

Issues of Vertical Imbalance in Ethiopia's Emerging System of Fiscal Decentralization

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1. The Problem

A. Background: The Tradition of Centralism

If one excludes the brief and unsuccessful efforts of Tewodros, the first serious attempts to introduce a centralized system of administration in Ethiopia were undertaken during the Menelik era. However, the person who did most to strengthen the hands of the central government as well as to institute a modern fiscal system was Emperor Haile Selassie (Bahru 1991, Eshetu 1984).

The administrative system which he built up was a highly centralized one, and it became increasingly so with time. Thus, the regions had no autonomy whatsoever and they were all administered by his own hand-picked representatives. Not only was the system highly centralized, but it was also very personal, in the sense that the monarch was the ultimate decision maker in all matters of consequence. Although his personal control declined over the years, partly on account of his advancing age, his reign was characterized by a system of administration that left very little power to regional administrations.

This naturally found its reflection in the fiscal system as well. All major budgetary matters, both on the expenditure and revenue side, were made by the central government. The Ministry of Finance did have branches in the regions, but these were merely its administrative arms, essentially meant to facilitate its tasks of revenue collection, and were not accountable to regional administrations. The only arrangements even remotely approximating fiscal autonomy for the regions were the education and health taxes, earmarked for financing primary education and health in the regions where they were collected. But even this was probably more form than substance (Eshetu 1968).

The military government (1974-91) that replaced the imperial regime found it convenient to continue with this tradition of centralism in both administration and finance. When the "People's Democratic Republic of Ethiopia" (PDRE) was set up, a new system of regional administration was introduced, with some regions designated as "autonomous". But even those so designated were not assigned any independent sources of revenue and had virtually no say in their expenditures (Eshetu 1992c; PDRE 1988). Thus, in spite of a change in form, the practice was virtually a continuation of the imperial tradition. In fact, the system was perhaps even more centralized on account of the institution of monolithic party rule and even greater concentration of power in the hands of one person.

Therefore, when it assumed power in 1991, the Transitional Government of Ethiopia (TGE) inherited a highly centralized system of administration and finance.

*B. Towards Fiscal Decentralization***1. Regional Administration**

However, the new government did not lose time in instituting significant departures in this regard. An early indication of new directions was the Charter which set up the TGE (TGE 1991), in which were enshrined "the rights of nations, nationalities and peoples to self-determination and to determine their own affairs by themselves". The next significant legislative act was Proclamation No.7/1992, which provided for the setting up of "national/regional self-governments" (TGE 1992b).¹

This law provided for a new administrative structure made up of a central government and fourteen regional governments.² Regional governments have two tiers, the *wereda* (which is defined as "the basic unit of hierarchy") and the region. However, they have the power to set up intermediate levels of government if they so desire, i.e., between the *wereda* and the region as well as between the *wereda* and the *kebele*. In fact, nearly all regions have "zones", intermediate between the region and *weredas*. The law stipulates that regional governments are responsible to **both** the Council of Representatives of the central government **and** the people who elected them. It also defined the powers of the central government and regional governments (see III.A below).

The next major legal development in this regard was Proclamation No.41/1993 (TGE 1993a), which defined the allocation of powers and duties between the executive organs of the central government and the regional governments. In effect, what it set up in the regions were mirror images of the central government. The law provided for each region to set up, "as may be necessary", a number of "bureaus", or miniature ministries, including - for our purposes - a finance bureau.

2. Fiscal Decentralization

As indicated above, Proclamation No.7/1992 provided for a division of powers between the central government and the regions. Of those reserved for the latter, some were in the area of fiscal policy, including the right to "prepare, approve and implement their own budgets" and to "borrow from domestic lending sources and to levy dues and taxes". The law further provided for grants from the central government to regions "that cannot undertake by themselves basic social services and economic development programs due to relative underdevelopment".

¹ In this paper, we shall eschew the cumbersome phrase "national/regional self-governments" and use "regions", "regional governments" or "subnational governments", as distinct from the central government in Addis Ababa.

² Five of the regions subsequently decided to consolidate themselves into one region. There are thus currently ten regions and the city of Dire Dawa.

But the most important legal instrument with respect to fiscal decentralization is Proclamation No. 33/1992 (TGE 1992c), which defines the objectives of revenue sharing, sets out the principles used in framing revenue sharing arrangements, and proceeds to categorize revenue sources into three: those reserved for the center, those reserved for the regions, and those to be used jointly by the center and the regions (see section III.B below).

This law also makes provisions for grants (also called subsidies) from the central government to the regions, with the proviso that "the amount of subsidy to be granted shall be proportional to the contribution made from the revenue collected by the Regions". It also includes stipulations that would make it possible for the regions to borrow from central financial institutions. All these are very significant departures from past practice and are bound to raise several new problems, one of which is that of vertical imbalance.

✓ *C. The Issues of Vertical Imbalance*

Any type of federal arrangement involves a division of functions between the central government and subnational governments (expenditure assignment) as well as assignment of different sources of revenue to different tiers of government (revenue assignment). In such circumstances, only rarely does one encounter balance between the spending needs and revenue capacities of either the central government or the regions. All too often, either the center is unable to cover its expenditure from its own fiscal resources or the regions face a similar predicament. It is this mismatch between expenditure needs and revenue sources to which the term vertical imbalance is given³ (Shah 1991a, 1991b).

