where conditional grants are extensively used, there is an attempt of equalization in determining the matching rates. Accordingly, rich states pay a greater share than the poor states.

According to Wallace Oates, the main reason for the federal government to introduce matching grants is for the purpose of encouraging states to spend on activities which at the same time benefit the nation at large, and also to economically utilize the scarce federal resources. At the same time, this allocation of matching grants enables the central government to influence the states instead of directly interfering in their autonomy. Furthermore, matching grants have the objective of encouraging recipient states to 'maximize the initiative for self-financing'. Matching grants can be constitutionally entrenched, as is the case in Germany, or unilaterally decided by the federal government as is the case of the USA.

The allocation of grants on a formula basis has been found to be a necessary step towards resource allocation, but it has not yet been perceived as an effective instrument in achieving equity. Rather, there is a spillover from other political wrangling to fiscal-related issues, particularly to the grant formula. Thus, designing an effective grant formula and selecting

appropriate variables have become necessary steps in determining the trends of fiscal federalism. Developing a grant formula that can be applauded by all the constituent units is a difficult task, but an initiative to implement a reliable formula could be a significant step towards efficient intergovernmental fiscal relations.

The amount of grants vertically transferred from the centre and horizontally distributed to each regional government follows certain steps:

- the first step is determining the overall resources that could be available during the fiscal year for the federal government from the national treasury, external assistance (foreign grants), and external loans. But this step encounters problems as most of revenue sources are based on estimations from domestic as well as foreign sources and overall forecasts in GDP. As a result, the actual budget distribution is subjected to several revisions.
- second, dividing the overall amount between the federal and the regional governments on the basis of the expenditure assignment of each level of government. The total amount available for the regions is determined after deducting the budget required by the federal government which takes the major portion of the fund for road construction, defence, foreign debt payments and federal administrative costs.
- third, allocating the total amount available to all the states from the federal government among the individual regional governments based on the applicable grant formula.
- fourth, deciding on the amount of the grant for each region that originates from the central treasury, foreign assistance and loans.

The grant formula used in Ethiopia has been amended on several occasions since 1992, the variables used and the weight attached to them are the main factors inherent in the system. In 1992/93, no precise grant formula was implemented because in late 1991/92 and 1992/93, the major 'breakthrough' was the process of the formation and organization of regional governments, organizing offices and the transfer of staff and projects to the regions. During this period, no precise formula was used for allocating resources to the regions. However, it can be inferred from the economic policy directives and the objectives of the Transitional Charter that the central government was primarily engaged in rehabilitating war-torn zones.

The allocation of grant subsidies in the 1993/94 and 1994/95 fiscal years followed the format of general purpose grants divided into grants for recurrent and for capital expenditures respectively. The formula that has been operational for the last thirteen years was based mainly on subjective weights given to variables that indicate size of population, differences in level of development, revenue collection effort and sectoral performance. The weights variation to different variables was used in different formula from 1995 to 2007. In May 2007 the HOF introduced a new formula with variables: population, differences in relative raising capacity, differences in relative expenditure needs and performance incentives.

Activity 3

1. What is the concept of revenue transfer?
2. There are basic rationales of transfer and downsides of transfer. write the objectives and downsides of transfer including the political ones.
3. The revenue transfer is meant to cure fiscal imbalances resulted from assignment of revenues and inefficient revenue administration. Do you think that correct constitutional design on assignment of revenue sources resolve the problem? Why? Why not? Does the processing and designing techniques of transfer entail extra burden on the federal organs?
4. Write the two cases of revenue sharing.
5. Discuss the Indian, German and Switzerland's scheme of revenue transfer vis-a-viz the Ethiopian one.
6. Write the difference and similarity of revenue sharing and grants.
7. What are the kinds of grants? Discuss the pros and cons of each.

4.2.3. Federal - States Transfer in Ethiopia

4.2.3.1. Intrastate Transfers

In line with a federal principle which deals with the tension between unity and diversity between the centre and the states, local governments do not have constitutional status. Any (financial) tension between sub-regional levels is left to the concern of the regional government. Of course, an issue may arise as to whether federal and regional entities would

provide an effective response to all the complexities related to the needs of diversity in Ethiopia in general and the disparity between the regions themselves and between local governments in particular. In a federation where local governments have constitutional status, they must be accorded with certain constitutional means of protection, including their taxing power and entitlements in the transfer mechanism.

Against this background intrastate revenue transfer was not implemented in the regions, except for some attempts in Amhara and SNNPR until it was formally introduced in the 2002/03 fiscal year in all regions. The states of Amhara and SNNPR have introduced the allocation of grants to sub-regional levels in the 1997/98 fiscal year according to a formula similar to the one used for federal transfer. The SNNPR has allocated grants to zones and weredas, but the Amhara region has done so only to the zones. Both regions have attempted to allocate grants by dividing them into recurrent and capital expenditure. Tigray's attempt to distribute resources equitably is indeed appreciated, but they have encountered a number of difficulties due to capacity constraints, lack of available data, and the uncertainty of the volume of federal grants (particularly the unpredictability of foreign aid and loans). Furthermore, they have problems in properly distinguishing the role of zones and weredas.

Although the Constitution states that adequate power shall be granted to the lowest units of government and the weredas exist as local governments next to the state government, the zonal administrations act as agencies of the state government but are more powerful than the weredas. Thus, in order for the weredas to undertake economic and social services and to narrow the disparities between weredas, all states have amended their constitutions to focus on the transfer of revenue that augments the capacity of weredas. As a result of the revision the (state) constitutional recognition of zonal governments next to state governments is made clear in the SNNPR, Gambela, and BenishangulGumuz regions. Accordingly, in these regions, a three-tier government exists, i.e. state, zonal (or special wereda) and wereda governments. The Oromia, Tigray, Afar, Somali and Harari regions have a two-tier government at the state and wereda levels, but zonal administrations remain as agents of the state government. The Amhara region recognizes the autonomy of three special zones.

During the 2003/04 fiscal year, the grant formula which was applied at the federal level, was

used to determine the amount of grants allocated to weredas and zones in SNNPR, Amhara and Oromia. Thus, the variables used in the grant formula were population (55 percent), level of poverty (10 percent), expenditure needs (20 percent), and revenue raising capacity and execution efficiency (15 percent). According to the preliminary data the State Council of Oromia transferred to the weredas 47 per cent, Amhara 51 per cent and SNNPR 81 per cent of the total regional financial resources.

However, the report from the regions shows that the grant formula had resulted in a number of obstacles which should be resolved in the subsequent fiscal years. As the grant formula was mainly based on population and development level, it did not necessarily correspond to the existing situations. The allocation did not consider the existing expenditure needs and the available resources of urban and rural weredas. Accordingly, some weredas had a financial surplus but were administratively incapable of planning and executing projects. This was because rural and less developed areas did not attract skilled labour. There were also certain institutions in which the provisions of their services were not limited to only one wereda. For example, some schools and hospitals provide services to several weredas, but their costs were covered by the wereda where the institution was situated. Such kinds of costs which provided external benefits to other governments should have been covered by special grants or by the regional government. Another problem was encountered in allocating grants from foreign aid and assistance. It is recommended that such financial resources should be administered solely by the regional government as special grants.

4.2.3.2. Regional Borrowings

After devoting considerable attention to the transfer of revenue, we should, for the sake of completeness, make a number of remarks on borrowing. Borrowing is the other possibility by which states may supplement their financial constraints.

The major issues concerning borrowing are the adoption of appropriate criteria for acquiring the loans, setting the upper limit to be borrowed, interest obligations, the repayment period and debt servicing capacity. Unlike the centre, sub-national governments are mostly restricted to domestic borrowing and they may even be subject to direct control by the central government. The main reason for participation and control by the centre is that monetary and fiscal policies are centralized. But there are various forms of control and the extent of central control might

significantly differ from one country to another. In a more general approach, control mechanisms have to be designed to suit the circumstances of a particular country. Moreover, it requires the creation of possibilities for a timely adjustment, depending on the capacity and fiscal balances or imbalances of regions.

Teresa Ter-Minassian and Jon Craig in their studies of the practice in several countries conclude that the central control mechanisms generally encompass either of or a combination of the following four broad categories.

In the first category, the control mechanism may simply rely on a free and open market discipline. In this case, the role of the central government is very limited. The market may set stringent conditions to be met by the guarantor government (that are unlikely to be realized in many countries), or the central government may bailout debts. The sole reliance on this mode is not considered appropriate for developing federations because unregulated state borrowing may affect the macroeconomic stability of the country as a whole.

