

**THE PRACTICE OF FISCAL FEDERALISM IN ETHIOPIA:  
A CRITICAL ASSESSMENT 1991-2012  
AN INSTITUTIONAL APPROACH**

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## Abstract

The long statehood history of Ethiopia is known for its decentralized governance system with many autonomous regions and principals ruled by hereditary regional chiefs under various titles, but accountable to King of Kings at the centre. The autonomous regions were not only paying annual tribute to the king of kings, but also had to cooperate with the centre. Powers of the regional chiefs started to diminish at the turn of the nineteenth century and had been completely abolished in the early twentieth century. The century old exclusive, suppressive and highly centralized governance system came to end in 1991 and a multi-ethnic federal arrangement has been adopted.

The Federal Constitution of 1995 guarantees the right of self-determination of Nations, Nationalities and People (NNP) up to secession. Considerable political and administrative powers have been devolved to the states. Constitutionally speaking assignment of responsibilities to the states makes Ethiopia one of the most decentralized federations. The states have also access to a range of tax bases, except the custom duties related taxes. They have power to determine tax base, tax rate and administer. They have legislative power to levy and administer jointly over concurrent taxes. The Constitution also guarantees borrowing right of the states. The devolutions of all these powers to the States are political preferences of the ethnic-based political forces for having strong states.

This dissertation examines the constitutional setting of the political decentralization, the devolution of assignment of responsibilities, taxation powers, the vertical intergovernmental transfer system and borrowing autonomy of the States as well as the *Wereda* (district) level decentralization *vis-à-vis* the practices at ground. The study finds that (i) the decentralization processes have been guided by specific circumstances of political, economic and historical realities of the country; (ii) The Federal Constitution aims at creating strong states. In practice, however, the political decentralization is not only more visible than the taxation and borrowing powers but also there are gaps between the *de jure* and *de facto*; (iii) the states hardly exercise their constitutional taxation powers. The uniformity of 'choices' has jeopardized the state's tax autonomy; (iv) there is little relation between

the degree of decentralization and the states' borrowing autonomy. Generally speaking, the two decades of fiscal decentralization practices show that the intention of the Federal arrangement to have strong states has less congruence with the *de jure*.

### **Author's short curriculum**

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## Lists of Acronym

Abbreviations	Full name
AAPO	All Amhara Peoples Organization
ALF	Afar Liberation Movement
ANDM	Amhara Nation Democratic Movement
ASSP	Agricultural Sector Support Program
BPT	Business Income Profit Tax
BPLM	Benshangul Peoples Liberation Movement
BRICS	Brazil, Russia, India, China and South Africa
CBDS	Capacity Building for Decentralized Service Delivery
CIT	Corporate Income Tax
CoR	Council Of Representatives
CSA	Central Statistics Agency
CSO	Central Statistics Office
CUD	Coalition for Unity and Democracy
EDP	Ethiopian Democratic Party
EEA	Ethiopia Economic Association
ESM	Ethiopian Student Movement
EFFORT	Endowment Fund For Rehabilitation of Tigray
EPLF	Eritrea Peoples Liberation Front
EPRDF	Ethiopian People’s Revolutionary Democratic Front
EPRP	Ethiopian People’s Revolutionary Party
FDRE	Federal Democratic Republic of Ethiopia
FGTF	First Generation Theory of Fiscal Federalism
FZ	Functional Zone Administration
FR&CA	Federal Revenue and Custom Agency
GPDM	Gambela Peoples Democratic Movement
HoF	House of Federation
HoPR	House of Peoples Representative
HPL	Harari People League
HSDP	Health Sector Development Program
ISEN	Institute for Studies of Ethiopian Nationalities
LGs	Local Governments
MEISON	<i>‘Mela Ethiopia Socialist Niknakie’</i> (All Ethiopian Socialist Movement)
NNP	Nations, Nationalities and People
NAs	Nationality Administrations
OFDM	Oromo Federalist Democratic Movement
OLF	Oromo Liberation Front
ONLF	Ogden National Liberation Front
OPDO	Oromo People’s Democratic Organization

PCDP	Pastoral Community Development Program
PIT	Personal Income Tax
PLC	Private Limited Company
PMCA	Provisional Military Council Administration
PSCB	Public Service Capacity Building Program
PSNP	Productive Safety Net Program
SGTFF	Second Generation Theory of Fiscal Federalism
SEPDM	South Ethiopia People's Democratic Movement
SEPDFU	South Ethiopia People's Democratic Forces Unity
SNNP	South Nations, Nationalities and People
SH.CO	Share Company
SDPRP	Sustainable Development and Poverty Reduction Program
SWA	Special Wereda Administrations
TGE	Transitional Government of Ethiopia
TPLF	Tigray Peoples Liberation Front
TVET	Technical and Vocational Educational Training
UEDP	United Ethiopia Democratic Party
ULGs	Urban Local Governments
ULGDP	Urban Local Government Development Program
VAT	Value Added Tax
WA	Wereda Administrations
WLD	Wereda Level Decentralization
WSLF	Western Somalia Liberation Front

## Glossary

Ethiopian Calendar	Ethiopia uses its own calendar which starts from <i>Meskerem</i> <sup>1</sup> (September 11) having 12 months with 30 days each plus 5 or 6 days of <i>Pagume</i> . Ethiopian year calendar lags by 7 years from September 11 to January <sup>1</sup> , and 8 years from January <sup>1</sup> to September 10 from the European calendar.
Ethiopian Fiscal Year	runs from July 8 to next July 7





## Box 1.1. Chronology of (de) centralization Governance system

Period	Major events
100BC to 1137AD	Era of Axumite dynasty. The dynasty constituted many autonomous regions and principalities.
1137-1270	Era of the Zagwe Dynasty. It handed over its political power to the Amhara (Solomonic) dynasty through negotiation.
1270-1769	The era of Amhara (Solomonic) dynasty. The dynasty continued when Menelik II came to power but abolished in 1769
1769-1855	Known as <i>Zemene Mesafint</i> (Era of the Princes). The Yeju Oromo emerged as political contestant with the traditional Tigrians, Amhara, and Agew ruling classes and became among central political power players throughout the <i>Zemene Mesafint</i> .
1855-1869	Tewodros II united the ancient core of Ethiopian Empire by bringing together Gonder, Gojjam, Tigray, Wollo and Shewa. He intended to build a strong central government.
1872-1898	Yohannes IV pursued a <i>de facto</i> federal system by recognizing traditional authority to regional Chiefs.
1898-1913	Menelik II completed the second phase of unification by incorporating new autonomous territories south, east and west of Shewa and crystallized the present political map of Ethiopia.
1917-1935	Ras Tefferi, who became an emperor with crown name of Haile Selassie I in 1930, took consecutive political, administrative and fiscal reforms.
1935-1941	Italy occupied Ethiopia and established an 'Africa Orientale Italiana' by merging the Ethiopian Empire with the former Italian colonies(Eritrea and Somalia) into five regions based on various criteria such as ethnic, history, politics, etc
1942	The Imperial Government of Ethiopia reorganized the administration into five administrative layers.
1945	Municipal governance system was introduced. Some urban centres were given municipal status.
1947	Local Education Board was issued with the objective to expand primary school (grade 1-6) by mobilizing education tax.
1966	Local-self Administration Order was issued with the intention to decentralize some public services to <i>Awraja</i> (County) administration layer.
1975-1991	Era of Military ( <i>Dergue</i> ) regime. It perpetuated centralized state building strategy.
1976	<i>Kebele</i> Administrations were established in rural and urban areas with the objective to bring government closer to the people.
1987	By Proclamation No. 14 of 1987, the First Republic (Peoples Democratic Republic of Ethiopia) was created.
1991	EPRDF assumed power. It organized a Conference on Peace and democracy in May 1991. Political organizations ratified a Charter of the Transitional Government.
1992-1994	The administration structure was reorganized into 14 <i>Killils</i> (Regions) mainly along ethnic lines. Significant political, fiscal and administrative powers were devolved to the Regions.
1995	The Constitutional Assembly ratified the Constitution of Federal Democratic Republic of Ethiopia in December 1994 and came into force in August 1995.
2002	Wereda (district) level decentralization, the second generation of decentralization, came into force.



## **1.1 Statement of Research Problem**

Fiscal federalism deals with separation of assignment of responsibilities and taxation powers among different levels of governments, why and how intergovernmental transfers are designed and distributed as well as the right of sub national governments to borrow from financial institutions. Art.51 and Art.52 of the Ethiopian Federal Constitution defines powers and functions of the Federal Government and the States respectively. The separation of power enables the Federal Government and the States to make decisions independently on their domain areas. But, it is by no means to say that the assignments of responsibilities are strictly exclusive of each other. Rather there are numerous shared functions which call for co operations and negotiations between the two levels of government. The residual power vests in favour of the States (Federal Constitution, 1995 Art. 52(1)). This has been made by design not only to empower the states but also to avoid any ambiguity and vagueness that might arise any claims of power that are not explicitly stated in the Federal Constitution.

In terms of tax assignment, the Federal Constitution categorizes the taxation powers into those of the Federal Government (Art.96), the States (Art.97) and concurrent taxation between the Federal Government and the States (Article 98). The Federal Constitution stipulates that both the Federal Government and the States jointly levy taxes and administer concurrent revenue sources. The adverb “jointly”, however, is not clear whether it implies all states together deal with the Federal Government as a group or each State should reach to consensus with the Federal Government to jointly determine related to tax base, tax rate and tax administration.

Constitutionally speaking, the tax assignment between the Federal Government and the states gives the latter access to various revenue sources. In terms of tax type, it is only the import-export duties exclusively assigned to the Federal Government. Paradoxically, the Federal Government collects about 81 percent of the national tax revenues. Fiscal capacity of the states is weak and they cover below 30 percent of their expenditure needs from their own revenue sources (see MoFED Annual Financial Reports). One may ask why the Ethiopian fiscal

relation is characterized by such a wide vertical fiscal gap, while the states have access to various revenue sources. Many factors have contributed to this. The existing taxation structure is the main reason. Custom tax (import related duties), which is a taxation power of the Federal Government, overwhelms the national tax structure. Sources of direct taxes are at a low level. Weak institutional capacity of the states to efficiently administer tax system is another factor. Third, the distribution of concurrent revenues between the Federal Government and the States favours the former. Fourth, because of the legacy of the previous socialist economy, the ownership of revenue source criterion of tax separation between the Federal Government and the States has made the former to control over lucrative sources of revenues such as the financial sector (Commercial Bank of Ethiopia, Business and Construction Bank, Ethiopian Insurance Corporation), telecommunication, the Ethiopian airline, sugar corporation, cement plants, etc.