Where a problem of vertical imbalance exists, it needs to be resolved somehow by filling the revenue gap at whatever level of government it appears. For instance, action could be taken on the expenditure side, which would necessitate reassigning responsibilities for expenditure. However, it is more common to act on the revenue side, the mechanisms usually resorted to being revenue sharing and transfers between different levels of government. There could also be arrangements whereby regions could borrow from the center. But it is only rarely that these arrangements provide full and satisfactory solutions to the problem.

The major purpose of this paper is to examine the extent to which the problem of vertical imbalance arises in the Ethiopian context and to critically assess existing arrangements for resolving it. Since the country is just beginning to experiment with fiscal decentralization, and given its tradition of a highly centralized fiscal system, it would not be surprising that, at least in the initial stages, vertical imbalance would feature in regional budgets. In making progress towards greater decentralization, the country would be well-advised to consider its

³ This is to distinguish it from "horizontal imbalance", which "refers to inconsistency between revenue raising ability and fiscal needs of governments at the same level in a federation" (Shah 1991a: 26). Horizontal imbalance raises fundamental issues of equity between regions and is therefore important. It is, however, outside the scope of our present concern, which is focussed on center-region relations.

steps carefully in order to avoid the extremes of either too weak a central government or regions that are autonomous only in name.

The exercise we are attempting here is rendered difficult by the novelty of the Ethiopian experience, which makes any empirical evaluation impossible. It is only for fiscal year 1993/94 that the budget has been presented separately for the center and the regions. Therefore, in this paper we will address the problem by confining ourselves to the relevant legislation and the 1993/94 budget (1993b). Our intention is to identify problems that are likely to be particularly vexing and to draw attention to them before the new system of fiscal decentralization assumes final shape.

II. General Principles

A. Expenditure Assignment

The central issue in decentralization is how much power to retain at the center and how much power to give to the regions.⁴ Although the major driving force behind decentralization is usually political - not economic - there are also compelling economic arguments for decentralization. First, it is contended that subnational governments are closer to the people than national ones and are therefore most likely to be responsive to their needs. Thus, there are many instances where local provision of goods and services is more efficient, provides for greater accountability, is more manageable, and ensures greater autonomy of lower levels of government.

Second, it is argued that decentralization takes greater account of regional differences in resource endowments and makes it possible for subnational units to specialize in economic activities that are more consonant with their respective comparative advantages. In contrast, central provision may overlook such advantages or not give them the attention they deserve. In the cultural sphere, too, it is contended that decentralization allows more opportunity for regions to exercise greater control over spending on items such as education and culture, which are important in defining the unique identity of the people of particular regions.

Third, it is claimed that decentralization promotes competition between regions in attracting investment, thereby leading to greater efficiency in the economy as a whole.

However, not all virtue is on the side of decentralization. To begin with, there are many functions, which - because of their country-wide significance - are the proper domain of national governments. Examples are stabilization policy; monetary policy, including the regulation and supervision of the banking system; exchange rate policy, including the management of the foreign reserve; and overall fiscal policy, including the management of the aggregate budget deficit.

⁴ The treatment in Section II is intentionally highly condensed; it draws on Shah 1991a, 1991b; Wallich 1982, 1992 and Mahar and Dillinger 1983.

A second compelling case for central provision is that of goods and services characterized by significant economies of scale, examples being transportation, electricity, water and sewerage, telecommunications, etc. In such cases, local provision may not be feasible, and even if feasible, it may be prohibitively costly.

A third case where central provision makes more sense concerns goods and services with considerable external economies (and diseconomies), involving important regional spillovers of benefits and costs. In such circumstances, there is need to take account of all costs and benefits, which makes central provision the only viable option.

Fourth, however affluent a society may be, there are bound to be ceilings on its capacity to generate revenue, which means that there is a limit on the extent to which resources can be divided up between the center and the regions. A certain degree of centralization is therefore inevitable.

Fifth, a major practical problem is that subnational governments may have limited capacity in such areas as budget preparation and execution, as well as tax collection. And attempts to improve their administrative capacity may lead to unnecessary duplication of staff and skills at the central and subnational levels (World Bank 1988: 157).

These are some of the general considerations that need to be borne in mind in allocating functions between the central government and regions as well as in assigning revenue sources to different levels of government. The first is the problem of expenditure assignment, to which we will now turn; the second is the problem of revenue assignment, which we shall consider later.

It is not accidental that expenditure assignment issues should be resolved prior to those related to revenue assignment, because- logically- in order to divide revenue sources between various levels of government, one needs to be clear about the functions each of them is expected to undertake.

However, there is no universally acceptable formula in allocating functions between various levels of government. Each country has to address this question based on its own individual circumstances. However, there seems to be a wide degree of consensus on the proper jurisdiction of certain functions. Thus, defence, foreign affairs, international and inter-regional trade, currency, highways, immigration, civil aviation, and environmental legislation, are usually assigned to the central government. On the other hand, police, local roads, the utilities, water and sewerage, and street lighting and cleaning are considered more appropriate for subnational governments. In between are services that require the involvement of both central and subnational governments, examples being education, health, and social welfare.

In this connection, there is an important distinction to be made between **providing services** and **financing** them. The level of government providing a given service does not necessarily have to finance it (Wallich 1992: 64). For instance, although the central government

may finance social welfare programs, their administration may be better left to subnational governments.

Country experiences with respect to expenditure assignment represent a wide spectrum, from those in which the role of the central government is extremely limited (e.g., the former Yugoslavia) to those in which the center plays a dominant role (e.g., Brazil, India, the former Soviet Union). In this context, it is useful to distinguish between *de jure* and *de facto* arrangements for expenditure assignment, because there is often a divergence between the two. Thus, a central government whose role is rather narrowly defined by laws may in actual fact be far more dominant in practice (Bird and Wallich 19993: 3).