In the second category the centre is authorized to exercise control over state borrowing through constitutional or statutory rules. Some of the rules may extend to authorizing borrowing for specific purposes, setting a maximum amount allowed, and prohibiting loans from the central bank.

The third approach is to set rules for the cooperation of all levels of government in the preparation and adjustment of financial administration to reduce the indebtedness of the governments. The objective of their equal participation is to enhance responsibility in the use of budgets supported by loans. In Australia, for example, public borrowing by the federal and state governments has been a matter which is regulated by an intergovernmental council called the Loan Council and which is established by the Constitution. The main reasons for establishing the Loan Council were to avoid loan competition and to control state spending which had been lavish for some years and which in the end imposed a burden on the commonwealth to make up deficits by grants.

The fourth model is direct administrative control by the central government. It ranges from the approval of the purpose and the authorization of proposed borrowing to a subsequent supervision of the financial operations by the regional governments. The details of centralizing all government borrowing pertain to the terms and conditions of borrowing, the amount each regional government can borrow, and the repayment capacity. This kind of direct central government control is more common for unitary systems than in federations.

Compared to the above categories, the laws concerning state borrowing in Ethiopia emphasize the importance of federal control through statutory regulations and intergovernmental cooperation, but presently sub-national borrowing has a very limited application. In Ethiopia, the federal constitution recognizes the states' right to borrow from domestic sources. It stipulates that the federal government shall determine by law the conditions and terms under which states can borrow money from domestic financial institutions. This provision, on the one hand, affirms the possibility that states can borrow from domestic sources and, on the other, grants the regulatory power to the central government. Accordingly, the federal financial administration law requires the regional governments to provide all the necessary information to determine the amounts to be borrowed by individual regions. Thus, the states have to fulfill the obligation to submit to the Ministry of Finance and Economic Development the loan amount required to cover their deficit together with statements showing the relations of the requested amount with their revenue collection forecast and with economic indicators, and shall attach a copy of their consolidated loan as required with the loan application form. However, under the present economic conditions it is hardly possible to imagine that regions can repay their debts from revenue collected within their jurisdiction.

According to the Finance Administration Law, regional governments may borrow from the National Bank of Ethiopia and/or from other commercial banks. First, if they borrow from the National Bank, the amount has to be determined by the ministry and its disbursement has to be managed by the National Bank. According to this law each region must convince the minister that the money is required for financing a specific project and they have a capacity to repay the loan within the appropriate time as laid down by law. The minister to whom the application is submitted must evaluate the capacity of the regions and the impact

of the loan on the national budget, if the loan is granted. The Minister has the power to study the accuracy of the information and later to communicate a decision indicating the amount of loan to be given to the state. Whatever the decision may be, limiting the purpose of the loan to a specific project is usually considered to be a good case of borrowing. The assumption is that if it has an investment purpose it may have an adequate economic and social return.

Second, if borrowing is to be made from commercial banks (or other financial institutions), the respective regional government and the federal Ministry of Finance shall jointly agree on the administrative arrangements related to such borrowing. This has the drawback that borrowing is only considered as a bilateral issue, but in reality, however, it may become a national burden. Thus, in the long run there should be a forum to accommodate the participation of all regions. But if we limit ourselves to the existing legislation, what could be the objectives of the agreement? And what could be the role of the National Bank in dealing with the cooperation between MoFED and a region? Does the Ministry or the National Bank guarantee the loans? Can the agreement authorize commercial banks to lend money to the regions? If that is the case, then, on what criteria do they lend the money? If the same rules and procedures which are applicable in the market are equally implemented, then the regional governments have to fulfill the requirements set by the banks. In normal circumstances, the banks have to secure the repayment capacity of the regions and study the feasibility of the projects. However, considering the very limited revenue-raising capacity of the states and the fact that they are absolutely dependent on grants given by the central government, borrowing from banks currently does not seem to be a workable alternative to finance regional governments. Finally, what would be the situation if a regional government borrows without presenting the case to the MoFED? The existing financial laws do not give adequate answers to the issues raised above. Nonetheless, few cases of borrowing have been witnessed in the regions. For example, the Amhara regional government authorized its finance bureau to borrow money (150 million birr in each year) and to issue security on behalf of the regional government for the provision of agricultural inputs and animal packages to farmers with a view to develop regional agricultural production. However, the whole process of lending the money to and collection from the farmers has led to controversies. The purchase and distribution of the agricultural inputs are administered by companies affiliated to (or owned by) the ruling

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party, irrespective of the consent of the farmers. The impact of the repayment period and the manner of its administration are also not adequately taken into consideration. Farmers are coerced into paying all debts; there is a fee for land use, income tax and loans collected by development experts in one (harvest) season.

In addition to the regular taxes and contributions the regime has introduced involuntary seed and fertilizer purchases from its own business enterprises, which are made to prosper at the expense of the peasants. The demand for cash from peasants has another exploitative side. Cash collectors on legal and illegal obligations arrive at harvest time when the peasants will squander harvested crops; all peasants are forced to take their produce to the market at about the same time. Prices for their crops drop abysmally. Consequently, they are forced to sell more of their crops in order to meet their cash obligations. This is the socio-economic origin of famine.

One important point is that in spite of central control of borrowing, regional (or local) governments may become indebted for large sums of money. This may compel them to seek supplementary funding from the centre or further borrowing and therefore this should be treated cautiously. One can easily envisage several grounds which may lead to indebtedness which in turn requires some form of intervention from the centre or to force the region to cancel its planned expenditure. On the one hand, regional governments with a relatively better administrative capacity and commitment to execute their responsibilities may genuinely need more funds. For example, a report by the assessment team of the World Bank and other donor institutions shows that although the Tigray region has the capacity to execute more projects, it is forced to revise its plans according to the federal grants available. However, the report does not comment on whether the region has a debt-servicing capacity from its own revenue sources if it borrows to execute projects.

On the other hand, in lowland regions such as Somali, sometimes it is difficult even to pay salaries or cover the ordinary costs of running the administration. This is due to lack of skilled personnel, lavish spending, embezzlement and lack of political commitment. Moreover, sometimes people abscond with a great deal of public funds so that the budget lapses before the end of the fiscal year. Some of the major problems in the lowland regions are large debts

through payment arrears due to the failure to effect payments to projects and lack of effective monitoring and controlling mechanisms. The sub-national governments may, therefore face serious financial problems for various reasons ranging from personal incompetence and criminal behaviour to national economic problems. The consequence is a major concern not only for the creditors of the government concerned, but also for the citizens living in that area in particular and the nation in general.

The decision to bailout the debts of a state could be considered as a necessary measure taking into account the cost and its political and economic implications. But this will be a financial burden to the central government. At the same time, such problems imply that the viability of the regional government is in question. When regional governments fail, at least, to manage the costs of administration according to their own budget, the dire consequence should be a limitation of autonomy for the financial assistance they seek. The impact of such financial problems in developed federal systems could be the imposition of high taxes and a relatively lesser provision of public services in the region concerned. But, the impact in a country like Ethiopia will be considerable and may mean a perpetuation of poverty. The most worrisome experience is the vexatious position taken by the centre with regard to regional financial embezzlement.

The issue is if sub-national governments are in a position in which they cannot pay their debts, can the regular financial laws govern the problem, for instance, through a declaration of bankruptcy? The ordinary bankruptcy law accords some beneficial treatment for both the debtor and creditor, but may also lead to the liquidation of the debtor. But, when it comes to government bankruptcy, the main concern is to rehabilitate not to enforce insolvency.

The issue of governmental bankruptcy is better dealt with in the USA. As a result of the Great Depression of the 1930s some 2,019 municipalities, counties, and other sub national units defaulted on their obligations since they were not able to pay their debts by imposing high taxes. Since governments could not be liquidated, the option was to provide relief from court litigation, to get some obligations paid, and to provide sub-national governments with a new start for their financial operations. The bankruptcy law of the USA applies to municipalities not to states since the latter are sovereign concerning state matters. The law

respects the autonomy of municipal governments to conduct their finances without supervision or control from the centre. But when they are bankrupt, the bankruptcy law (of the USA) on the one hand gives protection to municipalities to rehabilitate during a given time, and on the other hand, paves the way to greater supervision on their autonomy. Actually, the bankruptcy law gives wider protection to the municipalities (debtor) compared to individual or business debtors. In practice, according to Mikesell, when municipalities are in financial jeopardy, most state governments intervene through the respective financial emergency procedures by imposing extraordinary controls on payments, plans, and policies concerning priorities.