Wide horizontal fiscal disparity is also a visible problem. Uneven distribution of economic bases, disparity in infrastructure development, and low tax efforts of the States are major factors for the existing wide horizontal fiscal disparity across the States.

The House of Federation (HoF) designs the distribution of federal subsidies to the States (Federal Constitution, Art.62 (7)). The Article is vague as to whether the power includes determining conditional grants or not, although the practice is limited to unconditional grant. The unconditional grant is a major revenue source of the State. This has two conflicting impacts on the States. On the one hand, it gives to the States more discretion to set their priority expenditure packages between capital and recurrent budgets as well as among various sectors. On the other, it has developed dependency behaviour on federal transfers. The grant system is equity-oriented and it gives little weight to efficiency. The Constitution neither identifies the source(s) of the Federal grant nor set a federal grant floor. States' grant entitlement depends on the decision of the Federal Government.

Sub national government's borrowing power to determine the purpose, the sources and the limit manifest the degree of fiscal decentralization. Article 51(7) of the Federal Constitution enshrines that the States can borrow from domestic financial institutions. Yet, the

legislative body has not yet enacted specific laws on the conditions and terms under which the States can borrow money from internal sources. In practice, however, states' borrowing is exceptional rather than the rule.

The Federal Constitution does not recognize local governments (LGs). Rather, they are creatures of the States. Such arrangement allows the states to structure their LGs in a way that fits their specific circumstances. LGs are major providers of public services. But they have little discretion over capital expenditure as the States determine what, where and when capital investments should be carried out. Moreover, they have no taxation power except over municipal revenues. State politicians are reluctant to devolve taxation powers on the pretext of managerial incapacity of the LGs.

In Ethiopia, the prescriptions of the first generation of fiscal federalism have little influence in designing the assignments of responsibilities and the revenue assignments between the Federal Government and the States. In addition to the economic principles, distinctive circumstances of the country have necessitated to take into account non-economic variables. It is with this understanding this dissertation attempts to critically assess the practice of fiscal federalism *visa-à-vis* the provisions of the Federal Constitution as well as the States' Constitutions and laws.

## **1.2. Research Objectives**

The general objective of the study is to critically assess the *de-jure* framework in comparison with the practice of fiscal federalism in Ethiopia over the last two decades.

The specific objectives are:

1. To examine the discretionary authority of the States and local governments in relation to their *de-jure* powers and the *de-facto*?
2. To explore the economic and non-economic principles those have been applied in setting the assignment of responsibilities between the Federal Government and the states.
3. To explore the unique principles of tax assignment those have been applied in the Ethiopian fiscal relations.

4. To investigate if the revenue assignments between the Federal Government and the States attest tax autonomy of the states.
5. To assess the rationales and features of the intergovernmental transfer system.
6. To examine the practice of state borrowing in Ethiopia, and
7. To examine if the 'revisited golden rule' of borrowing is respected in financing long term investments.

### **1.3 Research Questions**

The Federal Constitution ensures considerable political, fiscal, and administrative powers to the States so that they would be able to determine their affairs, to have discretionary authority in allocating their budget that reflects local preferences. Therefore, the research questions of the study are:

1. To what extent is the Ethiopian fiscal federalism decentralized in terms of de-jure and de facto?
2. What principles govern the separations of assignments of responsibilities between the Federal Government and the States?
3. What principles govern the separation of taxation powers between the Federal Government and the States?
4. To what extent do the States enjoy tax autonomy?
5. What are the objectives and characteristics of the Ethiopian intergovernmental fiscal transfers?
6. Does the states' borrowing practice attest strong states?
7. Is the 'revisited golden rule' respected?

### **1.4 Research Methodology and Source of data**

This dissertation is explorative and descriptive analytical research. It examines the practice of fiscal federalism in Ethiopia from an institutional approach. The assessment considers all the states and the two city governments. In addition, all capital cities of the States were purposely selected to examine the practice of the Wereda (district) level decentralization program launched in 2002.

The research uses secondary and primary data. Libraries; archive sources; federal, State and local governments' official reports; minutes; proclamations and regulations...etc, were the main source of secondary data. Primary data were created through carrying out in-depth discussions with key informants by designing semi-structured questionnaires. Knowledgeable key informants were drawn from politicians at Federal, Regional and Wereda levels of government and experts on the basis of their professional capacity and/or political assignments. Accordingly, discussions were made with Chief Regional Administrators; Heads of Bureaus/ Offices of Finance and Economic Development, Education and Health, Water supply, and Road authorities. In addition, in order to solicit a wide variety of information, discussions were also held with members of Finance and Budget Committees of the HoPR, HoF, Council's of the States and Heads of the selected urban LG. Field observations were also used as part of primary information source.

### **1.5 Relevance of the study**

The highly centralized state-building strategy and assimilationist policy during the past century had failed to bring political stability, democratization and economic prosperity in Ethiopia. As a response to the assimilationist policy that ignored and/or concealed the existence of ethnic, cultural and language pluralism, the multicultural federal system affirms equality and rights of the NNP to Self-determination including secession. Such a bold federal experiment is believed to have some relevance for the multiethnic African countries in general and to the emerging decentralized/federal system in the Horn of Africa (Kenya, Somali, Sudan, South Sudan Republic, Eritrea etc) in particular. If the experience of Ethiopian fiscal federalism is associated with equal access to public services of citizens irrespective of their state residence, political stability, accommodation of diversity, individual and collective rights, democracy, budget autonomy and states' tax sovereignty etc, then it will be an important reference to any comparative study of a multicultural federal system in Africa. An examination of its drawbacks may also provide a good lesson to African brothers and sisters not to repeat similar mistake(s).

The practice of fiscal federalism in Ethiopia from the political economy perspective has been barely researched, although there are numerous studies on the constitutional and administrative aspects of the Ethiopian federalism.<sup>1</sup> Hence, this dissertation will also contribute to the global experiences of fiscal federalism. Finally, it may encourage other scholars to carry out further research on the subject matter.

## **1.6 Time period considered**

It has been about two decades since Ethiopia has adapted a decentralized system. A *de-facto* federal structure had been instituted in the country during the Transitional Period of 1991-1994. After the end of the Transition, the FDRE Constitution entrenched a federal structure in the country. Therefore, the dissertation covers the periods of 1991/2 to 2011/12.

## **1.7 Organisation of the dissertation**

This dissertation is organized into ten chapters. The first chapter is an introductory section that describes statement of research problem, research objectives, research questions, research methodology including sources of data, scope of the research, significance of the study, and organization of the study. Chapter 2 gives brief historical overview of the (de)centralization governance system in pre-1991 with the objective to familiarize the readers with the relationship between the centre and the constituent provinces and the state building strategies that have been pursued since 1855. Emphasis was given to the Emperor Haile Slassie and

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1 Solomon Negussie (2006) did his PhD entitled “Fiscal Federalism in the Ethiopian Ethnic-based Federal System”, Utrechts Instituut, Netherlands. It emphasizes on the legal aspect of fiscal relations between the Federal Government and the States. Pawlos’ (2007) dissertation entitled “What One Hand Giveth, the Other Hand Taketh Away: Ethiopia’s Post 1991 decentralization reform under patrimonialism” the ISS, Netherlands, examines the practice of decentralization from a public Administration Perspective.



the Dergue regimes as their centralized and assimilationist policies had instigated nationality question and has been led to the present multiethnic federal arrangement. Chapter 3 discusses the constitutional context, uniqueness of the Federal constitution, institutional arrangements and the making and remaking of the States and local governments in the 1990s. Chapter 4 reviews the economic and non-economic principles of assignments of responsibilities to different levels of government with the objective to give theoretical background to the readers. Chapter 5 examines the practice of assignment of responsibilities among different levels of government in Ethiopia and examines how the practices are coherent with the theories of fiscal federalism and/or how the practice enriches the theories. Chapter 6 is about the general principles of revenue assignment and discusses from the first and second theories of fiscal federalism. Chapter 7 assesses the separation of taxation powers between the Federal Government and the States as well as between the State of Tigray and respective urban local governments. The next Chapter discusses the rationale of transfers, legal framework and principles of transfers, and assesses the practice of intergovernmental transfers in Ethiopia. Chapter 9 gives some conceptual background and rationale of borrowing. It also briefly describes the legal framework and examines the practice of borrowing in Ethiopia. The last chapter provides a summary of the main findings and suggests some policy recommendations.



periods, the constituent provinces used to enjoy self-rule with a wide range of political, judicial, military and taxation powers. The second section deals with the (de)centralized empire and state building strategies that took place from the period of unification (1855) to 1991. This section emphasizes the political, tax and administration reforms that had been undertaken under various regimes. It also discusses how the century-old centralized and exclusive political systems of the Emperor Haile Selassie and the Dergue regimes had induced ethnic-based movements which paved the way to the supremacy of multi-ethnic politics since 1991.

Therefore, the purpose of the historical narration is not as such to describe what and when events had happened but to briefly sketch the evolution of (de)centralized governance systems in the Ethiopian empire and how the highly centralized and exclusive political system of the 20<sup>th</sup> century has influenced the shaping of the present multiethnic federal arrangement.

## **2.1 Governance System during the Ancient and Medieval Periods**

Ethiopia is the home of human origin and the cradle of civilization with city states like Yeha, Keskesse etc since the 5<sup>th</sup> century B.C. (Sergew, 1972). A well organized state emerged around the first millennium BC at Axum, the present-day Tigray State (Fattovich, 2000:13; Munro-Hay, 1991). The remnants of pre-Axumite city states, the longest monolithic obelisks in the World standing in Axum, the Sabeen and Geez scripts, the golden Axumite coins, the fine and extensive Palaces, the metal works in silver and bronze are some living testimonies of the glory of past Axumite kingdom.

The political system of the Axumite kingdom was characterized by “...a loose federation” comprising many autonomous states and principalities accountable to the king of kings at the centre (Munro-Hay, 1991:134). The decentralized system enabled the Axumite emperors to maintain their hegemony over their subjects by recognizing the hereditary local autonomy. It also seemed to contribute to effectively administer and to promote political stability.