B. Issues of Revenue Assignment

Once functions are allocated between the central and subnational governments, the primary task is one of assigning to each level of government revenue sources that will enable it to discharge the tasks with which it has been entrusted. This is the problem of revenue assignment.

It has been asserted that "ideally each subnational government provides both the level and mix of public services and the means of financing these services that most closely meet the preferences of individuals in its own jurisdiction" (World Bank 1988: 157). However, in practice, here too there is a wide range of country experiences, and it would be difficult to evolve rules that would meet universal acceptance, beyond the stipulation that the revenue sources assigned to a particular level of government should, as far as possible, be adequate to permit it to discharge its functions. However, on the basis of considerations of efficiency (minimizing resource cost) and equity (consistency of revenue means with expenditure), Musgrave suggests the following principles:

- i) Progressive redistributive taxes should be central;
- ii) Taxes suitable for economic stabilization should be central; lower level taxes should be cyclically stable;
- iii) Tax bases distributed highly unequally between jurisdictions should be centralized;
- iv) Taxes on mobile factors of production are best administered at the center;
- v) Residence based taxes such as sales of consumption goods to consumers or excises are suited for states;
- vi) Taxes on completely immobile factors are best suited for local level;

- vi) Benefit taxes and user charges might be appropriately used at all levels (Shah 1991: 4-5).

But even agreement on these rules of revenue assignment leaves some questions unanswered. The assignment of certain revenue sources to a given level of government need not necessarily give it authority to determine the bases and rates of collection, or even their administration and collection. Thus, legal authority for levying a certain tax (including the determination of tax base and tax rates) may rest with the central government while a lower level of government may be given the authority to collect revenue from it and use it for its own purposes. Although there are no simple criteria to guide decision-making in this regard, clarity on jurisdictions is of the utmost importance.

In this connection, one can identify five possible categories of revenue sources: a) those levied and collected by the central government and used for its own purposes; b) those levied and collected by the central government, but used entirely by the regions; c) those levied and collected by the central government, but shared by it and the regions according to some formula or formulas; d) those levied by the central government, but collected by the regions and used for their own purposes; and e) those levied, collected and used by the regions.

C. Addressing the Problem of Vertical Imbalance

1. Measuring Vertical Imbalance

As indicated earlier, vertical imbalance arises when expenditures and revenues at different levels of government - central or otherwise - do not match, a problem that is encountered in most federal arrangements. However, measuring the extent of imbalance may not be a straightforward matter.

But there have been attempts to suggest such a measure, usually referred to as the coefficient of vertical imbalance. Thus, Shah (1991a: 27) suggests the following formula for the coefficient:

$$1 - \frac{(B + C)}{D},$$

where A= total revenue and grants;
 B= transfers (grants from other levels of government);
 C= net borrowing = (A-D); and
 D= expenditures (total expenditure + lending - repayments).

A value of 1 for the coefficient would mean absolute control by the central government over lower units, whereas a value of 0 would mean that lower units are absolutely autonomous.

While a high value of the coefficient is considered desirable because it would approximate the expenditure rules discussed above, a value of 1 is not set as a goal.

In another paper, Shah (1991b: 19-21) proposes three alternative measures for the coefficient of vertical imbalance, "one considering conditional transfers and borrowing only, a second one by incorporating unconditional transfers and a third one by bringing in shared taxes as well". These are referred to as V_1 , V_2 and V_3 , respectively, and their expressions are presented below:

$$\begin{aligned} V_1 &= 1 - \frac{(S_c + B)}{E}; \\ V_2 &= 1 - \frac{(S_u + S_c + B)}{E}; \text{ and} \\ V_3 &= 1 - \frac{(S_u + S_c + B + T_s)}{E}; \end{aligned}$$

where:

- S_c = conditional transfers from the center to lower units;
- S_u = unconditional transfers from the center to lower units;
- B = net borrowing by lower units;
- E = expenditures by lower units; and
- T_s = shared taxes.

Still another measure for the coefficient of vertical imbalance appears in Wallich (1982):

$$V = (a_1 T_o + a_2 T_s + a_3 NTR + a_4 Gu + a_5 G_c + a_6 B),$$

where,

- V = coefficient of vertical imbalance;
- $a = 0$ or 1 , depending on whether the revenue source is controlled by lower levels of government or the central government, with possible variations between 0 and 1 if the center and lower levels share control over the same revenue source;

- a_1 = own taxes;
- a_2 = shared taxes;
- a_3 = non-tax revenues;
- a_4 = unconditional grants;

- a_s = conditional grants;
- a_g = borrowing by lower levels of government;
- T_o = own tax revenue;
- T_s = shared tax revenue;
- NTR = non-tax revenue;
- G_u = unconditional grants; and
- B = borrowing.

Whatever measure of vertical imbalance is used, where such imbalance exists, it calls for adjustments on the revenue side, on the expenditure side, or on both sides. As indicated above, on the expenditure side, it would involve re-assigning responsibilities so that expenditures would be more in tune with revenues. More often, however, the adjustments are made on the revenue side, and the principal mechanisms for doing so are revenue sharing and transfer arrangements. Loan finance, although somewhat different, can also be considered in this context.