In comparative terms, the Indian Constitution explicitly provides for a financial emergency clause, perhaps to avoid the issue of state sovereignty if similar problems of the economic depression of the 1930s are to arise. Article 360 of the Indian Constitution gives power to the president to declare a financial emergency by a proclamation when a situation has arisen whereby the financial stability of India's credit or any part thereof is threatened.

The Ethiopian Constitution, on the other hand, does not explicitly provide for a state of financial emergency as a ground for the intervention of the federal government in the states. The Proclamation which enumerates the grounds for federal intervention does not explicitly mention financial problems as a ground for intervention. The HOF is empowered by the Constitution to order federal intervention when the constitutional order is endangered. It envisages an armed uprising and activities that endanger the peace and security of the federation. However, in a situation where a state becomes administratively non-viable, fails to provide public services or is unable to pay its employees, it should be possible to consider them as factors which imperil the constitutional order. Generally, the problem during the last decade can partly be related to a failure to genuinely empower the people at the local level to choose their authorities, or to decide on major local interests and effectively control the misuse of power and embezzlement. Moreover, the facts on the ground indicate that the economic impact of a fiscal crisis should not be tolerated for any political expediency since it does not guarantee self-administration. Thus, to this date, unilateral regional borrowing does not seem to be a feasible alternative to finance regional expenditures

Activity 4

1. Why states need to have intrastate transfer in addition to revenue sharing and grants in center – state relations? Is there any link between the ethnically homogenous and heterogenous configured population and intraregional transfer? Contextualize your answer with the states in Ethiopia.
2. If a zone ethnically differentiated from the state has benefited from intraregional transfer, Do the viability and development of culture, language and socio-economictactoy adversely affectit if such transfer is not made? Why? Why not?
3. Why local borrowings are subject to different institutional control than intrastate transfer? Discuss the institutions and their role involved in regional borrowing

Summary

After reading the lessons and tackling the in-text questions and activities of this chapter, one can infer that it is vast encompassing many issues. It is the core of the fiscal federalism that conceptually and practically challenges the federations. It has two broad parts concerning fiscal imbalance and inter-governmental fiscal transfers. While the former is caused by the disparity of the revenue sources and expenditure responsibilities due to allocation of the expenditure responsibilities and revenue resources among the tiers of governments in federation discussed in the previous consecutive chapters, the later is meant to cure the fiscal disparity. They are branches of thoughts that explain the broad concept in pragmatic ways. Thus, fiscal imbalance is of two kinds: vertical imbalance and horizontal imbalance and inter-governmental transfer buttresses in to three: revenue sharing between center and regions, grants by the center to the regions and federal-state transfers.

The causes of vertical imbalance are mainly attributed to non-correspondence of constitutional assignment of revenue sources with the states' expenditure responsibilities and ineffective and inefficient administration of revenue raising power and expenditure spendings of the tires of the governments. This can be measured by computing the percentage of the share of state expenditure covered by the state revenue and federal transfer and the percentage of share of the state revenue in the total revenue of the federation. The great disparity of the share implies the

greater interference of the center in the economic and political autonomy of the regions. On the other hand, horizontal imbalance mainly is caused by disparity of revenues resources and expenditure responsibilities among the states. Difference in natural resource endowments that gives rise to variation in revenue sources; urban centered industrialization that pools investments and high dependency ratio of young, old and poor, or naturally difficult terrain or generally higher cost disability factor which entails different access and quality of public services for individuals in different states are the major. This can be measured by computing per capita expenditure and revenue of all states. This implies a better social and public services in richer regions than the poorer, thereby differences in personal developments. Horizontal fiscal imbalance also entrenches within the state in local administrations such as zones and weredas. It is also amplified by contraband and ethnicity which are rampant in Ethiopia.

The second prong of this chapter is fiscal transfer. Fiscal transfer is a common fiscal phenomenon in federations. It is a mechanism designed to channel the vertical and horizontal fiscal flow between the center and the states and among the states respectively. The main objectives of fiscal transfer are to fill the gap between the expenditure and revenues and enable the states to have equal capacity of rendering public services. The whole process of adjusting the fiscal imbalances through fiscal transfer is termed as fiscal equalizing system. It can be materialized by revenue transfer, grants and federal-state transfer.

By scheme of revenue sharing, the center and the states share revenue accrued from some sources identified to this effect. The determination of certain revenue sources to this purpose is different from federation to federation. On the other hand, the center mostly designs formula to grant the states. This can be made by two ways: general purpose (unconditional) grants or specific purpose (conditional) grants. General purpose grants are allocated to states to spend the money in any area of public purposes designated by them. It is characterized by the absence of significant restrictions on the use of funds, as it is at the region's discretion to spend the money for any preferred purposes. Conditional grants are aimed at spending in a specific sector supported by the central government. The grantor may require, for example, a state to use the funds for a specific activity in the education sector, such as the construction of post-secondary institutions or the purchasing of books, with a possibility of further specifications. Conditional grants may also be further classified as matching (cost-sharing) and non-matching

Thirdly, federal-state fiscal transfers are other schemes in response to financial imbalances. This system includes intrastate vertical revenue sharing and grant to their lower level administrations: zones and weredas and regional borrowings from federal and states' financial institutions. Federal-state fiscal transfers involve the center, states and local governments and web of terms and conditions against each other governments.

CHAPTER FIVE

INSTITUTIONAL ARRANGEMENTS AND THEIR FUNCTIONS

Introduction

The main idea of this chapter is to present the student the soul and brain of the system of fiscal federalism. The concept of collecting revenues and spending them is not sensible and nor appreciable without the institutions which design, implement and administer them. The system of expenditure, revenue-raising and revenue transfer which are discussed in the previous chapters have their own running institution. In federal system, for decentralization of powers between tiers of governments, financial institutions do the same. Hence, the federal financial operation is undertaken by different institutions from those of the states and vice versa. The student should appreciate and identify the federal and states finance institutions responsible on public finance. To this end, the chapter will discuss the institutions responsible for expenditures, revenue and revenue transfer as well as auditing in both federal and state level. The activities and in-text questions are also helpful to understand the lessons. Therefore, the students are recommended to toil with them well together with the lessons.

Chapter Objectives

At the end of this chapter the students will be able, among other things, to;

- understand the concept and meaning of fiscal institution in general,
- identify the basic federal and states finance institutions,
- identify the function of the finance institutions in each level of governments,
- analyze the systems of revenue collecting, budget formulation and revenue transfer,
- Familiarize themselves with the finance institution of fiscal federalism in Ethiopia,
- identify the institutions employed by other federation in revenue transfer, and
- aware themselves about the final stage of finance operator, auditing institutions,

5.1. Fiscal Institutions in General

The term ‘fiscal institution’ is a generic term that implies any institution in a state which operate in any financial activities. But, in the scope of this course we specify the term only in relation to the concepts discussed in the aforementioned chapters.

- ? Students, what comes in your curious mind after your are introduced to the term ‘financial institutions’? Can you crudely enumerate them in relation to fiscal federalism that you are aware of before? Write some aspects from the previous Chapters, which need an institution for their operation and the possible institution?

In a broad sense, the term ‘fiscal institution’ refers to any institution which is engaged in any financial activities such as banks, insurance companies, reserve fund institutions, microfinance institutions, etc. even to the extent of Ethiopian traditional saving scheme ‘*ekub*’. However, in relation to this course, ‘fiscal institution’ refers to those institutions involved in the operation systems of public finance. Accordingly, the whole subject matters of government finance run in to operation and being implemented by brain and legs of financial institutions. For instance, the power of expenditure responsibilities and revenue-raising of a government need institutions which determine the items and the scope through legislation and implement the legislation. In this respect, the legislature enacts laws concerning taxes and non-tax resources and yearly budget expenditures. The executive, likewise, collect revenues and spent them through its different ministerial offices and agencies. In federal arrangements, parallel autonomous states institutions appear to share these powers. Furthermore, the financial transfer from one level of government to the other channels through special arrangement of institutions.

5.1.1. The Structure and Role of Institutions

In a federal system, constitutionally recognized level of governments can formulate their own economic, social and development strategies and determine their expenditure preferences. This is because they have constitutionally recognized jurisdictions having the respective autonomy to impose tax and to spend on expenditure needs. It should be noted that both the autonomy and the accountability principle are applicable to both level of government. Such financial autonomy and

accountability of both level of jurisdiction is considered as ‘a necessary and appropriate’ feature of federalism.