The Axumite kingdom started to decline in the eighth century and came to an end in the early 12<sup>th</sup> century for various external and internal

factors.<sup>3</sup> The invasion of the Agew (Zagwe) against the Axumite kingdom caused to shift the centre of political gravity from Axum and Axumites to Lasta and Agew, who established the Zagwe dynasty (1137-1270) in North Wello, Amhara State.

Like the Axumite, the Zagwe dynasty was a hereditary monarchical system where the emperors placed themselves at the centre having many kings and chiefs with substantial autonomy at regional and local levels. Urbanization and urban cultures (such as architectural skill, ecclesiastical matters<sup>4</sup>) also characterized the Zagwe dynasty (Tekeste, 2006:131). The Zagwe dynasty lasted only for two centuries because, the Amhara strongly resisted both in peaceful and armed means by claiming they were direct descendants and sole heir of the Axumite kingdom (Munro-Hay, 1991:23). As an effect, the Zagwe dynasty's came to an end by abdicating its power to the 'Solomonic' dynasty through negotiation (Alemaheyu, 2003 EG: 44).

The Amhara controlled political power until 1974<sup>5</sup> by creating the so called "Solomonic dynasty"<sup>6</sup>, which served as an effective political ideology for gaining royal legitimacy and hereditary power right. Like the previous dynasties, until the second half of the 19<sup>th</sup> century, the Solomonic dynasty political structure was characterized by "a loose confederations of regional princedoms" (Tekeste, 2006:133, cited from Tadesse, 1972:95).

During the Medieval periods, the empire faced a "series of threats from Islam..." (Tekeste, 2006:135). The long war between the Christian Empire and the Islamic state (1524-1543) diminished political and economic powers of the Ethiopian empire, destroyed its social capital,

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3 The invasion of Arabs from the Red sea cut-off the Axumits from their former external trade partners (Trimingham, 1952:46), Roland and Page, 1970:92). The uprising of the Beja against the Axumite (Buxton, 1970:43) was among the factors for the decline of the kingdom.

4 The dynasty has left the monolith rock-hewn churches of Lalibela, which is one of the World's wonders.

5 With the exception of the Zemene-Mesafint (Era of the Princes) which took place from 1769 to 1855 and the periods of Emperor Tewodros II( 1855-1869 ) as well as emperor Yohannes IV( 1872-1889).

6 The Amhara rulers linked their roots to the King Solomon of Israel through Menelik I, who is believed, at least by the majority of Ethiopians, to be the son of King Solomon and Queen Sheba of the Axunmite kingdom.

and resulted in the expansion of the Oromo all corners of the Empire<sup>7</sup>. The “Solomonic” dynasty was also divided into the Gondorian line and the Shewa line (Jones and Monroe, 1970, Lapiso, 1982:236 and 243). The former line established a permanent political and administrative centre at Gondar and controlled the political power until it was thrown out by the Yejju Oromo in mid 19<sup>th</sup> century. The latter line made its centre in the present north Shewa. It maintained its autonomy but used to pay annual tributes to the Emperors in Gondar. It also expanded its empire southwards to control resources including the slave trade route.

The ancient and medieval histories of Ethiopia were characterized by a loose federation governance system, although during the 15<sup>th</sup> and 16<sup>th</sup> centuries, there were attempts of centralization of power<sup>8</sup>. During the ‘*Zemene-Mesafint*’, emperors at the centre had very weak power. Gonder, Gojjam, Tigrai, including Bahire-Negash, the present highland of Eritrea, Wello, Yejju, Lasta and Shewa and others were semi-independent regions with strong standing armies, revenues and judicial powers. Vertical relations between the Centre and the Regional lords were not stable and institutionalized, rather they were volatile depending on their military strength, economic base and the marriage

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<sup>7</sup> Yejju Oromo emerged as a competing ethnic group for power in the Gonder Palace with the coming of emperor Bakaffa to the throne in 1721 until Tewodros II brought to an end the political upper hand of Yejju Oromo dynasty in the Gonder Court (Molla, 1994:197-198).

<sup>8</sup> Historical documents reveal that there were trends of centralization–decentralization cycles as a means of empire building strategy. For example, Emperor Zera Yakob (r1434-1468) instituted a strong central government at the cost of the provincial autonomy. The emperor used the Ethiopian Orthodox church as an instrument to monopolize power and to impose values, custom and religious doctrine of the ruling class on the other peoples, although he faced strong resistance that caused gross massacre, and blood shade in the entire empire (Alemaheyu, 2003:71:77, see also Getachew, 2003EC). Understanding the cost of power centralization and religion hegemonic policy of his father, Emperor BeEde Mariam (1468-1478), persuaded a decentralized governance system by reinstating autonomy of the provinces under a loose federation. He also relaxed his father’s fundamentalist Orthodox Church policy and guaranteed local people to exercise their traditional custom and values. The federal politics of BeEdemariam served as an effective instrument to restabilize his empire and to bring secessionist territories peacefully under his empire (Alemaheyu, 2003: 86-89 and 148). In contrast, Emperor Sertse-Dingle (r1563-1597) had pursued a centralized empire building strategy to restrain the desire of *Felash’* (Ethiopian Jew) to secede from the Empire (Alemaheyu, 2003:158).

relations they had with each other. Reciprocal recognition between the centre and the regions was necessary to promote stability and cooperation of each other. Regions were supposed to submit annual tributes, to supply warriors and other logistical support, to collaborate and to participate, on demand, when the Emperors carry out military campaigns. In return, the Emperor had to recognize and respect the sovereignty of the regional hereditary lordships and their titles and privileges. But mutual reciprocal recognition was not always a rule of the political game.

It is also worth noting that the provinces which had constituted the *de facto* federal empire were not enjoying symmetric powers and title. For instance, Shewa, Tigray, Gojjam, Begemidir and Lasta (Zagwe) were enjoying first class rank and were granted to wear a golden crown, while territories south of Abay river (towards Awash river) were entitled to wear a copper crown and the rest territories had granted to put on silver crown (Alemaheyu, 2003 EC:148).

## **2.2 Unification of Ethiopia: (De) Centralized State Building Strategies**

### **2.2.1 Emperor Tewodros II Reign (r1855-1868)**

Unification of Ethiopia started at roughly same period when the Meiji Restoration of Japan started. Throughout the periods of Tewodros II to Menelik II, the unification process and the state-building strategies of Ethiopia took place in two interrelated phases. Phase I refers to the unification of the ancient Abyssinian territories of the north. Emperor Tewodros II, a pioneer of modernization and a symbol of Ethiopian unity, ended the *Zemene-Mesafint* by unifying the semi-independent regions of Abyssinia, namely Gonder, Gojjam, Tigray, Lasta, Yeju (Wello) and Shewa. The Emperor pursued a centralized state building strategy. As part of his political and administrative reforms, the Emperor reduced the status of the regional governorship to *Meslane* (representatives/ agents of the centre) with the objective to break down the traditional powers of the regional lords by appointing loyal indigenous aristocrats to rule their local

areas<sup>9</sup>. The *Meslanes* had little military and fiscal powers. Their prime responsibilities included, among others, to maintain local law and order, to provide justice and to collect tithes and taxes on behalf of the Central Government (Jones and Monroe, 1970:131; and Shifereaw, 1990:303).

The Emperor attempted to abolish the military powers of the regional lords by establishing a salaried national army. As part of his economic and social reforms, the Emperor introduced land reforms to mobilize resources for his army, limited church lands and the number of clergy for a church to liberate the peasantry from the exploitation of the Coptic church; introduced salaried public officials; established a territorial police forces to ensure peace and order; and attempted to built an ammunition plant by employing foreigners at Gaffat, north Wello, declared anti slavery (Asmelash,1987:27, Keller, 1981:527 and Keller, 2005:94; Zenebe, 1902 EC; Welde Mariam, 1902EC).

Couple of things seemed to motivate emperor Tewodros II for a strong central government: (i) to protect the sovereignty of the empire from the imminent and long standing expansionist policy threat of the Ottoman/Egyptian's to control the source of Blue Nile, and ii) to see a stable and modern Ethiopia by abolishing the dark age of Zemene-Mesafint characterized by civil wars among the regional lords and backwardness (Tekletsadik, 1981 EC, Zenebe, 1902; Weldemariam,1902; and unknown writer,1902 in Tesfaye, 2004 EC).

The Emperor had a noble vision to see a united, militarily strong and progressive Ethiopia. However, many of his political, economic and social reforms did not endure, due to the strong resistance of regional nobilities, conspiracy of the Coptic Church, brutal gross measures against the peasantry and the British military campaign in 1868 against the Emperor (Zenebe, 1902 EC; Welde Mariam, 1902EC; unknown author, 1902EC; Tekle Tsadik, 1981EC)). And, therefore, all his modernization initiatives and endeavours remained futile (Keller, 2005:94). Shiferaw (1990:304) questions the feasibility and desirability of Tewodrose's excessive power centralization as an empire building strategy.

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9 In the revolting and unstable regions, the Emperor used to appoint among his strong commanders as *Meslen*

### 2.2.2 Yohannes IV Reign (r1871-1889)

Yohannes IV continued the empire building imitated by Tewodros II but with a different approach. Understanding the strong resistance and rebel of the regional nobilities against the power centralization of Tewodros II, and realizing the hereditary regional power based political history of Ethiopia; Yohannes IV pursued a federalist approach or a *de facto* federalism as his state building strategy (Crummey, 1971:115; Shiferaw, 1990:306, Assefa 2007:21). Emperor Yohannes IV was sensitive to the historical autonomy of the regions. He recognized and respected hereditary powers of the regional lords who remained loyal to him and granted the title of King to Menelik of Shewa and Tekle Haimanot of Gojjam; the title of 'Ras' to Micael of Wollo and Wag 'Shum'<sup>10</sup> Teferi of Lasta, by making himself a king of kings of Ethiopia. In the absence of bureaucratic institutions and a constitution, one cannot envisage legally defined power division between the centre and regional lords. Nevertheless, there were clear *de facto* power separations. The Emperor was responsible mainly for defending the sovereignty of the empire from external aggression; carrying out foreign relations and seating in imperial *chilot* (Justice) including appeals from regions, while the regional lords had full-flagged authorities in military, judicial, and levying taxes in their jurisdictions (Shiferaw, 1990:306, Bahru, 2001:60). They had obligation to pay annual tributes to the centre to supply fighting forces to the centre when asked and to defend the empire under the leadership of the emperor against foreign invasions. Yohannes tried to manage internal conflicts by granting genuine internal autonomy to the regional lords, although there were instances of non-co operation from Menelik II, a major power rival of Yohannes IV.