2. Revenue Sharing

Conceptually, it is useful to distinguish between tax base sharing and revenue sharing. The former involves "two or more levels of government levying own rates on a common base" (Shah 1991: 6). The usual practice is for the higher level of government to determine the tax base (e.g., sales) and for lower levels of government to levy supplementary rates on the same source. It is customary for one level of government to collect the revenues and share them with other levels (Shah 1991: 6-7).

In the case of revenue sharing, "one level of government is given an unconditional access to a specified share of revenues collected by another level of government" (Shah 1991: 7) on the basis of criteria mutually agreed upon. This requires a determination of what revenue sources to set aside for this purpose and the share of revenues going to different levels of government. This is by no means an easy task. However, the over-riding consideration is one of enabling the various levels of government to raise sufficient financial resources for the discharge of responsibilities assigned to them.

3. Inter-governmental Transfers

But revenue sharing arrangements by themselves are unlikely to resolve the problem of vertical imbalance. It is therefore inevitable that there will be need for transfers of finances from one level of government to others. Although the usual practice is for transfers to be made from the central government to the regions, it is also possible to have reverse flows (Hardy and Mihaljek 1992: 14).

One major motivation of grants is equity. Where resource endowments are uneven and different regions exhibit different levels of development, grants are an important means of

narrowing regional inequalities, but it is also common to use grants for promoting efficiency as well.

Grants may either be general or specific. In the case of general grants, the practice is for the central government to set aside a certain proportion of total revenue as grant funds and distribute these among the various regions on the basis of certain criteria (e.g., level of development, population size, absorptive capacity, regional development initiatives and special political considerations, if any). With general grants, regions are not subjected to any restrictions in the use of funds; they can use them as they see fit. The major policy questions involve the size of the grant fund and the criteria to use in allocating money among different regions.

In the case of specific grants, however, funds are granted for defined purposes, usually activities that the central government wishes to encourage (e.g., rural road construction, primary education, basic health services, etc.).

Grants could also be classified as non-matching and matching. In the case of matching grants, the funds received by regions are proportional to what they themselves raise from their own resources, the basic motive being encouraging the regions to maximize initiatives for self-financing. If they are of the general type, they can be used to correct inefficiencies in the provision of public goods with significant externalities (Shah 1991a, 1991b). But they are insensitive to regional disparities in fiscal capacities, because they operate on the principle "to those who have more, more will be given".

Non-matching grants (which could be general or specific) are funds transferred from one level of government to another without requiring the recipient to raise matching funds. While they widen the freedom of the recipient considerably and are less biased against disadvantaged regions, they are not designed to encourage regional initiatives for resource mobilization.

The most fundamental policy issue is how to design a judicious package of grants that will, at the same time, enhance the fiscal capacities of regions, give them a reasonable latitude in spending, promote equity, and provide the center some control in the spending of money that it makes available.

4. Loan Finance

Even with revenue and transfer arrangements in place, regions may still find themselves with a shortfall of revenue relative to expenditure. This raises the need for regions to borrow from domestic and/or foreign sources. In most federal arrangements, borrowing from external sources is a power reserved for central governments, although some countries allow subnational governments too to borrow externally (Bird and Wallich 1993). Therefore, we will confine ourselves to issues of domestic borrowing.

In principle, such borrowing could be made from the public (by floating bonds), from private financial institutions or from the financial institutions of the central government. Since the first two do not involve more than one level of jurisdiction, it is inter-governmental borrowing that interests us.

Such borrowing may either be general, i.e., devoted to the financing of the overall budgetary deficit or it may be tied to specific projects. From the perspective of the region taking the loan, loans are less preferred than grants because they involve repayment obligations. However, they have the advantage that they may provide greater spur to efficiency in their utilization because they have to be paid back, which means that resources for servicing them have to be generated.

From the viewpoint of policy, the major issues involved in loan finance are what the upper limit of borrowing should be, conditions of borrowing (including grace period, interest obligations and repayment period), criteria for eligibility (including whether or not they should be project-tied), and the formal procedures that have to be followed in acquiring them. While all these are important considerations, perhaps the most significant from the viewpoint of overall fiscal management is the extent to which regions are permitted to borrow from the central government. Their needs will have to be viewed in conjunction with macroeconomic concerns, which would necessarily dictate prudence.

5. A Summing Up

The discussion in this section may now be summed up by pulling together some of the salient points (Shah 1991a: 14-15; Litvack and Wallich 1993: 6). First, as much as possible, regional governments should have broad autonomy in determining their own priorities with respect to functions assigned to them. Second, revenue assignment should ensure that, as much as possible, there is a matching between expenditure needs and revenue generated from their own sources. Third, where there is a mismatch between the two, there should be adequate provisions for resolving the matter, through revenue sharing, transfers and loans. Fourth, attention should be given to ensuring equity between regions. Fifth, center-region relations should be characterized by transparency and simplicity, which means there should be no room for arbitrariness regarding what regions can get from the center, and the rules and procedures should not be unnecessarily complicated. Sixth, a concern with equity should not, however, lead to the undermining of efficiency. Seventh, the system should, as much as possible, give incentives to subnational governments to maximize their resource mobilization efforts. Finally, whatever relationships are established between the center and the regions should not jeopardize overall fiscal management.

III. Vertical Imbalance in the Ethiopian Context

A. Expenditure Assignment

1. Legislative Provisions

Table 1 summarizes the functions assigned to the center and the regions, based on Proclamation No. 7/1992 (TGE 1992b). As is evident from the table, the regions have been assigned specific functions on top of which they are expected to perform those not explicitly reserved for the center. The responsibilities assigned to the regions are fairly extensive.