The general structure of the FDRE is composed of the federal government and the nine member states. The member states of the FDRE are divided into zones (which are absent in some states and restructured in others), which in turn are divided into weredas and further subdivided into smaller units called kebeles. Both the federal and the states have legislative, executive and judicial organs. Expenditure responsibilities and revenue raising powers lie on the executive organ of both levels of government. The highest executive power of the federal government is vested in the Prime Minister and the Council of Ministers, whereas, the states executive power is vested in the State Administration. In turn, the subsidiary executive powers are left to respective lower authorities. In federal level, the ministries and their subsidiary authorities, commissions and agencies partake in implementations of the mandate of their respective higher offices in all expenditure responsibilities and revenue-raising as well as revenue transfer activities. In states, the Administrative Council organizes sector bureaus, which are analogous to the federal ministries and they are responsible for executing all the above mentioned fiscal responsibilities.

5.2. Federal Fiscal Institutions

The federal fiscal institutions are discussed here in line with the subject matters of the fiscal federalism: institutions of expenditure responsibilities, institutions of revenue-raising and institution of intergovernmental fiscal transfer. While the first two are dealt under this subtopic, the last one will be dealt under separate subtopic 5.4.

a) Federal fiscal institutions for expenditure responsibilities: in general, expenditure responsibilities are of two dimensions: preparation of budget plan and spending of finances accordingly. Hence, the budget process involves two activities: the identification of priorities and goals and managing funds in order to fulfill these needs. In Ethiopia, the federal planning, implementation and evaluation of the expenditure responsibilities are under the Prime Minister and the Council of Ministers, and, ultimately the political organization which run government – the House of Representative (HOR).

The process of budget plan in federal system begins from the lower institutions such as authorities, commissions, agencies, offices, etc. and they send to their respective higher level institutions. Ultimately, the budget plan shall be ratified by the House of Representatives by proclamation of every fiscal year. Let's illustrate, taking higher education because it is the mandate of the federal government. Government universities are structured as divided basically into faculties/institutes/schools, which in turn are subdivided into departments of respective disciplines. For their expenditure responsibility, each department draw up its budget plan yearly, then, the information will be conveyed to its respective faculty. The faculties by consolidating the information from various departments form the budget plan of the academic year of the university. Likewise, the administrative wing also aggregates the budget plan of various service departments accountable to it. Therefore, the universities' budget having capital and recurrent budget is consolidated from the information gathered from academic and administrative section and it will be transfer to the Ministry of Education. The Ministry of Education approves the budget plan of each university and sends to the Council of Ministers. The budget process of other sector offices accountable to their respective higher institutions, ministries, is drawn up in the same fashion. The Council aggregates the budget plan of various ministries and other institution accountable to it and draw up to form the annual federal budget to be approved by the House of Representatives (Art.77 (3) of the Constitution).

The second element of budget process next to budget plan is budget implementation. The federal budget implementation is governed by the finance laws. The laws require the head of every public body to ensure the proper implementation of the budget consistent with the rules and regulations defined by the finance laws. They also require the federal budget execution against which planned expenditure shall be reviewed by the Ministry of Finance and Economic Development (hereafter MoFED).

The ministry itself makes payments of the federal government institutions through banks to their finance offices after the claim is approved by their respective ministries. For instance, the MoFED makes payments to the finance office of public universities through their nearby banks after their claim of payment is approved by the Ministry of Education. The disbursement of recurrent budget normally takes place on monthly bases to the bank account of finance offices. But, the payments of capital budgets vary according to the project undertaken mostly on

quarterly base by the respective higher level institutions. For instance, the Ministry of Education makes the payments for construction of buildings in public universities.

a) Federal fiscal institutions for revenue-raising responsibilities:- the collection of tax and non-tax federal revenues employs different institutions. From them, the newly established Ethiopian Revenues and Customs Authority (hereafter ERCA) retain the lion share of the function. ERCA is established by amalgamating the previous three institutions responsible for revenue-raising function: the Ministry of Revenue, the Ethiopian Custom Authority and the Federal Inland Revenue Authority pursuant of establishment legislation, Proclamation No.587/2008 as of July 14, 2008.

Previously, the Federal Inland Authority, accountable to the Ministry of Revenue, was the main institution responsible for collecting federal revenues. It had seven regional branches at Addis Ababa, Dire Dawa, Adama, Awasa, Jimma, Bair Dar and Mekele and was supported by delegated state finance bureaus and custom offices where the revenue sources are out of the reach of the branch offices. The branch offices are not limited only to the federal revenue sources situated in the state/region they reside, but they also collect revenues beyond the state jurisdiction if it is convenient, for the matter is federal one. For instance, the Dire Daw branch of Federal Inland Revenue Authority was responsible to the federal revenues in Dire Dawa and Eastern Oromiya.

In addition, based on the types of taxes there are specific federal institutions assigned to collect them. For instance, Large Tax office (LTO) and VAT Department collect taxes from taxpayers having four (4) million and above capitals and VAT respectively in Addis Ababa. On the other hand, custom duties and related taxes were collected by the Custom Authority and its branches. The Custom Authority and its branch offices were collecting taxes beyoned custom duties by delegation of power from Federal Inland Revenue Authority. The ECRA, by the virtue of constitutive proclamation is empowered to assume the power and function of the Ministry of Revenue, the Custom Authority and the Federal Inland Revenue Authority and will follow the same system of revenue-raising.

The non-tax federal revenues are collected by the respective service provider and by the federal public enterprises and channel through their hierarchical order offices and ministers to the final

reservoir, the MOFED. The MOFED is the very institution that designs the amount to be collected and spent in each fiscal year by conducting analysis on the country's economic growth. It also exercises the federal power of foreign borrowings, loan and grants. In addition, it also supervises the whole revenues of the Federal Government in Government Treasury.

Activity 1

1. Your university/ institution is not running its function without finances. Whether it is public or private it has revenue sources and its own system of expenditure and offices to these effects. Hence, perform a group project on the financial system of your institution and comment on its weaknesses; non transparent, encouraging corruption, etc. or strengths?
2. In fiscal federalism which level of government and which subject matter of fiscal federalism has numerous fiscal institutions than the others? Why?
3. Students, VAT is collected and administered by the federal government then, which institution is responsible to collect VAT in the vicinity of your institution?
4. Write down the institutions responsible for federal revenue-raising power?

5.3. States Fiscal Institutions

The institutional arrangement of state finances follows the state financial operation. Hence, the fiscal operation of the state governments' in expenditure responsibilities and in collecting revenue creates institution to their implementation. Therefore, the state fiscal institutional arrangements are discussed hereunder following their function.

a) State fiscal institutions for expenditure responsibilities; The FDRE Constitution requires that the state shall determine all financial expenditure necessary to carry out all responsibilities and functions assigned to them by law (Article 94(1)). However, the expenditure performance of the states is, among other things, depends upon the ability to draw up and administer their budgets. The independent budgeting process actually began in most states of Ethiopia in the 1993/94 fiscal year. To understand budgeting process we have to remind ourselves how state governments are organized at least to the purpose of the budget system. The State Council, the state administration and the state judiciary are established at the state level. The state

administration consists of sector bureaus which are also organized at zonal and wereda level. The sector bureaus are the major actors in states' budgeting and spending activities.

? What are the constitutive units of states in decentralized power?

The states' budgeting process in Ethiopia can be classified into two periods: before and after the 2002/03 fiscal year. The budgeting process before the 2002/ 03 fiscal year involved the coordination of several channels which ultimately make up the state's budget. This coordination involved a 'bottom-up' information flow before the final amount was determined at the state level. The bottom-up process refers to the process in which the budget was consolidated at the state level by taking into consideration the request from the wereda and the zone level.

In the process of identifying priorities and goals, the major activity was to gather the budget needs of each administrative office. All the information about the budget request was finally consolidated at the state level by the state planning and economic development bureau and was approved by the state council. The information flow to the bureau took two directions: horizontal and vertical flows.

The vertical information flow starts from a sector office at the lower level to the office at the higher level, and a flow of consolidated information from the wereda sector office to the zonal sector office, and from the zone the aggregate of the report of several weredas sectors office to the state sector bureau. For example, in education sector, the budget plan of the wereda education bureau flow to the zonal education bureau then the zonal bureau after consolidating the information gathered from all weredas education bureaus transferlt to the state education bureau. The state bureau gather and consolidate information from all zonal educational bureaus. In similar fashion, each sector bureau at state level consolidate the information gathered and specify the implementation of capital and recurrent budgets.