### 2.2.3 Menelik II Reign (r 1889-1913)

The second phase of empire building strategy refers to the completion of the making of the modern Ethiopian Empire to its present-

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<sup>10</sup> Ras (literally Duke), *Dejazmach* and *Shum* are traditional titles.



day. Menelik II incorporated the autonomous territories of South, West, and East of Shewa with the core ancient Ethiopian Empire from late 1880s to early 1900s (Asres 1958). The present-day political map of Ethiopia is a product of Menelik II's military campaigns to the south of Shewa as well as the various border agreements made between Ethiopia on the one hand, and Italy, British and France, which colonized Eritrea and Somalia Mogadishu; Kenya, the Sudan and Somaliland, and Djibouti respectively on the other hand (Tekletzadik, 1983; Bahru, 2001; Teshale, 1995).

In terms of governance, Menelik II pursued pragmatic centralized and decentralized governance policies-. On the one hand, he abolished sovereignty of the conquered territories of the south, south west and east of Shewa and instituted a '*Neftegna* system'<sup>11</sup> by appointing

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- 11 Menelik's military campaigns to the south, east and west of Shewa was beyond the traditional raiding and counter-raiding military campaigns of his ancestors periods. Instead, he established permanent settlements in the newly annexed territories and instituted a '*Neftegna*' system or '*Gebbar*' system by appointing governors from Shewa and "*balabats* (local chiefs) who acted as appendages of the centre. Menelik II's military campaigns to these territories are the most contested events in the modern political history of Ethiopia. Three narrations are advanced by Ethiopian historians and politicians. The Amhara thesis, views the move as a restoration of the Ethiopian empire by bringing back "the lost provinces subsequent to Gran's invasion" in the 16<sup>th</sup> century (Asres 1958 :34, Mesfin, 1996:96-99). It is viewed as an outstanding missions of '*hager maknat*' (literally meaning empire-building) process, and plausibly argue that it was similar to what had been done in Germany by Bismarck and in Italy by Garibaldi in 1871. A related narration to this, Assefa (2012) contest that " Ethiopian history of migration, conquest, subjugation and hegemony was fully bidirectional. The so called "abyssinians' from the north and Oromos from the south have competed for supremacy over central and southern Ethiopia prior to Minelik's national consolidation of the state."

A diametrically opposite to the Amhara thesis is the colonial antithesis, which equates Menelik II's move as part of the European scramble for Africa project in the 19<sup>th</sup> century to control and exploit the resources of the autonomous territories. The colonial antithesis demands for full independence from the 'Abyssinian colonialism' (Assefa, 1993:52-53). This antithesis is subscribed by OLF, SLF, WSLF and ONLF and their supporters.

The third view is the EPRDF synthesis. It argues that Menelik's moves had made the conquered people landless as agricultural lands in the newly annexed territories were granted to the newly appointed Shewan governors, soldiers, and officials; Moreover, it argues that Menelik II and his successors established political, economic and social hegemony of the Amhara over the others and resulted in national/nationality oppression (see also Merara, 2003:4-6). The EPRDF synthesis advances self-determination of Nations, Nationalities and People (NNP) under a

governors, judges and tax collectors from the centre. According to Guluma (2002:51), the appointed officials had, at least, dual objectives: “to suppress any resistance and ensure imperial control” and to facilitate “the transfer of resources to the imperial centre.” It is worth noting that some of the newly incorporated territories such as Jimma, Welega-Lekemt, Welega-kellem, Benshangul, Awsa (Afar) and Goba had retained their internal autonomy as a reward for their peaceful submission to Menelik’s army (Asmelash, 1987:30). On the other, Menelik II recognized and maintained the traditional right to self-rule of the north provinces of Shewa namely; Tigrai, Gojjam, Gonder, Wello, Lasta. However, Menelik’s appointment of two appellate judges and three court recorders from the centre to each region was interpreted as a “further move towards a centralization of judicial authority in Ethiopia, and accordingly diminished the jurisdiction power of the provincial authorities” (Marcus, 1970:573).

Menelik II introduced European institutions by customizing to the Ethiopian context. He established European style Ministerial Council in 1907 with the objective to ensure smooth power succession, and to avoid battling among the strong nobilities for power (Marcus, 1975:227-228). He also introduced new tax base (for example tobacco and post stamp) as revenue sources to finance government expenditures. Menelik II was also known for his keen interest to transfer European technologies to Ethiopia. Accordingly, he established Djibouti-Addis Ababa railway, introduced telephone, telegraph and postal services in the emerging towns of the time. Moreover, Ethiopia joined the World Postal and telecommunication organizations. He opened modern education and hospital, the Bank of Abyssinia and issued coins and one Birr note to introduce monetary economy, established a Ministerial Council (Alemayehu, 2003; TekleTsadik, 1982).

#### **2.2.4 Haile Selassie I Reign (r 1930-1974)**

In the 1920s and mid-1930s, *Ras* Teferi, who later became Haile Sellasie I (HSI), introduced new administrative, fiscal and military

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democratic Ethiopian as a solution . In line with this synthesis the Charter of the TGE and in the FDRE’s Constitution of the 1995 recognize the right of NNP to self-determination up to, and including, secession to address the national question.

institutions in a piecemeal manner. In the early 1930s, the empire was restructured into thirty two administrative divisions, which enabled the emperor to assign Regional Governors from the centre (Asmelash, 1987:35). The administrative reform brought about an end to the traditional semi-autonomy of Jimma (Guluma, 2002:530) and Gojjam (Imru, 2001) by appointing governors from the centre. He also took measures to replace the traditional regional army by a National Army. More importantly, the Emperor enacted a monarchical constitution to consolidate power<sup>12</sup> and to constitutionalize the perpetual attachment of the Imperial dignity to the line of the Haile Selassie I (Imperial Constitution of 1931 Art.2 and the Revised Constitution of the 1955). The political and administrative reforms were supported by a fiscal one. ‘*Kurt-Gibir*’<sup>13</sup> (Fixed tax) and ‘*gebar*’ tax on agricultural land, entertainment tax, income tax, and excise and consumption taxes were introduced and managed centrally. Custom duties became entirely imperial taxation power (Bahru, 2008:107,114 and 115). The centralization of revenue had a political and economy impact. In political terms, the fiscal reforms intended to weaken the regional lords by diminishing their economic powers. In economic terms, it increased central government’s revenue. The cash payment had also laid down a cornerstone for setting up monetary economy. Nevertheless, the centralization process was interrupted by the Italy’s invasion in 1935 and the subsequent occupation, which lasted until March 1941.

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12 The 1931 Constitution installed an absolute autocracy system. Article 5 of the Constitution says “By virtue of His Imperial Blood, as well as by the anointing which He has received, the person of the Emperor is sacred, His dignity is inviolable and His power indisputable. He is, consequently, entitled to all the honors due to Him in accordance with tradition and the present Constitution. Any one so bold as to seek to injure the honor of the Emperor will be punished.” Article 4 of the Revised Constitution of 1955 also takes this article as it is.

13 Generally speaking two modalities of agricultural land taxes were in practice. ‘*Kurt Gibr*’ was applied in Tigrai, Gojjam, Begemidir and Shewa, while in the newly incorporated territories ‘*gebar*’ tax was in operation. The agricultural tax policy discouraged agricultural production as heavy taxes were imposed on cultivated lands whereas uncultivated lands were immune from any tax. Besides annual tributary payments, ‘*gebars*’ (tenants) were obliged to provide wide-ranging services- free labour and periodic presentations like grain, honey, animals, ...etc (Guluma, 2002: 51-52;)

Italy established an 'Africa Orientale Italiana' (A colony of Italy in the Horn of Africa) by aggregating the Ethiopian Empire with its former colonies of Eritrea and Italian Somaliland, which comprised six autonomous jurisdictions.<sup>14</sup> *The Regions* were demarcated primarily on political criteria. By and large, people of the same linguistic practices were put together. In addition, geographical factors, traditional laws, customs, religions and languages were used as criteria for the demarcation between the regions and local governments (Sbacchi, 1985; Bahru, 2008:380).

The Italian colonial Administration took some accommodative measures- language and, religion diversities that characterize Ethiopia by introducing new language and religion policies. Amharic was purposely ceased to be an official language and each "*Governor*" adapted local language in public and in schools.<sup>15</sup> Orthodox Christianity was separated from the state. These policies however, are viewed cynically. Aleme, (2003) considered the Italian policies as tribalism and argued that they were designed to divide-and-rule Ethiopians and to gain political support from the majority of non-Amhara and non-Orthodox Ethiopians.

### **Centralization as 'modernization' and assimilation policy instrument (1941-1974)**

Immediately after the restoration of the independence of Ethiopia in March 1941, Emperor Haile Selassie came to power and once again took a series of centralization measures. His first move was restructuring the

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<sup>14</sup> The Regions were:-Eritrea (consisting Eritrea, Tigrai, Afar, Wag and Lasta); Amhara (Gondor, Gojjam, Wollo, North Shewa); Harar (Arisi, North Bale, Dire Dawa, Jijiga); Galla [Oromo]-Sidamo [Sidama] (including large part of present West Shewa, Wellega, Illubabour, Borena, the present Regions of SNNP, Benshagul-Gumz and Gambela), Somalia (made up by annexing the Ethiopian Somali Region proper and Italian Somaliland), and AddisAbaba, a seat of the General '*Governatore*' of the occupation force). Each '*Governo*' had been structured in three tiers of lower government: '*Commissariato*', '*Rezidenza*', and '*Vice-Residenza*' (Aleme, 2003).

<sup>15</sup> Tigringa in Eritrea, Amharic in Amhara and in Addis Ababa, Offan Oromo in Oromia-Sidama, Arabic in Harari and Somalinga in Somalia region were used as working languages.

administrative divisions into 12 '*Awrajas*' (counties),<sup>16</sup> 60 '*Weredas*' (districts),<sup>339</sup> '*Meslenes*' (sub-district) and 1176 '*Miktil Meslene*' (communes)<sup>17</sup>. The public administration reform drastically removed traditional regional lords from power because the *Awraja* governorship fell into the hands of three strongmen-a Governor-General, a Director, and a Secretary, who had been appointed by the centre (Asmelash 1987:40; IGE, Decree No.1 of 1942). It laid down a consolidated and centralized administrative system in the entire country. In many instances, physiographic features (mountains, gorges and rivers) served as boundaries between administrative units. Economic viability, administrative convenience, and settlement pattern criteria were hardly considered in the demarcation of the Provinces. In rare cases ethnicity criterion was applied in creating local administrative units.