The division of functions between the central government and the regions seems fairly conventional. However, partly because the expenditure assignment is presented in a highly condensed form, it is characterized by many ambiguities. For instance, economic policy is reserved for the center, but it is not clear what aspects of economic policy this refers to. Presumably it means macroeconomic policy, but there is no explicit statement to this effect. A conspicuous omission in this regard is foreign trade, which normally falls within the jurisdiction of central governments, but there is no provision made for it in Proclamation No.7/1992.

In a similar vein, the task of "establishing and administering major development establishments" is reserved for the central government, but since no definition of "major" is offered, one is not clear as to the criteria establishments have to meet in order to be designated major. Obviously, there are various ways of defining "major", including size of investment and employment. Unless this is clearly spelled out, it provides opportunities for different interpretations, and therefore a potential for creating tension between the center and regional governments.

2. The 1993/94 Budget

Based on the 1993/94 budget, Tables 2 and 3 provide a summary of the distribution of expenditure between the central government and the regions, for recurrent and capital expenditure, respectively. Looking at the distribution of recurrent expenditure first, we note that the share of the regions is only slightly over 37%, indicating that the bulk of the expenditure is allocated to the central government.

There are, however, significant sectoral variations. The areas in which the shares of the regions are pronounced are essentially the social sectors as a whole (77.6%), particularly health (83.2%), and education and training (83.2%). Of spending on economic services, too, the share of the regions is a respectable 58.3%. Another area in which their share is significant is public order (65.8%). In contrast, their share in defence is nil, as is to be expected, and their share in general services is low (25.5%). One also notes that their share in "other expenditures" is low (8.8%). This category mostly consists of external debt service payments, the burden of which is totally borne by the central government, although the regions share in the benefits.

In general, although their share in given sectors is quite high, they account for less than 40% of total expenditure because the sectors in which they have sizeable shares do not figure prominently in the recurrent budget.

Table 1: Expenditure Assignment in Ethiopia

Central Government	Regional Governments
Defence	All matters with the exception of those listed in Column 1
Foreign affairs	
Economic policy	Borrow from domestic lending sources and levy duties and taxes
Conferring of citizenship	
Declaration of state of emergency	Issue and implement laws and rules relating to public services which do not conflict with the relevant policy of the central government
Deployment of army where situations beyond the capacity of regional governments arise	
Printing of currency	Establish, direct and supervise social and economic development establishments or enterprises
Establishing and administering major development establishments	Prepare, approve and implement their own budgets
Building and administering major communications networks and the like	Administer, develop and protect their natural resources
	Employ and administer their own personnel in accordance with the public service and pensions laws of the central government
	Establish and direct security and policy forces in accordance with the policy and directives of the central government
	Establish judicial organs to decide on matters not specifically assigned to the central government
	Own properties of the region; acquire ownership of property; and transfer property

Source: TGE 1992a

**Table 2: Share of Central Government and Regions
in Recurrent Expenditure (million Birr)**

	Total	Center	Regions	Share of Regions (%)
Total	4600	2890	1710	37.2
Administration and General Services	1345	990	355	26.4
National Defence	658	658		0.0
Public Order	231	79	152	65.8
General Services	294	219	75	25.5
Economic Services	463	193	270	58.3
Social Services	1220	273	947	77.6
Education and Training	790	133	657	83.2
Health	301	50	251	83.4
Other Expenditures	1572	1433	139	8.8

**Table 3: Share of Central Government and Regions
in Capital Expenditure (million Birr)**

	Total	Center	Regions	Regional Share (%)
Total	3847	2413	1434	37.3
Administration and General Services	152	92	60	39.5
Economic Services	3049	2185	864	28.3
Social Services	646	136	510	79.0
Education and Training	317	83	234	73.7
Health	198	24	174	87.8

Source for Tables 2 and 3: TGE 1993b

Interestingly, their share of the capital budget is the same as that for the recurrent budget. Here again, one observes the same sectoral pattern, with most of the expenditure on the social sectors assigned to the regions: health (87.8%) and education and training (73.7%). A striking difference, however, is that their share of capital expenditure on economic services (28.3%) is much lower than the figure for recurrent expenditure (58.3%). The major explanation for this seems to be that capital expenditures in the areas of mining and energy, industry, transport and communications, trade, and financial services are largely borne by the center, whereas the regions have greater responsibility for such activities as agriculture and natural resources.

B. Revenue Assignment

1. Legislative Provisions

The major legislative act defining revenue assignment is Proclamation No.33/1992 (TGE 1992b), which deals with both tax base sharing and revenue sharing. According to this law, the objectives pursued by the government are enabling the regions to carry out the responsibilities assigned to them; encouraging regional initiatives; narrowing the development gap between regions; and promoting activities that are "of common interest to regions".

The criteria employed in assigning revenue sources are stated as being ownership of sources of revenue; the national or regional character of the revenue sources; convenience of tax levying and collection; considerations such as population size, resources and levels of development; and considerations of the integrated and balanced development of the economy.

The provisions of the law regarding allocation of revenue sources are presented in Table 4. A careful reading of this law reveals that there are a number of problems. First, what is the extent of the regions' powers in raising revenue? Although Proclamation 7/1992 is unequivocal in giving them the power to levy dues and taxes, the provisions of Proclamation 33/1992 seem to qualify this power considerably. In the first place, the rates of taxes reserved for joint use by the central government and the regions (in addition to those assigned exclusively to the center) are to be fixed by the central government. Thus, the regions have no say in these matters. What about the sources reserved exclusively for them? Specifically, can they introduce new taxes and can they raise the rates on existing ones? While Proclamation 7/1992 would suggest a positive answer on this score, the following provisions of Proclamation 33/1992 show that matters are not so simple after all:

In order to avoid cascading incidence effect of the tax levied by the Center and the Regions and to enable the harmonized implementation thereof, the tax systems shall have a unified policy base.