The horizontal informational flow existed at three levels: the wereda, the zonal and state level. At wereda, all sector offices and other government offices prepare their plans and the budget request, and sent to the wereda council. The special committee of the council mandated with the

power to review, consolidate and adjust the plan and submit it with its own proposal to the wereda council for approval. However, because of lack of skilled man power, the horizontal information flow was not effective. The zones and the states do the same horizontal flow of information.

The final step was followed by the state planning and economic development bureau to aggregate the entire budget request submitted by all zonal sector office and other government agencies. Its duty was to evaluate the information in light of the zonal and the state economic development goals. The information gathered from the sector offices and the budget request from the wereda council forms the zonal budget divided into recurrent and capital budgets. Here, the aggregates of the recurrent and the capital budget request made up the zonal development plan. The recurrent budget was then passed to the state finance bureau, whereas the capital budget was sent to the state planning bureau. However, the two bureaus were merged to form finance and economic development bureau after 2001/2002. The final state budget was consolidated by two separate bureaus. While the state finance bureau consolidate the state recurrent budgets, the planning and development bureau consolidate the state capital budgets.

However, the post-2002/03 fiscal year budgetary process reversed the trends of the previous year and focus on autonomy of the weredas in order to achieve more decentralization of power and to curb the conflict between weredas and zones in some states. Accordingly, the weredas receive general grant but the budgetary process which allocate recurrent and capital budget is only approved by the wereda council. In doing so, the major drawbacks of the preceding period; weak local participation and the broader financial and administrative autonomy of zonal administrations were corrected. Even the state of Tigray abolished the zonal administration structure while Oromiya and Amhara retained zones with diminished power for they have unmanageable territorial and population size. The SNNPR is with the same problem, but ethnic diversity prevail at zones.

? Compare and contrast the state budget process and the change in financial institutions before and after 2002/03 fiscal year?

The next point to be raised is how the budget is implemented for it is the second element of expenditure responsibilities and it has specific institutions than budget plan, designed by many institutions. The state expenditure plan implementation begins by the fiscal year budget ratification of the state council by legislation. Each administrative sector is responsible for the management and execution of its own budget approved by state council. The proper execution of the budget is defined and evaluated by respective states financial laws. The laws also required that the budget execution against planned expenditure to be reviewed by the state and weredas finance bureaus.

The disbursement of the recurrent budget normally takes place on the monthly basis from the authorized finance office and is collected from the banks. Payments are made at the state, zonal and wereda finance offices depending on the nature of the claim. On the other hand, the payment of capital budget is subject to be spent by the state sector bureaus through the state finance bureau. The major actors within the respective states are the sector offices in the three tiers where the lower is accountable to the higher one.

b) State fiscal institutions for revenue-raising responsibilities; the revenue sources of the states are the taxpayers and the particular things assigned to them by the Constitution. The collecting of taxes and other non-tax revenues mainly is undertaken by the respective finance bureaus of each level of administrative offices. The last pot of the proceeds of state revenue-raising is the state finance bureaus by their account in the banks. Registered taxpayers are also required to pay their tax duties through banks assigned to this purpose. All revenue proceeds may not be transferred to the state finance bureaus, for instance, the wereda finance bureaus retain the revenue proceeds to spend thereof but the financial account balance that is transferred from the wereda revenue to its expenditure shall be reported to the higher finance offices to be evaluated and recorded in the total state revenue and expenditure report. This may be possible for public finance the budget plan of each administrative office perceives and envisages the revenues from that administrative office in a given fiscal year.

The Addis Ababa and Dire Dawa City administrations also have their own agencies to collect revenues from the sources assigned to them by law. In Addis Ababa, the registered taxpayers pay their duty through banks assigned to this effect to the account of sub city administrations and the

sub city administrations in line with their approved budget plan spend it on the expenditure responsibilities subject to report the account balance to the Addis Ababa Administration.

The non-tax revenues of the state are subject to be collected by the state service providers or by the state public enterprises through their higher authorities to their final destination state finance bureaus.

Activity 2

1. There are two directions for the flow of state budget plan; for instance, the same budget plan of the wereda educational bureau shall be conveyed to both the wereda council in horizontal informational flow and to the zonal education bureau in vertical information flow. The same is true for the zone sector bureaus that they send the budget information to both the state sector bureaus and to their zone administration. At apex, the state council has acquired the same information from both directions, the aggregate budget plan of state sector bureaus and the aggregate of the budget plan of zones.
 - Q1. Illustrate the structure and the relationships of the institutions by drawing?
(Assume that the budget plan initially is drawn up by the lowest structure called kebele)
 - Q2. State the advantages and disadvantages of such structure of state budgeting process
2. Identify the state finance institutions responsible for payments of budgets?
3. Addis Ababa and Dire Dawa City governments have tax sources assigned to them by subsidiary legislation while the FDRE Constitution allocates revenue sources as between the federal government and the states. Discuss the constitutionality of those laws that provide revenue-raising power to Addis Ababa and Dire Dawa City governments?

5.4. Institution Responsible for Revenue Transfer

5.4.1. International Experience

The process of revenue transfer involves two important questions: determining the amount of finance subject to transfer and how it is to be transferred among the states. Although there is horizontal interstate transfer revenue in an attempt to equalize the revenue capacity of the states in Germany, most of the issues related to transfer in all federations are held at the center through different institutional arrangements. Broadly, four models of constitutional mechanisms can be discerned.

The first model is followed by Australia, India, South Africa and Nigeria whereby expert commissions are given by the task of determining the grant formula for equalization and redistribution as recommendation to the central government.

The Australian Grant Commission is a standing commission established by the federal government whereas the Indian National Financial Commissions, and the South African Fiscal and Financial Commission are established by the respective constitutions. Since its establishment in 1933, the Australian Grant Commission is well-known for it is an effective equalization instrument by dealing with both the revenue and expenditure needs of the states, and the overall recommendations to reduce both vertical and horizontal imbalances. It is mandated to deal with the general/ unconditional transfer of grants but with time it has been able to influence the federal government in its decision on allocation of conditional grants. In India, the revenue transfer is administered by two Commissions: the Financial Commission and the planning Commission. The Financial Commission, appointed for five years and in its history reaches to the 12th Commission, makes recommendation on the sharing of revenue between the center and the state and as between the states themselves. The principle it uses mainly focuses on the financial capacity of states, leaving the expenditure need to be determined by the Planning Commission. The latter commission recommended the allocation of special purpose grants for the major developmental expenditures of the states.

The other important institution is the South African Financial Commission which was set up under Article 220 of the Constitution and the fiscal Act No.99/1997. It is an independent body of

experts where provincial and local governments are also represented. The principal duty of the commission is to make recommendations with regard to the equitable division of national revenue among the three tiers of government with a view of facilitating cooperative government. The commission's mandate includes adjustments to both vertical and horizontal imbalances. The commission is also allocated specific functions through other legislations, notably the borrowing of power of provisional governments Act of 1995 and the intergovernmental fiscal relation Act of 1997.

The commission assumes a difficult task especially for two major reasons: the provinces' responsibility for providing major public goods and services, and the need to aggressively address the economic disparity attributed to the legacy of apartheid. In Nigeria, too, the importance of an independent fiscal commission has been stressed since independence in order to ensure that revenue sharing is done on a rational basis. Compared to the other commissions mentioned above, its history is marred by interventions or rejections by the military regimes, ethnic and regional competition dominating the fiscal issues, the increasing number of states and the impact of frequent political and constitutional changes that have taken place in Nigeria.

The second model is found, for example, in Malaysia (National Finance Council) where the Constitution provides for the establishment of a formal council for intergovernmental cooperation composed of representatives from the federal government and the states (Art. 108 of the Constitution of Malaysia).

The third model refers to the system of revenue transfer which is decided by the federal government, but there is the states' representation at the federal legislature (through the Upper House) for expressing regional interest. This model is followed in many federations including Germany, Switzerland and the USA. However, the role of the states at the center concerning their interest, particularly the design and approval of revenue transfer is much more constitutionally entrenched in Germany than in other federations. Any federal decision in areas of concurrent or exclusive state jurisdiction is effected through the consent of a majority in Bundesrat (Germany's Upper House) where the Lander (states) are represented. In Switzerland, in addition to the cantonal (states) representation in the federal legislature, the cantons can

challenge any federal legislation through the referendum. In USA, any decision on federal transfer requires the consent of Congress and the President.

The Ethiopian situation may be categorized under this third model since the issue of revenue sharing and the grant formula are decided by the HOF (Upper House). However, as we shall see further below, the composition of and the powers conferred on the HOF have made it different from the above countries.