Assimilation policy was the guiding principle in the restructuring of the administrative divisions. *Teklay-Gizats*, *Awrajas* and *Weredas* were carved by bringing two or more ethnic groups together. Blending feuding ethnic groups was viewed as a resolution mechanism of ethnic conflicts at local levels. Weakening ethnic groups which were perceived as real or potential political threats to the regime by partitioning the ethnic group in two *Teklay-Gizat* Administrations were also policies of the regime. The Raya community was a case in point<sup>18</sup> (Asmelash, 1987: 41).

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16 Later the number of *Teklay Ghizates* increased to 14, following the split of Bale from Hararghe province and the liquidation of the Ethio-Eritrea federation that led to a complete unification of Eritrea with Ethiopia as the 14th province in 1961. The justification for the split of Bale from Harerge province was inconvenient to administer due to its enormous geographical size, lack of modern institutions and absence of road network (Asmelash,1987:40).

17 Four years later, a new government tier known as '*Teklay Gizat*' (Province) was created next to the centre. As a result, the '*Awraja Ghzats*' were elevated to '*Teklay Ghizat*'; '*Wereda Ghizat*' to '*Awraja Ghizat*'; and '*Meslenes Ghizat*' to '*Wereda Ghizat*'. By this Decree, '*Miktil Mislene*' was replaced by a new lower government level known as '*Meketel Wereda*.' Note that the *Mikitle WeredaGizat* was abolished in 1960 to bring bureaucratic efficiency (Asmelash,1987:41).

18 The Raya community, which was historically part of Tigray, had revolted against the central government in 1920s and in 1943. As a reaction, Raya was broken up into two smaller *Weredas*: Raya Azebo and Raya Kobo. Surprisingly the latter was taken away from Tigray Province, a historical power rival to the Shewan Amhara, and incorporated with Wello province in 1949 Ethiopian Calendar.

The emperor also established a professional national army with the objective not only to protect the sovereignty of country but also to make regional armies non-functional. The establishment of the national army, once-for-all had eliminated the potential power rivals who used to claim the crown.

Modernizing the taxation reform was another decisive reform area in the 1940s. The Emperor restructured the archaic fiscal system by introducing a new monetary taxation and public expenditure system under the Ministry of Finance. Salaried tax officers were appointed from the centre to all levels of Administration. All collected taxes had to be transferred to the central treasury, leaving nothing to the provinces. The tax reform also curtailed the privileges of the regional nobilities to levy and collect taxes (Keller, 1981:533 and Keller, 2005:94).

As far as decentralization is concerned, during the emperor's forty years tenure, he made three attempts of power devolution. The first one was related to municipal governance. Mayorship system which includes Municipal Council and municipal management under a '*Kentiba*' (Mayor) or Town Officer was introduced in 1945. Municipalities' competences included the following functions: provision of public health and hygiene services, water supply and sewerage, electricity and street lighting, registration services of properties(land, building, weapons) and civil status, provision of public amenities; construction of intra-town roads, bridges and squares; slaughter houses; supervision of animal and vehicle traffic; issue of driving and small business licenses; demarcation of market and cemetery areas; management of fire brigades; provision of welfare services like poor relief, hospitals, asylums, and schools; and approval of plans for private constructions (IGE,1954(a) and IGE,1954(b)).

With regard to revenue power, municipalities were entitled to fix local rates on fares for taxis, carts, and saddle; and on all immovable properties;<sup>19</sup> to assess and collect charge fees for water supply, and for municipal public services such as licenses on trade and professions, use of market place, vehicles and driving license, slaughtering and meat delivery fees, sanitary charges, land survey and registration fees,

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19 Property taxes on land and buildings were assessed by area or calculated as a percentage of the rental value of the Property (IGE,1954a).

advertising, cattle registration, and to collect rental income tax, as well as health tax (IGE, 1954a). In addition, Addis Ababa was given the right to borrow for investment purposes by issuing bonds (IGE, 1954a) and to impose 1 percent custom duties on the value of export goods leaving the city and 2 percent on the values of imported goods entering to the city (IGE, 1954b). Pursuant to the introduction of fuel tax, all municipalities were entitled to share revenues from excise tax on petroleum and lubrication products on origin basis.

Considering the possible institutional and manpower constraints in the 1940 and 1950s, the move was a positive measure as the assignments of responsibilities and revenues to the municipalities were of interest to local people. However, looking more closely, the devolution of power remained static throughout the regime. The municipality governance hardly promoted accountability and local participation for a couple of reasons. First, residents had no full power to elect or to demote local officials from power. Mayors/Town Officers were appointees of the Emperor. Second, the requirement to own immovable property to run for Municipal Council had also made the governance system undemocratic. Third, in practice, municipal governance remained centralized. The Municipal Councils had no power to determine municipal budget, local tax rates, and municipal fees but merely to propose to a higher authority and wait for decision from the then Ministry of Interior or from respective Governor-General. Intervention from Governor-Generals and the Ministry of Interior in administrative affairs of the municipalities was also a common practice (Asmelash 1987:41-42). Moreover, the municipalities had little fiscal power and were unable to carry out municipality functions.

The second area of decentralization was the establishment of the Local Education Board (LEB) at provincial level with the objective to expand education and to promote local participation in the provision of elementary education (IGE, Proclamation 94 of 1947).<sup>20</sup> The

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<sup>20</sup> The Board was established at province level consisting of five members drawn from: (i) one member from each municipal Council in the Province, (ii) one member from each wereda of the province, (iii) Head Master of the Principal school in capital of the province and a senior education Officer in the province, and (iv) General-Governor of the province (IGE, Proclamation 94 of 1947). Members from (i) and (ii) were elected by secret ballot, while (iii) and (iv) were ex-officio members.

Proclamation empowers the Board (i) to make recommendations and suggestions concerning the expansion of education to the MoE, and (ii) to oversee the MoE if all Educational Tax<sup>21</sup> collected in the provinces was allocated for the expansion of elementary education in respective province (IGE, Proclamation No 94/1947). In practice, however, there was no legal mechanism that enabled the Board to compel and supervise the Ministry of Finance (MoF) to allocate the Education tax collected only for the purpose of expanding elementary education in respective province. For instance, in 1950, the MoF deducted 34 percent of the Education tax collected in Tigray from its education budget and channelled it to the Orthodox Church of the Awraja (see Tigre Awraja Education Office, LEB Minute, 1943EC). Moreover, contrary to the very spirit of the Proclamation 94 of 1947, the Imperial Government degraded considerable elementary schools to traditional Orthodox Church schools in Tigray, Gojjam and Semen & Begemidir [Gondor] with the pretext that these provinces are the home of Ethiopian Orthodox Christianity. As an effect, 35 of the then 39 elementary schools of Tigray, which were providing modern education for about 3000 pupils by 73 teachers, were reduced to traditional church education centres (see Tigre Awraja Education Office LEB Minute, 1940 EC).

In spite of the fact that a relative expansion of education had been witnessed during the Imperial regime in 1961, gross participation rate remained only 3.8 percent and 0.5 percent for primary and secondary education respectively, far below as compared to greater than 40 percent primary and 3.5 percent secondary education achievements in the rest of Africa (Balsvik, 2005:5). National average gross primary enrolment rate increased to 16percent in 1974 (MoE, 1976), but still the lowest rate by the standard of Sub Sahara countries.

The third attempt of decentralization refers to the Local Self-Administration (LSA).The Emperor issued Order No 43 of 1966 to set up Awraja self-administration in seventeen selected '*Barajas*' across the country with the objective to encompass gradually all *Barajas*. Each pilot '*Awraja*' was to have a Council elected from all rural '*Weredas*' and from

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<sup>21</sup> The education tax rate was uniform and was set centrally.



small '*Wereda*' towns within respective '*Awraja*'. LSAs were to be subordinates of their respective province.

According to the Order, each LSA was to have competences in the fields of: education (to build, maintain and administer elementary schools(1-6 grade));health (to construct clinics and health centres, equip with necessary equipments and administer them); road (construction and maintenances of rural roads and small bridges); agriculture and Community Development (construction of small dams, irrigation canals, and wells, as well as distributing water supply); and trade and commerce (construction of market places and promoting local marketing) (IGE, Order No.43/1966; Kifle,1965:51EC, Asmelash 1987; and Tegegn, 1998).

A draft Proclamation on Revenue assignment for the LSA was also prepared by the then Ministry of Interior. According to the draft proclamation, the LSAs were to have the following revenue sources: (a) Land and cattle taxes; (b) education and health taxes; (c)property tax related to urban land and buildings; (d) revenue from licenses for trade, professional and vocational activities; (e) charge fees payable for surveying, and registration of real property; (f) charge fees for considering and approving construction plans, and (g) revenues from fees chargeable in respect of other services rendered by the LSA including water rate. (h) Grants-in-aid from the centre (on the recommendations of the Ministry of interior), (i) borrowing (on the approval of the Ministry or respective General-Governorate) and (j) community contributions. Note that the draft Proclamation was designed to grant LSAs the authority to assess taxes listed on (a) and (b) of the Order<sup>22</sup>.LSA Council could set property tax rate and license fees without exceeding the maximum limit determined by the Parliament. LSA Councils could determine user fees but it was subject to the approval of the Ministry of Interior (Bekele, 1999:85-87; Kifle, 1965:50-56). The draft Proclamation never became a law, however, because the joint meeting of the Chambers of Deputies and Senate suspended the draft,<sup>23</sup> showing lack of

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22 According to the draft, taxes listed as (a) and (b) were to be collected by a government body (likely branch Office of Ministry of Finance) on behalf of the LSA.

23 Initially the draft proclamation received acceptance with some amendments from the Chamber of Deputy(Lower House), while the Senate(Upper House) failed to pass the bill (Kifle,1965:49)

political commitment of the Emperor to devolve certain power downward (Kifle, 1965:49).