The Ministry of Finance shall ensure that the tax laws issued at both levels adhere to the provisions of sub-article 1 of this Article [the paragraph immediately preceding this one].

The phrase "unified policy base" is highly ambiguous and is therefore amenable to a variety of interpretations. At any rate, it is quite clear that the regions do not have a *carte blanche* even with respect to the revenue sources specifically assigned to them, since the last word seems to rest with the Ministry of Finance.

Secondly, even though the division of revenue sources between the center and the regions is generally clear, there are certain issues that could be contentious when it comes to practical implementation. Take, for example, the provision that reserves revenue from "profit tax, personal income tax and sales tax from enterprises owned by the Regional Governments" to the regions. This is not problematic in principle, but could create difficulties of implementation. It would require the handing over of certain enterprises to the regions, and this could cause problems of both equity and efficiency, given the uneven distribution of such enterprises between the regions. The same is true of "taxes collected from rent of house [sic] and properties owned by the Regional Governments"; however, it appears that ownership of most such properties has already been transferred to the regions.

Perhaps an even more difficult problem would be determining a formula whereby revenue from the sources for joint use by the center and the regions can be divided among them. It is stipulated that a committee will be set up "to study conditions and submit recommendations guiding sharing of revenue", including suggestions on how to resolve disputes when they arise. There is no public knowledge that such a committee has been set up. But one can foresee certain problems that it can encounter. In the first place, it will not be easy to work out a formula that will be acceptable to both the center and the regions. Secondly, the law seems to imply that joint sharing only applies to cases in which regions undertake the kind of activities mentioned, such as enterprises jointly owned by the center and regions, organizations paying taxes, "large scale mining, petroleum and gas operations", and forests. This is bound to raise questions of equity in view of the uneven distribution of such resources between regions.

An additional problem concerns the adequacy of the revenue sources reserved for the regions, especially in view of the responsibilities entrusted to them. As will be demonstrated in Section III. B below, given the structure of the Ethiopian revenue system, the money likely to be raised from these sources is bound to be limited (Eshetu 1992c). However, the special case of the agricultural income tax needs to be noted. Although the law provides an elaborate and progressive rate structure for annual agricultural incomes exceeding Birr 600 per year, past practice almost invariably has been that farmers pay the minimum flat rate of Birr 20 (Eshetu 1987). Now that the regions have a much greater incentive in the efficient collection of this tax, their revenues may increase considerably.

Still another problem that has not been addressed in the legislation is the allocation of external assistance and grants. In the 1993/94 budget these account for more than 50% of total revenue, which is evidence of their dominant role in the revenue structure. Given their importance, the question of their allocation between the center and the regions should have been explicitly treated. Although the issue has not been dealt with in the relevant legislation,

Table 4: Revenue Assignment in Ethiopia
(Article 5, Proclamation No. 33/1992)

Central Government	Regional Governments	Central and Regional Governments
<p>duties, taxes and other charges levied on the importation and exportation of goods;</p> <p>personal income tax collected from employees of the Central Government and International Organizations;</p> <p>profit tax, personal income tax and sales tax collected from enterprises owned by the Central Government;</p> <p>taxes collected from national lotteries and other chance winning prizes;</p> <p>taxes collected on income from air, train and marine transport activities;</p> <p>taxes collected from rent of houses and properties owned by the Central Government;</p> <p>charges and fees on licenses and services issued or rendered by the Central Government.</p>	<p>personal income tax collected from employees of the Regional Governments and employees other than those covered under sub-articles 2 and 4 of this Article;</p> <p>rural land use fee;</p> <p>agricultural income tax collected from farmers not incorporated in an organization;</p> <p>profit and sales tax collected from individual traders;</p> <p>tax on income from inland water transportation;</p> <p>taxes collected from rent of house and properties owned by the Regional Governments;</p> <p>profit tax, personal income tax and sales tax collected from enterprises owned by the Regional Governments;</p> <p>without prejudice to sub-article 4(c) of this Article, income tax, royalty [sic] and rent of land collected from mining activities;</p> <p>charges and fees on licenses and services issued or rendered by the Regional Governments.</p>	<p>profit tax, personal income tax and sales tax collected from enterprises jointly owned by the Central Government and Regional Governments;</p> <p>profit tax, dividend tax and sales tax collected from organizations;</p> <p>profit tax, royalty [sic] and rent of land collected from large scale Mining, any Petroleum and Gas operations;</p> <p>forest royalty [sic].</p>

budget implementation requires that some *modus operandi* be developed, a problem to which we will return when considering the 1993/94 budget.

Finally, there is a larger political question which may also have an impact on center-region fiscal relations. This concerns the problem of the dual accountability of regional governments that is enshrined in Proclamation 7/1992. According to this law, regional administrations are accountable to both the people of the region and to the central government, a provision that is likely to be problematic when cases of conflict between regional governments and the central government crop up. In this connection, it should also be noted that the relationship between the Ministry of Finance and the regional finance bureaus is not clearly spelled out. In actual practice, however, it seems that this relationship is confined to purely technical and procedural matters, and that it is not jurisdictional. Thus, the formal procedure is for the Ministry of Finance to communicate with the council of the concerned region and not directly with its finance bureau.