The fourth model is typical of Canada where all matters of revenue transfer schemes and tax-related arrangements are determined by the federal government not by any formal independent commission or constitutionally provided institution. However, since the nature of fiscal relations involves extensive regional interests, several extra-parliamentary mechanisms involving officials of the center and the provinces (intergovernmental cooperation) have been established.

? Which one or more of model(s) would you seem preferable and not preferable to Ethiopia? Discuss why? Why not?

5.4.2. Ethiopian Approach

Although the FDRE Constitution provides for the sharing of concurrent taxes between the federal government and the states and the transfer of grants from the center to the states, it refrains from laying down any rigid formulas or specific amount payable to the state in the form of shared taxes and grants. The drafter of the constitution seems to have learnt from the experience of other federal countries or have realized the problems of determining permanent formulas in the effort to meet the changing socio-economic conditions of a country. Unlike the early days of the Canadian and Australian constitutions, in which the use of fixed formulas provide to be inadequate, the experiences of many federations have shown the importance of adequate room in the constitution to set specific formulas and to make any necessary adjustment taking into consideration the contemporary economic conditions and the financial position of the center and each region.

This can be done successfully when the task is constitutionally conferred on a specific institution that is well received by the constituent units of the federation. Federal experiences have demonstrated several options in using different institutions dealing with the issue of revenue transfer as discussed above. Some have opted for independent commissions mandated with advisory role, while others use the federal legislature or some form of intergovernmental councils.

In Ethiopia, the institutional arrangements took different approach during the transition period and after the adoption of the federal Constitution. During the transition period, the Council of Ministers had the power to decide on the sharing of joint revenue and the provision of grant subsidies to the newly formed regional governments based on the recommendations from the 'Committee for the sharing of revenue' and the Ministry of Finance. The Committee for Revenue Sharing was empowered by law to study the conditions and make recommendations to the Council on matters concerning revenue sharing, particularly the percentage according to which the joint revenues of the federal and the states are shared. The Committee which was supposed to be composed of representatives of federal and state governments was hardly transparent in its role. There were at least two objections: first, some rigid authorities complained that the actual transfer was different from what they had been informed previously, sinking fund was utilized by some regions without their knowledge. Second, there was no specific percentage of shares for the division of joint taxes between the center and the states, but the grant subsidy was budgeted for recurrent and capital expenditure on the basis of criteria which were not clear to most of the regional governments.

After the adoption of the Federal Constitution, the power to determine the sharing of revenue collected from joint tax sources and of grants that the federal government provides to the states is vested in the HOF (Art. 62(7) of the Constitution). It may be worthwhile to raise questions in relation to the power bestowed to on the HOF:

? Why is the power conferred on the HOF? Why the Constitution does not adhere the transitional government system?

The Constitution confers the power to HOF, first, for the Constitution follows the principle that non-political or majoritarian institutions should not deal with all major political issues. Accordingly, constitutional adjunction, secession issues and the transfer of revenue are the major political issues that have to be decided by the representatives of ‘nations, nationalities and people’ at the HOF. Second, the HOF is designed as an institution that can play a role similar to that of intergovernmental council. So, by having authority over revenue sharing and the transfer of grants, the HOF promotes intergovernmental relations. The idea of assigning the power over intergovernmental fiscal relations to the HOF seems similar to other federations such as Germany and USA whose Upper House plays a significant role in the allocation of revenue. But, unlike the others, the composition and competence of the HOF are unique. For instance, it has no legislative power, and although it was expected to be a counter-majoritarian institution to balance the majoritarian Lower House, House of People Representative, its composition replicates the situation in the latter institution.

As enshrined in Article 62(7) of the Constitution, the function of the HOF are ‘determining the division of revenues derived from joint federal and state tax sources and the subsidies that the federal government may provide to the states’. Concerning the sharing of revenue from joint sources, the HOF can determine the division of the revenue between the center and the states and the distribution among the states. Concerning the allocation of subsidies or grants, there is a difference between the two versions of the Constitution. Accordingly, the English version of Article 62(7) is not clear as to whether the HOF can determine the manner of distribution while the Amharic version clarify the same provision by referring specifically to ‘determining the grant formula’ for distributing the grant to each member states. The House will deliberate on the disbursement of the revenue pool made by the federal government from the sources assigned to it.

The other issue may arise in relation to the power of HOF in revenue transfer, whether the Constitution empowers the House over conditional grants? The power bestowed to the House is to determine the grant formula, which necessary in the allocation of unconditional grants for the equitable distribution of revenue to equalize the fiscal capacity of the states. Thus the HOF cannot choose project functions and allocate specific purpose grants to perform these functions. Article 94 provides that the federal government can allocate different forms of grants to the

states for the purpose of a state of emergency, rehabilitation assistance or loans. Further, the HOF does not have a power to allocate domestic loans to the states.

The HOF in executing the function in relation to inter governmental fiscal transfer, it is expected to perform a full-time job; although in practice it meets only twice a year for a few days. If the power bestowed to the House is similar to other institution of federations with the same concern, its task requires the gathering of relevant data from appropriate governmental bodies, analyzing and deciding on the adoption of grant types and revenue-sharing formula. Furthermore, carrying out essential inquiries, consulting appropriate institutions, conducting meetings with the respective states government representative will be necessary. Above all, the impact of revenue transferred to the states needs a series of studies. However, the HOF during the course of its work in the last decade for all aforementioned functions is dependent on recommendation of the Ministry of Federal Affairs (MOFA) and Ministry of Economic Development and Cooperation (MEDAC). It had no experts of its own; most of the members hardly understand the complexity of the grant system.

Solomon argues the use of Ministries on the fiscal transfer has the advantage of *inter alia*, they could be acting at the discretion of the federal government which makes the decision less objective and employees of the ministry could not have authority to discuss sensitive issues. This role can be better performed if an extra professional advisory body assists the House. It would be more effective if the power is reassigned to a permanent independent institution which has the necessary expertise and autonomy to conduct the ongoing complexity of data gathering and analysis.

? Trace the institutional order and their corresponding functions of Fiscal transfer in Ethiopia?

Auditing Institutions; it is not worthwhile to escape to end without discussing the institutions of the last phenomenon of healthy finance operations, i.e. auditing institutions. The budget evaluation begins at the institutional level by the internal auditor. The finance laws require the internal auditor to produce a monthly report stating the monthly revenue and expenditure of the

institution and this report is sent to the finance office of the level of administration (Article 57 of the Council of Ministers' Regulations on the Finance Administration of Federal Government No.17/ 1997). At the federal level, all public bodies which execute the federal fund should account monthly, quarterly, semi-quarterly and annually to the Ministry of Finance and Economic Development (MoFED).

The state governments are also required to report to the MoFED corresponding to the financial reporting system of the federal government. The MoFED and the Auditor General have power to conduct an audit of federal offices and as well as the state governments concerning the use of subsidy grants they have received from the federal government (Article 95 of the FDRE Constitution).

The Auditor General of both the federal and the state review the audit reports of internal auditor of each administration office and made their own auditing on the whole financial operation of their respective governments. However, because of human and capital resource constraints, they focus on selected federal or state institutions based on their own judgment. On the other hand, most of the projects that financed by foreign assistance and foreign aid are regularly audited by external (non-governmental) auditing firms while the rest are audited occasionally.

The state budget evaluation has to be done formally every quarter on the basis of the activity reported and submitted by each sector bureau. All the state government institutions have to be audited by internal and external auditors. And the audit report shall be published.

The whole purpose of the auditing is to reassess the progress achieved and the remaining activities. This helps to take timely action by the state council or the finance bureau such as to study the problems encountered by the responsible office, or to reallocate the remaining amount of the budget, ultimately to enhance efficiency of public services, to encourage transparency and accountability and to avoid corruption as much as possible.

Activity 3

1. In the above lesson four models of revenue transfer are discussed, what basic differences exist among them?

2. The intergovernmental revenue transfer signifies the interest of both the federal and the state governments, some of the models of commissions of the federations includes the representatives of both governments to avoid the conflict between the two while the other are not. Therefore, how the non-representative commissions protect the conflicting interest of both governments?
3. Which federations have followed the same institutions of revenue transfer?
4. The Amharic and English versions of Article 62 (7) of FDRE Constitution have different meanings. Discuss the difference and the practical impact after the English version.
5. What are the two basic functions of the House of Federation enshrined in Article 62 (7)?
6. The composition of the House of Federation is 108 representatives, for having greater ethnic diversity, 54 of which is constituted by the representatives of SNNPR. To a simple majority, SNNPR needs one vote like Harari in the House. If decision is made by a simple majority the interest of SNNPR allied with other small ethnic number representative would prevail. Does this hurt the interest of the other states with the larger population? What do you recommend for such problems?
7. Write down the problems of the HOF in deciding on the revenue transfer and the possible remedies.