There is a tendency to equate Haile Selassies's centralization policy on the slogan of 'modernization' with the Meiji restoration of Japan. True, Ethiopian intellectuals of the 1920s and 1930s were inspired by the Meiji Restoration and used to advise the Emperor to pursue the Japanese development model in the Ethiopian context with a vision to see Ethiopia 'the Japan of Africa' (Bahru, 2002; Ghebrehiwet, 1912; Gorfu, 1952EC:76 and 88-95). However, the centralization and 'modernization' neither brought in significant economic progress and social changes in the country nor it was accompanied by a political liberalization. Unlike the experiences of the European and the Japanese monarchical constitutions, the Ethiopian monarchical constitutions of the 1931 and the 1955 had failed to promote checks and balances (separation of powers) among the legislative, executive and judiciary bodies. The emperor remained an absolute autocrat. HSI's state building strategy neither recognized the right of self-rule nor attempted to accommodate diversity. He failed to ensure political stability, to reform the backward land tenure system and to transform the political system in general and the economy of the country in particular.<sup>24</sup> The wide range of visible diversity in language, culture, and ethnicity had been purposely concealed. Rather, "One People and one language", and assimilation was a governing policy of the time.<sup>25</sup>

The Emperor had implemented perhaps the most ambitious centralization agenda than any of his predecessors. The subsequent political, administrative, and fiscal reforms had been undertaken to concentrate power at the centre at the cost of the regions. Centralization was perceived as a necessary condition for national unity and modernization.

In the centralization process throughout the 1900 – 1974, the influence of Europeans and American advisors to emulate the western

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<sup>24</sup> John Spencer, who served as a political advisor to the Emperor for about forty years, states the "Emperor's objective was not liberalization but centralization" (Spencer, 1987:131).

<sup>25</sup> Imposition of Amharic language, Orthodox Christianity, and political marriage had been used along with to bring non-Amhara elites to the centre.

style 'modernization' strategy was visible<sup>26</sup> (Mannford, 1947, Bauru, 2005).

Transforming the archaic, fragmented and isolated traditional administration system by modern administration institutions was a necessary and desirable measure to carry out efficient public administration. Similarly, the establishment of a modern army, the introduction of new taxation system and new legal institutions were necessary tools and methods for socio-economic advancement and modernization of the country. However, sweeping away all political and administrative powers of the regions; and drying up all regional/ local taxes were not compatible with the decentralized political history of the country. Neither the assimilation policy nor abolishing the historical right to self-rule owns region was a prudent public policy. The selective reforms that aimed at concentration of power at the hands of the Emperor hardly resulted in visible political and social changes. It failed to guarantee basic human and democratic rights and thus the Japanese development style in Ethiopia ended up with a failure.

### ***The Federation of Eritrea with Ethiopia***

Large parts of the present-day Eritrea (particularly the highlands and the coastal areas) were core domains of the Daamatise state and the Axumite kingdom (Sergew, 1972:22-23, and Lapiso, 1982:68), although the lowlands and the Red Sea coastal areas had fallen under the Ottoman Empire rule and latter under Egypt from the second half of the sixteen century to the 1880s. The Christian highlands of Eritrea were known as 'Mereb-Milash' (referring to north of the Mereb River territory) remained an integral part of the *Tigray-Tigrigni* region under the Ethiopian Empire (Tewelde, 1990:170). However, the advent of Italian colony in Eritrea in 1890 resulted in not only the partition of the *Tigray-Tigrigni*, the Afar and

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<sup>26</sup> Eroupeans and American embassies and appointed advisors to the Emperor, Ministers and Directors were instrumental to install unitary, and centralized European style constitutional monarchical system. Wheareas, the second generation prominent western educated Ethiopians such as Ghebrehiwet Baykedagn, Negadras Teklehawaryat, Hakim Werkinneh, Hiruy, etc were adherent to the Japanese style of modernization in the Ethiopian context for rapidly transformation (see Bahr, 2005).

the Kunama people into two but also denied Ethiopia's historical access to the Red Sea.

Following Italy's defeat by the British Army and the Ethiopian patriots in the Horn of Africa in 1941, the future status of Eritrea became a UN issue. The UN Security Council established a UN Commission for Eritrea, consisting of five member states, namely, Burma, Guatemala, Pakistan, Norway and Union of South Africa to assess the will of the people of Eritrea. The UN Commission consulted various Eritrean political parties, community representatives, and the public at large. Eritreans expressed their diverse wishes through gatherings, pleas, slogans and demonstrations. A political party known by *Mahber Fikri Hager/Mahber Hibret* demanded unconditional union of Eritrea with Ethiopia. Moslem League, at the outset, campaigned for union with the Sudan and later subscribed for independence of Eritrea. The Liberal Progressive Party, also swang from establishing an autonomous *Tigrai-Tigringi* (Greater Tigrai) State under the Ethiopian empire state<sup>27</sup> to an independent Eritrea after ten years of British trustship Administration. Pro-Italy Party advanced the return of Eritrea to Italian rule (Trevaskis, 1960:65, Tekeste, 1997:45, Habtu, 1993: 62-65; Zewde, 1998:82 and 86, Alemseged, 2001, Abbay, 2001).

Member states of the Commission did not reach a consensus on the future fate of Eritrea and they submitted three proposals to the UN security. Burma and Union of South Africa proposed a federation solution between Eritrea and Ethiopia to answer twin objectives: "(a) the wishes and welfare of the people of Eritrea, and (b) the maintenance of peace and security in East Africa"(Habitué, 1993:143). Norway recommended a complete reunion of Eritrea with Ethiopia and declared "... the claims for independence has to be dismissed, We [Norway Delegation] consider the

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<sup>27</sup> The Tigrai-Tigringi project was promoted by 'imminent' Eritrean highland politicians led by Ras Tesema. Welde Ab WeldeMaria (1946:4), who was among the prominent promoters of this project, boldly stated, 'I have no desire to separate Eritreans from Tigrayans and Eritrea from Tigray. I am sincerely struggling for the two not to drift apart. And when I speak about Eritrea and Tigray, it is certain that I am speaking about the whole of Ethiopia'. The Tigrai-Tigringi state was to comprise the so called "Bihere-Agazi" [Nation of Free] which includes the entire Eritrea and the Tigrai region which extends upto *Alweha Milash*, the historical southern boundry to Wello (Abbay, 2001:474). under the leadership of Ras Syum Mengesha (TesefaTsion, 1986).

reintegration of Eritrea into Ethiopia as the only rational and satisfactory solution....”(Habtu, 1993:150). In contrary, Pakistan and Guatemala recommended independence of Eritrea after ten years of UN trusteeship (Habtu, 1991:161; Zewde, 295-296). Ethiopia had also consistently claimed to the restoration of her historic right of access to the Red Sea<sup>28</sup> (Habtu, 1993:42).

The British policy on future of Eritrea used to swing from time to time. It chased two proposals. In the early 1940s, it supported the project of establishing the *Tigrai-Tigrigni* state. When this project failed, it pursued the partition of Eritrea into two parts: (i) joining the western lowlands to the Sudan, and (ii) bringing the highlands and the eastern low lands including Massawa and Afar land to Ethiopia (TesfaTsion, 1985, Zewde,1998; Alemseged,2001).

Finally, the USA promoted the Ethio-Eritrea federal project, which was proposed by Burma and the Union of South Africa, as a ‘compromise formula’. The British and France supported the American initiation (Zewde, 1998; Alemseged, 2001). The UN Security Council ratified the compromise formula under the UN Resolution 390(V) in 1950 by taking the following factors into account: (a) “The wishes and welfare of the inhabitants of Eritrea, including the views of the various racial, religious and political groups of the provinces of the territory and the capacity of the people for self-government”, (b) “the interest of peace and security in East Africa”, and (c) “the rights and claims of Ethiopia based on geographical, historical, ethnic or economic reasons, including in particular Ethiopia’s legitimate need for adequate access to the sea”(UN Resolution 390 (V) in Habtu,1993, and Tekeste, 1997).

According to the UN 390(V) Resolution, the UN Commission to Eritrea, in consultation with the stakeholders,<sup>29</sup> prepared a draft of the Eritrean Constitution and submitted it to the Eritrean Assembly for ratification. The Eritrean Assembly ratified the Constitution after it made due examination and deliberations on each Article. The 1952 Eritrean Constitution grants considerable political, fiscal and administrative powers to Eritrea. It assigns responsibilities of foreign affairs, national

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28 Note that Egypt also had claimed Massawa (Habtu, 1993-58).

29 Include the British Administration in Eritrea, the Ethiopian Government and the inhabitants of Eritrea.

defence, currency and finance, international trade, inter-state commerce, external and inter-state communications including postal service, highways, airports, ports, and railway to the Central Government. (UN Resolution 390(V) and Eritrean Constitution, Art. 5). Powers not vested in the Centre remained residual powers of the Eritrean Government including, but not limited to, “laws (criminal laws, civil law and commercial law), maintain internal police, health, education, public assistance and social security, protection of labour, exploitation of natural resources, regulation of industry, internal commerce, trade and professions, agriculture, internal communication, public utility services which are peculiar to Eritrea, [adopting]the Eritrean budget “(Eritrean Constitution of 1952 , Article 5).

In terms of fiscal, the tax assignment to the Government of Eritrean was based on the principle “...to meet the expenses of Eritrean public function and services“(Eritrean Constitution Art.5 (L). The taxation power of the Eritrean Government included “...the customs duties on goods entering or leaving the Federation which have their final destination or origin in Eritrea”<sup>30</sup>. (UN Resolution 390 A (V) Paragraphs 4, and the Eritrean Constitution Art.6).

Furthermore, the UN Resolution 390 (v) and the Eritrean Constitution: (i) entrust the Eritrean Government with the power to assess and levy federal taxes<sup>31</sup> generated in Eritrea, (ii) stipulate the establishment of a Federal Council composed of equal numbers of Ethiopian and Eritrean representatives to advise upon the common affairs of the Federation, <sup>32</sup> (iii) respect Eritreans’ right to shared-rule in the Federal Executive, Judicial and Legislative <sup>33</sup>branches.

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<sup>30</sup> Custom duties collected on goods entering or leaving the Empire of Ethiopia which have their origin of final destination in Eritrea were to be paid (transferred) to the Eritrean Government through the MoF (IGE, Proclamation No.126 of 1952).

<sup>31</sup> The documents do not specify what the federal taxes include. The IGE unilaterally determined and imposed:(i) “federal excise tax on goods imported and on goods manufactured within the empire whose title is transferred to other person either by sale or otherwise”; (Decree No.16 of 1956), and (ii) “Federal Transaction tax on goods imported or exported, and on goods manufactured locally” (IGE, Decree No.17 of 1956).