2. The 1993/94 Budget

Table 5 summarizes the essential information regarding the distribution of revenue between the central government and the regions, although it is not at all clear how the distribution was made in the case of the revenue sources assigned for the joint use of the center and the regions. This table, read in conjunction with Tables 2 and 3, reveals the striking degree of vertical imbalance that prevails in the Ethiopian budget. The regions, whose share in both recurrent and capital expenditure is about 37%, account for less than 10% of total revenue. If foreign assistance and loans are excluded, their share of domestic revenue rises to slightly more than 20%, which is still low. It is thus quite clear that the revenue sources assigned to them fall significantly short of meeting their expenditure needs.

Another way of looking at the picture is to consider the share of the regions' expenditures covered by the revenues assigned to them. These revenues cover only about 26% of total regional expenditures, and less than half (47.1%) of recurrent expenditures. In other words, the regions do not even have enough revenue to cover their running costs. A rough figure for the overall coefficient of vertical imbalance would be 0.74, which is very high.

This is to be explained largely the structure of revenue, as explained above. Thus, the revenue sources in which the claims of the regions are largest are the agricultural income tax, the land use fee, the tax on rental income, stamp sales and duty, charges and fees, and the pension contribution. These revenue sources between them account for only 9.6% of total domestic revenue. On the other hand, the share of regions in the most important revenue sources is nil or insignificant. Thus, their share in foreign trade taxes, which account for 32.1% of total revenue, is nil; and their share in indirect taxes, which account for 22.7% of total revenue, is only 11.9%.

Table 5: Revenue Share of Center and Regions (million Birr)

	Total	Center	Regions	Regional Share (%)
Total	8207	7401	806	9.8
Tax Revenue	3309	2654	656	19.8
Direct Taxes	1032	497	535	51.8
Personal Income Tax	294	155	139	47.3
Rental Income Tax	45	10	35	77.8
Business Income Tax	505	330	175	34.7
Agricultural Income Tax	107	-	107	100.0
Tax on Dividends and Chance Winnings	2	2	-	0.0
Land Use Fee	79	-	79	100.0
Indirect Taxes	1013	893	121	11.9
Excise on Locally Manufactured Goods	564	560	3.0	0.5
Sales Tax on Locally Manufactured Goods	348	293	56	16.1
Service Sales Tax	42	25	17	40.4
Stamp Sales and Duty	60	15	45	75.0
Foreign Trade Taxes	1264	1264		0.0
Customs Duty and Tax on Imported Goods	1210	1210		0.0
Duty and Tax on Coffee Export	54	54		0.0
Non-tax Revenues	571	425	146	25.6
Charges and Fees	84	25	58	69.0
Sales of Goods and Services	88	45	43	48.9
Government Investment Income	272	272		0.0
Miscellaneous Revenue	71	58	13	18.3
Pension Contribution	57	25	32	56.1
External Assistance	2012	2012		0.0
Capital Receipts	2315	2304	5	0.2

Source: TGE, Fiscal Year 1986 Budget Proclamation (Draft)

page 2

As indicated above, external resources account for more than half of revenue, but it is not clear how these are distributed between the center and the regions. It seems that, of the portion of these resources devoted to recurrent expenditure, nothing is allocated to the regions.

There is also no clear indication of how much of the resources allocated for capital expenditure belongs to the regions. One would have to arrive at a tentative figure by adding up the costs of the various projects assigned to the regions, in view of the fact that the entire capital budget is financed by external resources. The regions' share would probably fall short of 15%. The important point, however, is that there are no publicly known principles for allocation between the center and the regions or between the various regions. This is unfortunate because there are serious issues of efficiency and equity involved.⁵

Given this substantial degree of vertical imbalance in the regional budgets, the next question is how the system attempts to resolve the problem. This leads to the problem of transfers.

C. Dealing with Vertical Imbalance

As indicated earlier, inter-governmental transfers are one mechanism for dealing with vertical imbalance, and there are provisions for them in the Ethiopian legislation. There is, however, some terminological confusion. While Proclamation 7/1992 talks of subsidies, Proclamation 33/1992 talks of both grants and subsidies, apparently using them interchangeably (we will use the term grants in this paper). And matters are not made easier by the terminology used in the 1993/94 budget proclamation. In this piece of legislation there is an item entitled "grants in aid", which actually means subventions made to the Patriotic Association, the Ethiopian Red Cross Society and the Ethiopian Orthodox Church; and there is another category called "subsidy", under which the only item that appears is "fertilizer subsidy". Thus, there is no reference at all to inter-governmental transfers.

According to Proclamation 33/1992, the objectives of grants are multiple, and they are set out as follows: to promote regional socio-economic development; to accelerate the development of relatively disadvantaged regions; to narrow income disparities between regions; to encourage activities with positive externalities and to control those with external diseconomies; and "to encourage foreign currency earning projects and other projects of national interest". These are standard objectives for inter-governmental transfers.

It is interesting to note that only one type of grant is envisaged, namely the matching type. The relevant provision states that "the amount of subsidy to be granted shall be proportional to the contribution made from the revenue collected by the Regions". It may also be noted in passing that the Amharic version gives a slightly different interpretation. Literally translated, it would read "A subsidy will be granted in a manner related to what the region allocates from its own revenue". At any rate, there is no provision for non-matching grants.