Summary

This Chapter is situated at the end of the course material next to the course summary for the need to explain the institutions of fiscal federalism augments the understanding of the concept of fiscal federalism. The concept of expenditure, revenue and revenue transfer in federal system rests as abstract notion, if the operative institutions are not discussed. Finance institutions in general signify any institutions which operate in finance. But in relation to public finance, finance institutions mean those institutions which are involved in the planning and implementation of public expenditures, in collecting public revenues, as well the federal arrangement quests additional institutions for intergovernmental revenue transfer.

The institutions responsible for the expenditure responsibilities in both the federal and state level are the sector offices, their respective higher sector offices and the administrative offices. For instance, in state, all sector offices from the lower administrative level up to the higher draw their budget plan. The budget plan passes to respective sector offices from the wereda to zone and finally to state by undergoing approval in each level. The state council approved the annual budget plan of the state based on the information transferred to it hierarchically. The payment of budget is made to their respective finance office through the bank by the state finance bureau.

The institutions responsible for collecting state revenue are finance bureaus at all level of administration. Registered tax payers may also use banks assigned for this purpose for tax payment due them.

On the other hand, the federal budget process is finalized by the legislature approving each year's budget. Each sector office which accountable to the federal government draws up its budget plan and sends it to its respective higher sector office and lastly to the Council of Ministers to be approved by the House of Representative. The payment of federal finance is mainly made by the Ministry of Finance and Economic Development (MoFED) from the public treasury (National Bank) through other banks to their respective finance bureaus. Some times,

the finance bureaus may use the proceeds of revenues they collected, but they are subject to report details of the execution to the Ministry.

The Ethiopian Custom and Revenue Authority which substitute the Ministry of Revenue, The Federal Inland Revenue Authority and the Ethiopian Custom Authority by merging them to one institution and succeed their respective branches and finance bureaus of administrative offices responsible to the federal government are responsible to the federal revenue-raising. Registered taxpayers also pay their tax duties to different banks assigned to this purpose for the concerned tax collector office. The public enterprises and service providers of the Federal Government are responsible to collect the return of their function and businesses to their respective higher authorities and ministries and finally to MoFED.

While other systems and independent commissions are employed in other federations, the HOF, the Upper House is responsible for revenue transfer from the federal to the states in Ethiopia. The last stage of every financial activity rests in evaluation and auditing the compliance of the expenditure and the revenue and the manner of budget administration free of corruption, effective in public service and transparent etc. The MoFED and the state finance bureaus have the power to evaluate the financial performance in federal and state levels respectively. The Auditor Generals of both the federal and the state governments head the auditing of finance in their respective level of governments. The internal auditor of every administrative office and External Auditor participate in the auditing process, then the financial life dies except its history, so for the main discussion of the course material fiscal federalism.

COURSE SUMMARY AND CONCLUSION

1. Course Summary and Conclusion

Students, we are reaching to the end of the course material. The course fiscal federalism has discussed, from the beginning to the this end the concept of fiscal federalism in theory and practice, in a nutshell deal with the following main issues:

- allocation of expenditure responsibilities; which deals with the issue of which item of power of spending should be carried by which level of government,
- allocation of revenue raising power; which deals with the issue of which types of taxes should be levied and non-tax revenues should be assumed in which jurisdiction by which level of governments;
- the fiscal imbalance between the tiers of government and disparities between them in executing their respective responsibilities; vertical and horizontal imbalances; and
- the intergovernmental financial transfer; which deals with the issue of financial flows between the federal and the states and among the states; vertical transfer and horizontal transfer in order to adjust the imbalance and keep a viable federal system.

Before we summarize the details of the aforementioned issues, the material has conspectus of federalism. The principle of federalism is becoming universally acclaimed at least in fact for its objective, conducive administrative system, citizenry participatory and grassroots democracy, strong government, effective use of resources and other social rights. Only some states, however, are constitutionally structured and recognized in the form of federation. Ethiopia through the 1995 FDRE Constitution introduces federalism as its state structure. The whole notion behind federalism is a system of dividing the states sovereignty, government, population and territory among a central and more than one local government. Devolution of power among federating units strongly necessitates constitutional mechanisms which is variable from federation to

federation. Therefore, fiscal federalism which is different from fiscal decentralization of unitary state is drawn from the constitutional devolution of power in federalism.

In addition to the constitutional arrangement of allocation of expenditure responsibilities and revenue sources, fiscal federalism may be affected by other collateral issues: economic policy, foreign and interstate commerce for they are assigned either of the government and they collect huge revenue.

Fiscal federalism is not immune from advantages and disadvantages. Its advantages are optimum utilization of resources and development growth, creating job opportunity to professionals and workers and decreasing central bureaucracy and corruption. Whereas, the disadvantages are financial imbalances and competition among the level of governments, mobility and migration of workers and professionals and spillover effects because of disparity in finance capacity to render different public services.

The history of fiscal decentralization in Ethiopia dates back to the Axumaite kingdom where vast territorial area demanded federal system state structure in which the center control small conquered states. Decentralization of power continued throughout dynasties of the time up until the 19th and 20th century introduction of strong centralization. However, the official federal form of state structure thereby fiscal federalism was introduced during the sweep change made by the coming in to power of the FDRE.

Chapter two is meant for the allocation of expenditure responsibilities. Allocation of Public expenditure in federation in a broader sense signifies the constitutional division of powers and functions among the center and states. This is because every function assigned to each level of government needs sufficient budget as the extent to quench public service and utility of the people, without which the constitutional assignment of powers to each level of government remain a paperwork. Narrowly, allocation of public expenditure comprises a process of yearly budget preparation, implementation and evaluation in particular fiscal year.

The concept behind public expenditure is based on objectives and principles. From various objectives, security of life against the external aggression and internal disorder and injustice and

development or upgradations of social life in the community are the major. These can be more detailed as defence, justice, education, health, provisions of basic needs and other social amenities. The principles that underline public expenditure are social benefit, economic use, supervision, saving surplus, elasticity, productivity and equitable distribution of income. In terms of area of expenditure it is of two kinds: capital and recurrent. All sorts of administration costs such as salary, defence expenditure and debt servicing constitute recurrent expenditure. On the other hand, capital expenditures are those expenditures incurred for construction, agriculture and industrial development.

In allocation of public expenditure responsibilities, each layer of government has its own role assigned by the constitution. The center should cover the expenditures of the powers and functions assigned by the constitution such as defence, foreign policy, interstate commerce, transfer and grants and subsidies etc., which commonly serve the federation as a unit and the federal government. On the other hand, the states are entrusted with education, health, agriculture, police and other welfare functions, which inherently is associated with the state administration and their subjects. In addition, the staffs of government functions show the kind of the state. Accordingly, states are grouped as minimal, welfare and developmental.

Federations have different approach as to allocation of expenditure responsibilities owing to the difference of their constitutional arrangements. Therefore, the US and German experiences are selected for they can provide a good lesson to Ethiopian federation. USA is the pioneer to the concept of federalism has an old aged experiences of problems and their solutions. However, Germany is a moderate ethnic-based federation. The US Constitution is not detail enough to allocate expenditure responsibilities between the center and the states but general clauses are employed which are prone to broader interpretation. Yearly fiscal budget in USA involves the executive by the president budget, the appraisal of the president budget by the congress by means of legislation, the execution of the budget by the executive and auditing by the General Accounting Office (GAO).

The Basic Law of German having moderate nature of framework for allocation of expenditure responsibilities provides cooperation of the center and the states on common functions. For

instance, the center may legislate on joint matters of the center and the states, while their implementations are left to the states.

Under the FDRE Constitution, the center and the states are entrusted with powers and functions. In principle follows the method of listing the power of the center and reserving the rest to the state. However, it tries to guide the states power by using limited list. There is also limitation on the reserved power of the state such as the power of taxation. From the essence practices the center issue standards and policies applicable in the country while their administration and implementation is left to the states.

The budget processing of every fiscal year is the very instrument of public expenditure. Accordingly, the budget preparation, the budget implementation and the budget evaluation allocated among the organs and the tiers of government show the allocation of expenditure responsibilities.