<sup>32</sup> The Federal Council was established consisting of ten members, five each appointed representatives from the Eritrea and the Imperial Government (IGE, Order No. 8 of

The documents, however, are silent how the delegated federal functions should be financed although the Eritrean Government had to “bear it’s just and equitable share of the expenses of the Federal functions and services” as a contribution of Eritrea to the Federal expenses (The Eritrean Constitution Art.6 (2); UN Resolution 390 (V)).

Article 83 of the Eritrean Constitution recognizes the appointment of village and tribal community leaders from respective community members. Furthermore, unlike the 1955 Revised Imperial Constitution, the Eritrean Constitution guarantees the municipalities to manage their own affairs.

The Eritrean Constitution was designed in line to the western democracy style. It incorporates basic principle of human and political rights. It guarantees basic human and democratic rights (Art.22-33). It recognizes language and religion diversities and denounces any discrimination against any religion practiced in Eritrea (Eritrean Constitution, Art.27) as compared to the Imperial Revised Constitution (Art.126) that stipulates, “the Ethiopian Orthodox church is a state church.” The Eritrean Constitution ensures the right to use spoken and written local languages, “...in dealing with the public authority as well as for religious or educational purposes and for all forms of expression of ideas” (Eritrean Constitution, Art.38), whereas the Imperial Revised Constitution (Art.125) notes “The official language of the Imperial is Amharic” and does not recognize the use of local language in public. The Chief Executive of Eritrea was elected from the Assembly (Art.65 and Art.68), with limited powers and was “...accountable for any act performed by him in the course of his duties...” (Art.75), while the Revised Constitution of 1995 grants absolute powers to the Emperor.<sup>34</sup>

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1952) butin practice the Council had never set a session and remained in paper (Alemseged, 2005).

<sup>33</sup> Eritrea had three and five seats in the Senate and Chamber of Deputies respectively (see IGE Order No. 9 of 1952 and Proclamation No.125 of 1952).

<sup>34</sup> The following Articles substantiate the argument. “The sovereignty of the Empire is vested in the Emperor”(Art.26). “The Emperor is anointed...”(Art.4) and “No one shall have the right to bring suit against the Emperor”(Art.62(1). Furthermore, “The Emperor determines the organization, powers and duties of all Ministries, Executive departments,...”(Art.27 and Auditor General was appointee of the Emperor(Art.121).

Furthermore, the Eritrean constitution recognizes the political parties, while these were taboo in the Imperial constitution.

The Eritrean Constitution enshrines considerable political, fiscal, administrative autonomies and human and political rights. Unfortunately, the Ethio-Eritrea federal was short-lived and it is one of the failed federal arrangements in Africa because the Emperor undermined the Eritrean Constitution. For instance, the Central Government paralyzed the federal system. It contained transfers justly and periodically to the Eritrea Government which were being generated from custom duties on goods entering to or leaving from Eritrea as per the in Article 6(3) of the Eritrean Constitution (Alemseged 2005; Tekeste, 1997).<sup>35</sup> The federal delegated functions were unfunded. Article 7 of the Eritrean Constitution that provides the establishment of Imperial Federal Council (consisting of equal Members from the Imperial Government and the Eritrean Government) remained on paper. Moreover, Emperor Haile Selassie took consecutive measures against the spirit of the UN Resolution of 390 A (V) and the Eritrean Constitution.<sup>36</sup> The Imperial Government considered Eritrea not as a full-fledged political entity with state status, but as an “incorporation and inclusion of the territory of Eritrea within the Empire “(IGE, Order No.6 of 1952). Finally The Emperor dissolved the Ethio-Eritrea Federation in 1962 and Eritrea became the 14th Ethiopian province.

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35 This was a grave concern of the Eritrean Assembly and it was one of the issues that had created mistrust and conflicts between the Eritrean Assembly and the Ethiopian Government. It contributed to budget deficit of the Eritrean Government and negatively impacted the Government to provide public functions and services (Tekeste, 1997; Alemseged, 2005).

36 The Imperial Government of Ethiopia used to interfere in the Eritrean internal affairs since the early federation years. For instance, Bitewedend Endarkachew, the Imperial representative in Eritrea, boldly declared in his opening speech of the Eritrean Assembly in 1955 “there is no internal or external affairs as far as the office of His Imperial Majesty’s Representative is concerned and there will be none in the future. The affairs of Eritrea concerns Ethiopia as a whole and the Emperor” (Greenfield, 1965: 232). As an effect, series centralization measures were taken. By 1958, the Eritrean flag was banned and only the Ethiopian flag was hoisting. By 1960, the designation of the “Government of Eritrea” and its Head ‘Chief of Government of Eritrea’ were reduced to “Eritrean Administration” and ‘Administration of Eritrea’. By same year, Tigringa and Arabic, the official languages of Eritrea and medium of instructions in Eritrean schools, were replaced by Amharic, official language in Ethiopia (Abrha, 2014:647).



The Emperor had no political willingness to uphold and protect the Federal Act (Elazar, 1987:244; and Assefa, 2007:32). One possible hypothesis could be a fear not to inspire other provinces for autonomy, which Eritrea was enjoying of. Tigray would be among the front line provinces to demand for autonomy as the failed First *Weyane* (Revolution) of Tigray in 1942-3 against the Central government for self-rule was a fresh memory among the public. Resistances from Gojjam province, which had its own king and demonstrated its resentment against the appointment of officials from Shewa, and the self-determination banner from the Ethiopian Somali and Oromo, as evidenced in 1960s to 1990s, seemed to be possible sources of fear of the Emperor.

Many politicians and scholars agree that the dissolution of the Ethio-Eritrea Federation was the beginning of the separation of Eritrea from Ethiopia. Eritrean nationalists raised armed struggle for self-determination of Eritrea as “a direct reaction to Ethiopia’s abrogation of the federation in 1962” (Abay, 2001:460) by subscribing a ‘colonial question’ thesis.<sup>37</sup> Maintaining the federation would have been an effective mechanism not only in democratizing and economic betterment of Ethiopia and Eritrea but also in ensuring security in the Horn of Africa.

### **2.2.5 The Military (Dergue) Regime (1974-1991)**

The spontaneous popular movements against the Emperor’s regime had brought the military to power in 1974, known as ‘*Dergue*’ regime.<sup>38</sup> The regime completely restructured the political and economic systems of the country in line with the socialist ideology. In its 17 years of rule, the ‘*Dergue*’ regime made three reforms related to decentralization.

(i), *Kebele* Peasant Associations (KPA) were organized in the rural areas. Likewise, urban centres with a population of 2,000 or more were

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37 Whether the question of Eritrea was a colonia or national remain controvertial among politicians. Nevertheless, considerable politicians and scholars question the colonial thesis as large part of the present Eritrea was not only a core part of the Axumit civilization but had remained part of the Abyssynian Empire until 1890.

38 The Dergue regime ruled Ethiopia for 17 years under the Provisional Military Administration Council, PMAC, (1974-1987) and under the Peoples Democratic Republic of Ethiopia (1987-1991).

structured in *Kebele* Urban Dwellers Associations (KUDAs). One of the objectives of the KPA was to empower local people by bringing the administrative units closer to the people. KPAs' major responsibilities were land redistribution, construction of primary schools, rural roads, and clinics; establishing cooperative shops and distribution of some consumable goods at reasonable price; administering local security and providing social tribune service (PMAC, 1975a). KUDAs had similar objectives and responsibilities except land redistribution. In addition, KUDAs were engaged in administration of public houses, collecting house rent, and establishing and administering recreation centres (PMAC, 1975b). In practice, however, little effort had been devoted to empower local people. Both associations were purely policy implementers of the Central Government. They served the regime as political instruments by controlling day-to-day life of residents and conscripting the youth. The *Kebeles* and other local administration levels had no revenue raising power, but limited to levy municipal fees.

(ii), The 'Dergue' regime issued the New Democratic Revolution Program in 1976 with the objective to address the long standing national question. In principle, the program recognized the right of nationalities to self-determination. The Program recognized the right to self-administration in local affairs and to exercise cultural autonomy (PMAC, 1976). However, in practice, as Brietzke (1995:209) noted "apart from celebrations of local music and dance" the program did not result in tangible power devolution or meaningful cultural autonomy.

(iii), the regime recognized regional autonomy as a practical policy to address the national question. In line with this, the administrative structure of the country was reorganized into five Autonomous Regions and 24 Administrative Regions (see the 1987 Constitution of the Peoples Democratic Republic of Ethiopia). Demarcation of the regions took into account the following criteria: (i) ethnicity (distribution and settlement, historical relations of nationalities, language proximity of nationalities, cultural similarities); (ii) economic and geographic factors (population size and resource endowment); (iii) physical and social infrastructural developments; (iv) development centers (urbanization, state farms); and (v) administration of efficiency and periphery politics (ISEN, 1976 EC). As

an effect, many of the regions were created by blending many ethnic groups under a dominant ethnic group.

Competences of the autonomous regions were not designed in a way to bring about meaningful political, fiscal and administrative devolution of power. Autonomous Regions and the Administrative Regions hardly had legislative power to tax and to spend. They were mainly supposed to ensure implementation of laws, decisions and directives of the centre. Economic and social development plans, and budget allocations of the Autonomous regions had to get the approval of the National “*Shengo*” (literally meaning Assembly).

‘*Shengos*’ of the Autonomous Regions were subordinate bodies of the National *Shengo*. In other words, the Autonomous Regions were merely agents of the Central Government. Likewise, the Administration Regions were accountable to their next higher level of administration (Ghebrehiwet, 2002:37). Except municipal fees, all sources of revenue were apportioned to the Central Government, leaving nothing to the revenue generating jurisdiction.

The Dergue regime failed to show political commitment to devolve meaningful power. The 1987 Constitution that granted the Autonomous regions status to the politically sensitive provinces did not satisfy the Liberation Fronts such as Tigray Peoples Liberation Front (TPLF) and Afar Liberation Front (A.L.F), which were waging armed struggles against the Dergue regime for genuine regional autonomy, let alone for the Eritrean, Oromo and Somali movements, which were demanding full independence from the “Abyssinian colonialism.”