⁵ I have been informed that projects have been distributed between the center and the regions on the basis of certain criteria, including the extent of a region's devastation by war, vulnerability to drought, degree of economic backwardness, etc. It does not appear that absorptive capacity has been given significant consideration. Attempts to figure out how external loans and assistance have been divided are complicated by the fact that, at least in the 1993/94 budget, counterpart funds have been used in the same way as domestic revenues.

This is a provision that, although perhaps intended to encourage regional initiatives in resource mobilization, is of course disadvantageous to regions poorly endowed in resources and therefore with low capacity to raise revenue. In view of this, it does not seem that the objectives for grants set out in the law have been taken into account when defining the nature of center-region transfers.

With respect to procedures for regions to obtain grants from the central government, they are required to submit their requests to the Ministry of Finance and the Ministry of Planning and Economic Development, together with their planned expenditures. The two ministries then review the requests, but it is not clearly indicated what body makes the final decision. Nor is there any indication of the detailed criteria to be used in arriving at a decision. In the absence of such criteria, the danger is that the grant making process will lack transparency and depend on the negotiating strength of the regions rather than on their needs.⁶

The other means for dealing with vertical imbalance is borrowing by the regions from the center. According to Proclamation 33/1992, in order to borrow regions should

submit to the Ministry of Finance or to the Ministry of Planning and Economic Development as the case may be, the loan amount required to cover their deficit together with statements showing the relations of the requested amount with the revenue collection forecast [sic] and with economic indicator [sic] and shall attach a copy of their consolidated budget and the feasibility study report of the project for which the loan is required with the loan application form.

The next step is for the relevant ministry to study the request by taking into account general economic indicators and the overall country-wide budget, and then "obtain decision [sic] on the amount that each Region may borrow within the national limit set by relevant laws and communicate the same to the National Bank of Ethiopia and to the Regions".

Here again, it is not indicated which body has the final authority in deciding on the regions' applications for loans. One gets the impression, however, that the loans are to be tied to specific projects rather than being for general deficit financing purposes. Also, it seems that the ceiling for borrowing is set by overall economic considerations. Therefore, it appears that the center will exercise tight control over borrowing by the regions.

These are the legal provisions. What practice was followed in drawing up the 1993/94 budget? Unfortunately, there is nothing one can get by scrutinizing the budget and there is little public information that is available elsewhere. It seems that for 1993/94 the regions are not expected to engage in borrowing, which means that all borrowing will be done by the center.

⁶ This is a general statement, not one specifically related to the 1993/94 budget. In this case, in fact, it seems that the regions were not even consulted.

IV. Conclusions and Recommendations

As suggested at the beginning of this paper, a central problem of fiscal federalism is how to avoid the extremes of too much concentration of fiscal powers at the center or at lower levels of government. The first leads to regional fiscal autonomy that is more form than substance while the latter leads to a central government that is so economically weak that it cannot perform even its most rudimentary functions.

Our review of the Ethiopian situation leads us to conclude that the degree of vertical imbalance in regional budgets is rather pronounced and that there are a number of limitations in the mechanisms used in resolving the problem.

With respect to revenue assignment, it is obvious that the revenue sources assigned to the regions are inadequate to help them discharge the responsibilities assigned to them. It is also obvious that the present capacity of the regions for plan preparation and execution is extremely limited, although there are obvious regional variations. It is known, for example, that the 1993/94 budgets for the regions were essentially prepared for them by personnel of the central government. Since the country is new to the practice of fiscal federalism, neither this nor the limited revenue-generating capacity of the regions is particularly surprising. In fact, it would be more prudent to err on this side than to assign to the regions such revenue sources as will seriously incapacitate the center. As I argued in an earlier paper (Eshetu 1993), there should be no rush to open Pandora's box.

However, attention should also be given to measures that will boost the capacity of the regions to enhance their efforts at resource mobilization. This will require, in the first place, removing all ambiguities in the law regarding their powers to determine tax bases and tax rates.

Since grants will be the major means of covering the revenue shortfall of regions, it is also important to establish criteria and mechanisms for the provision of grants that are transparent and easy to administer. As much as possible, one should avoid the practice of determining grant sizes through negotiations. In this connection, it may be worth looking into the advisability of setting up a grants commission or some such arrangement (as is the practice in many federally structured governments) so that the process of advancing grants will be relatively free from political wrangling.

There should also be an attempt to depart from the practice of having only one type of grant (i.e., the matching type). It is especially necessary to introduce non-matching grants in addition to those already provided for in the law. This should be the major means of narrowing regional disparities in economic development. The procedures for providing grants should also be streamlined so that unnecessary red tape will be eliminated.

It is also necessary to develop detailed criteria to govern borrowing by the regions from the central government. The existing legislative provisions are inadequate and full of ambiguities.

Ultimately, however, the issue is a political one and centers on the relationship between the center and regional governments. The task is one of ensuring that this relationship is based on mutual understanding rather than distrust. Based on the experience of other countries, it has been observed that "regions will consent to the delegation of extensive powers to the central government only if each is confident that its voice will be heard in the formulation and development of policy" (Hardy and Mihaljek 1992: 17). There is no formula for ensuring this, and only time will tell what kind of governance will emerge in the country in the next few years.

In general, however, there is nothing to be gained by undue haste in implementing the new system of fiscal decentralization. There is a vast amount of experience in other countries that Ethiopia can learn from them. The system that will eventually take root should be based on the benefits of such experience. At least in this respect, the country should avoid its unenviable tendency of stubbornly repeating the mistakes of others.

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