The other main area of fiscal federalism is allocation of revenue-raising power among multiple tiers of governments of the federal system. In general the concept of public revenue consists of two powers. The power to legislate laws on some determined sources and the power to collect revenues accordingly. Particularly, in federal system where powers of the state including the revenue-raising power is divided among multiple layers of governments, the constitution demarcates the jurisdiction of each government.

Governments in general raise revenue from two basic resources. Taxes are substantial source of government revenue. The non-tax sources are the other sources of government revenue. The non-tax revenues accrue from administrative income such as fees and charges, fines and penalties, special assessments etc. In addition, price capital receipts and grants and gifts from domestic and foreign donors constitute the substantial part of non-tax revenues. Taxes with their category as direct and indirect play a vital role in government financing. They finance the government expenditure responsibilities, stabilize economic fluctuation, distribute the wealth of the state and encourage investment.

Devolution of power of taxation by specific method is the basic task of federal constitutions. Accordingly, the FDRE Constitution derives specific method of division of taxation between the federal government and the states. Hence, the category of tax payers and particular things

pertaining to either of the governments by constitutional decentralization of power and functions are taken as the base of revenue power allocation. Therefore, except custom duties exclusively given to the federal government, all taxes are allotted to both governments in their own jurisdiction. The Constitution addresses the division by setting 'federal power of taxation', 'state power of taxation' and 'concurrent power of taxation'. It also provides the residual taxation to be dealt by the joint meeting of the two houses.

Fiscal imbalance and inter-governmental fiscal transfers form the core of the fiscal federalism conceptually and practically challenges the federations. Imbalance is caused by the disparity of the revenue sources and expenditure responsibilities due to allocation of the expenditure responsibilities and revenue resources among the tiers of governments in federation. Inter-governmental fiscal transfers meant to cure the fiscal disparity. Fiscal imbalance is of two kinds: vertical imbalance and horizontal imbalance; and inter-governmental transfer buttresses in to three: revenue sharing between center and regions, grants by the center to the regions and federal-state transfers.

The causes of vertical imbalance are mainly attributed to non-correspondence of constitutional assignment of revenue sources with the states expenditure responsibilities and ineffective and inefficient administration of revenue raising power and expenditure spendings of the tiers of the governments. This can be measured by computing the percentage of the share of state expenditure covered by the state revenue and federal transfer and the percentage of share of the state revenue in the total revenue of the federation. The great disparity of the share implies the greater interference of the center in the economic and political autonomy of the regions. On the other hand, horizontal imbalance is mainly caused by disparity of revenues resources and expenditure responsibilities among the states. Difference in natural resource endowments that gives rise to variation in revenue sources; urban centered industrialization that pools investments and high dependency ratio of young, old and poor, or naturally difficult terrain or generally higher cost disability factor which entails different access and quality of public services for individuals in different states are the major. This can be measured by computing per capita expenditure and revenue of all states. This implies a better social and public services in richer regions than the poorer, thereby differences in personal developments. Horizontal fiscal

imbalance also entrenches within the state in local administrations such as zones and weredas. It is also amplified by contraband and ethnicity which are rampant in Ethiopia.

Fiscal transfer is a common fiscal phenomenon in federations. It is a mechanism designed to channel the vertical and horizontal fiscal flow between the center and the states and among the states respectively. The main objectives of fiscal transfer are to fill the gap between the expenditures and revenues and enable the states to have equal capacity of rendering public services. The whole process of adjusting the fiscal imbalances through fiscal transfer is termed as fiscal equalizing system. It can be materialized by revenue transfer, grants and federal-state transfer.

The scheme of revenue sharing results from the center and the states share revenue accrued from some sources identified to this effect. The determination of certain revenue sources to this purpose is different from federation to federation. On the other hand, the center mostly designs formula to grant the states. This can be made by two ways: general purpose (unconditional) grants or specific purpose (conditional) grants. General purpose grants are allocated to states to spend the money in any area of public purposes designated by them. It is characterized by the absence of significant restrictions on the use of funds, as it is at the region's discretion to spend the money for any preferred purposes. Conditional grants are aimed at spending in a specific sector supported by the central government. The grantor may require, for example, a state to use the funds for a specific activity in the education sector, such as the construction of post-secondary institutions or the purchasing of books, with a possibility of further specifications. Conditional grants may also be further classified as matching (cost-sharing) and non-matching

Federal-state fiscal transfers are other schemes in response to financial imbalances. This system includes intrastate vertical revenue sharing and grant to their lower level administrations: zones and weredas and regional borrowings from federal and states' financial institutions. Federal-state fiscal transfers involve the center, states and local governments and web of terms and conditions against each other governments.

The body of the course material ends with explaining the institutions of fiscal federalism. The concept of expenditure, revenue and revenue transfer in federal system rests as abstract notion, if the operative institutions are not discussed. Finance institutions in general signify any institutions which operate in finance. But in relation to public finance, finance institutions mean those institutions which are involved in the planning and implementation of public expenditures, in collecting public revenues, as well the federal arrangement quests are additional institutions for intergovernmental revenue transfer.

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taxpayers also pay their tax duties to different banks assigned to this purpose for the concerned tax collector office. The public enterprises and service providers of the Federal Government are responsible to collect the return of their function and businesses to their respective higher authorities and ministries and finally to MoFED.

While other systems and independent commissions are employed in other federations, the HOF, the Upper House is responsible for revenue transfer from the federal to the states in Ethiopia. The last stage of every financial activity rests on evaluation and auditing the compliance of the expenditure and the revenue and the manner of budget administration free of corruption, effective in public service and in transparent manner etc. the MoFED and the state finance bureaus have the power to evaluate the financial performance in federal and state levels respectively. The Auditor Generals of both the federal and the state governments head the auditing of finance in their respective level of governments. The internal auditor of every administrative office and External Auditor participates in the auditing process, then the financial life dies except its history, so does the main discussion of the course material fiscal federalism.

2. Selected Issues of Fiscal Federalism and Future Concerns

It is necessary to provide afterword issues for students in their future carrier to identify problems and curb them. Some of such issues are interstate competition, migration and mobility, spillover effect and double taxation.

Interstate Competition

Federalism entails devolution of sovereign powers of the state such as territory, population and government to different units. This mainly includes fiscal power devolution. They are quite different in their population size, natural resources, development etc. This creates competition among states. States are free to specialize in production any public services and goods. In most federation, states try to produce the same services and goods which the other state is specialized without due consideration given to the comparative advantages of producing in the state or importing it from the other states. Such phenomenon is conspicuously aggravated by ethnocentric administration of the states in ethnic-based federalism. Competition results in

duplication of services and goods which are surplus to the whole country and costs to the non-specialized states. Competition among the states in this case ultimately results in the phenomenon known as “race to bottom”

Migration and Mobility

Mobility and migration of professional and skillful persons is common in federations due to disparity of payment for the same professions in different states and in between the federal or states governments. The richer governments tend to pay better salary and provide wage increment according to the pace of their development where as the poor strive to satisfy public services than individual payment in their financial performance and development strategies. Hence, disparity of salary payment for the same professionals is inevitable and therefore it may result in migration and accumulation of the same professionals and experts to a state or the federal governments which pay better compared to other states. However, having the required expertise or skill or profession does not suffice to work in one state or in the federal government where the working languages of the federal and each state is not the same like Ethiopia. Thus, language requirement in addition to profession minimize the migration of the same professionals to the region of better payment. Ethno-linguistic based federalism like Ethiopia solves the problem to some extent.

Spillover Effect

Spillover effect is the fact that services which are provided by one federating unit either of the federal or a state or even a local administration in the region/state but used by people of other regions which are not perceived as the target of the budget. Township administrations which are surrounded by less developed rural areas owing to the center of service providing institution and faster rate of urbanization are prone to these effects. More developed part of regions adjacent to less developed part of other regions also face the same problem. The spillover effects which are caused by the “flow” from one region to another would be in one direction, while in other places it would be in opposite directions and such phenomenon is termed as offsetting effects.

Double Taxation

In federations, those revenue stuffs identified to joint taxation of both the level of governments may prone to Double taxation. This is mainly caused by unclear constitutional clauses. For instance, the FDRE Constitution made provisions under Article 98 to concurrent power of taxation where the Federal Governments and the States shall jointly levy and collect some taxes enumerated thereof. The problem arises for there are no joint house and executive for center and states to legislate tax laws and to collect taxes respectively. Or, there is no room for framework method of sharing power by which the center may legislate tax laws and the state collect to share jointly. In the absence of these arrangements, each level of government may levy and collect separately on the same matter they own jointly. This results double tax burden imposed by both level of governments on single tax payer.

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