### **2.2.6 The Emerging of Ethnic-Based Movements**

With the exception of the region-wide sporadic rural militants of Tigray, Bale and Gojjam against the Imperial agricultural tax, and land policies (Gebru, 1991), organized multi-ethnic political movements preceded the ethnic-based ones. The Ethiopian Students Movement (ESM), which emerged as a nucleus political force at the Haile Selassie I University (currently Addis Ababa University) in the 1960s had rallied Ethiopian students of all ethnic groups for democracy and equality under the visionary slogans of “Land to the tiller”, “equality of Nationalities”

and “social justice” (Balsvik,2005, Hiwot,2012). Many of the 1960s and 1970s multi-national and ethnic-based political organizations (like EPRP, *MEISON*, *MALERID*, *Wez League*, TPLF, and OLF) are direct off-springs of the ESM. Nevertheless all the political forces did not have similar political stand on the need for ethnic-based movements as a political mobilization strategy for equality, democracy and development. In spite of the fact that nationality question had become among a debate agenda of the ESM in late 1960s, EPRP, the then influential political organization and claimed itself as a vanguard of the oppressed Ethiopians in general and the proletarian class in particular strongly objected ethnic-based movements against national oppression<sup>39</sup>. It strongly argued that ethnic-based movements would weaken the class struggle and the Ethiopian revolution and put class oppression first<sup>40</sup>. *MEISON* and TPLF plausibly argue that ethnic-based liberation movements and class struggle can be carried out simultaneously for the same end. As far as prioritizing is concerned, they believe the root cause of the political, economic and social contradictions in the country is national oppression and subscribed the right of Nationalities to self determination up to secession as a solution to national oppression and injustice.

The Tigrrians, the Oromo and other minority ethnic groups from the newly incorporated regions view the years between the reign of Menelik II and the Dergue regime as periods of peripherization, manifested in political oppression, economic exploitation and cultural suppression. They also considered the Dergue regime as a continuation of the Amhara domination over the others. As an effect, ethnic-based rebels mushroomed against the centre chiefly from the Tigrrians, Oromos, Ethio-Somalis, Afar, Sidamas, Gambelas, and Benshanguls.

The political agenda of the ethnic-based militant movements can be clustered into two: national question and colonial question: Members of EPRDF and ALF subscribe guaranteeing self-determination of Nations/Nationalities and establishing unity of people on free will under

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<sup>39</sup> So did the leftist political organizations like *MALERID*, *WEZ LEAGUE* and *SEDED* shared the EPRP stand.

<sup>40</sup> EPRP recognized the right of self determination in principle, but unity of Ethiopian nationalities under socialist Ethiopia ( Tadess , the Generation Part I)

a democratic Ethiopia. The 'colonial question' thesis, which is advanced by OLF, OLN and WSLF, demands full independence from the 'yoke of Abyssinian colonialism'. The ethnic-based movements waged rural-based armed struggles and mobilized their fellow people for ensuring the right of Nations, Nationalities and Peoples to self-determination. TPLF/EPRDF played a decisive role to end the 17 years of *Dergue* regime in May 1991 and has laid down a corner stone for a new political system.

For various reasons, the multi-ethnic political forces failed to effectively lead to and mobilize the Ethiopian Peoples against the regime and therefore their role in overthrowing the *Dergue* regime was insignificant except the Ethiopian People's Democratic Movement (EPDM), a coalition of EPRDF.

The failure of the *Dergue* regime to accommodate diversity, its exclusive politics and economic marginalization had intensified the civil war against the central government which finally caused it to its collapse. The independence of Eritrea became clear following EPLF's control over Asmara in May 1991. The separation of Eritrea was formalized through "referendum" when the overwhelming Eritreans voted for full independence in 1993.<sup>41</sup>

## 2.3 Conclusion

Ethiopia has a long history of statehood. From the time of the Axumite Kingdom to the turn of the 19th century, the core Abyssinian Empire witnessed highly decentralized governance system, if not a loose confederation, although trends of centralization-decentralization cycle governance were observed. The traditional '*Niguse Negest*' (King of Kings) title of the emperors referred to the existence of many hereditary local kings, chiefs, sultanates and Amires with considerable self-rule

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41 Many scholars and politicians question the fairness and transparency of the 1993 Eritrean referendum process. The referendum failed to accommodate various options to Eritreans such as, Federation, Confederation with Ethiopia, full independence etc, as it was the understanding between the EPLF and the Transitional Government of Ethiopia. The voting option was only "YES for independence or NO". True, the referendum process would have been democratic, had various choices were offered to Eritrean voters. However, as long as the militantly victorious EPLF has advanced for an independent Eritrea, whatever options were offered, voting for independence was inevitable.

autonomy but accountable to the centre. Given the vast geographical domain of the Ethiopian empire, with absence of bureaucracy and the poor transportation facilities of those periods, it would have been formidable to effectively administer the remote regions from the centre without permitting a considerable decentralized system (Tekeste, 2006:136).

Governance systems are causes to and effects of new political developments, social and economic changes. Since the beginning of the unification in 1855, a cycle of centralization and decentralization state empire/building strategies have been adopted. With the exception of Yohannes IV reign, the periods of 1855 to 1991 witnessed a centralized state-building strategy. Tewodros opted for a strong centralized government partly to deter the imminent danger of the Egypt's desire to control the Blue Nile and the Red Sea and partly to end the ugly face of civil wars among the nobilities as well as between the nobility and the centre to control power and resources. Yohannes' decentralized state building strategy was the result of centrifugal pressures of regional nobilities. Menelik II adapted dual governance system: a decentralized system in the core of Abyssinian Empire and in the newly incorporated territories which cooperated to and took part in his military campaigns and a centralized one in those regions which resisted his military movements. Emperor Haile Selassie I took a series of centralization measures to weaken the traditional powers of regional nobilities. The frequent restructuring of administration did not aim at how best public services would be delivered to the local people. Rather, government institutions were far away from access to the people. For instance, only police, court and finance government agencies were operating at *Wereda Gizat*. Other functions of education, health care and rural roads had been deconcentrated at Awraja Administration level. In fact, the 'Dergue' regime attempted to bring the administrative structure closer to the people by instituting Kebele administrations although they served to control the daily life of residents rather than empowering citizens in decision making.

The highly centralized and unitary state building strategy in Ethiopia was a failed story not only because it was not accommodative to the diversities of language, ethnicity, culture, history and religion of

Ethiopians, but also to bring about liberal politics and/or economic development. Rather, it was characterized by political exclusiveness, poverty, backwardness, and social injustice. The Imperial regime also systematically undermined the Ethio-Eritrea federation and finally terminated it, because the regime, from the outset, conceived the federal arrangement not as a contract between two equal constituent unities but a federation of Eritrea with Ethiopia under the sovereignty of the Ethiopian crown.

We may draw a couple of lessons from the experience of the Ethio-Eritrea federation (i) a federal system allows constituent members to avoid security risks, to reap benefits from economies of scale and bigger market potential by remaining united as well as to take advantage from being a small jurisdiction to provide local demand driven public services, and (ii) the cost of any constitutional breach is extremely expensive and may lead to disintegration.

The national and class oppressions had instigated oppressed elites to raise rural based arm struggle by organizing themselves in ethnic-based liberation fronts for genuine autonomy or full independence. Thus, ethnic-based movements mushroomed in reaction to the political, economic and social exclusiveness of the previous regimes. The advent of the Ethiopia Peoples' Revolutionary Democratic Front (EPRDF) to power in May 1991 ended the century-old highly centralized governance system and has pursued a multiethnic federal arrangement on the principle of unity-in-diversity.





However, the first wave of decentralization was confined to the state (*Kilils*) until the States further devolved some functions and powers to the *Weredas* in 2002, known as the *Wereda* (district) Level Decentralization (WLD), was introduced.

This chapter has three sections. The first section gives a bird's eye view of the Federal Constitution. It also examines the impact of the federal subsidy distribution on the states and the jointly session of the HoF and HoPR on the determination of concurrent revenues in the environment of unequal representation of the states in the HoF. The second section, explores how historical, political, language and cultural variables have been employed in the crafting of the existing States and LGs. There is no consensus among the political elites on the EPRDF's multiethnic federal arrangement as well as on the principles and expected outcomes of the system. The third section therefore discusses the existing debates among political and intellectual forces on the impact of the multiethnic federal arrangement on national unity, conflict management, and democracy.

### **3.1 The Federal Constitutional Setting**

The Constitution of the Federal Democratic Republic of Ethiopia was ratified by the Constituent Assembly<sup>45</sup> on 8<sup>th</sup> December 1994, but came into force in 21<sup>st</sup> August 1995. The Ethiopian federal arrangement is unique in Africa for its bold recognition of ethnicity (Andréas, 2003:142). The major features of the Federal Constitution are outlined below.

- The Ethiopian federation is a federation of NNP, because “All sovereign power resides in the Nations, Nationalities and Peoples of Ethiopia” (Federal Constitution, 1995:Art.8 (1), not in the constituent member States as it is the case in the other federations. The Preamble of the Federal Constitution begins with “We the Nations, Nationalities and Peoples of Ethiopia...”).

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45 Some opposition parties strongly criticized the process of drafting the Constitution was symbolic than real and genuine as many of the political forces who participated in the Peace, Democracy and Reconciliation Conference of May 1991 and other oppositions did not participate in the process of drafting the Federal Constitution.

- The Constitution grants unconditional right to self-determination, including secession of Nations, Nationalities and Peoples (NNP).<sup>46</sup> Every NNP has the right to speak, to write and to develop its own language and to promote its own history and culture. Moreover, Every NNP has the full right to establish its own self-government in the territory it inhabits (Federal Constitution, 1995: Art.39 sub Articles 1-3).
- Article 43.2 of the Constitution affirms the rights of citizens to participate in national development and to be consulted on policies and projects affecting them.
- The rights of States to choose their working language, and to have own constitution are respected. The Constitution enshrines symmetric powers and rights to on the States (Art 47(4)).
- Type and number of local governments to be established are left to the judgement of the States (Art. 50(4)). Depending on the level of ethnic diversity, geographical size, and population, the States have the liberty to establish different local government (LGs) tiers.<sup>47</sup> Relatively homogeneous States have established *Wereda* and *Kebele* governments, while the heterogeneous States, in addition to *Wereda* and *Kebele* governments, have established ethnic-based *Zonal* and Special *Wereda* Governments to ensure the rights of minorities to self-government. Powers and functions of LGs are derived from the States.

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46 For the purpose of this study, the definition of 'Nations, Nationaliteis and Peoples' is taken from the Federal Constitution, which defines it as "a group of people who have or share large measure of common culture or similar customs, mutual intelligibility of language, belief in a common or related identities, a common psychological make-up, and who inhabit an identifiable, predominantly contiguous territory." (Federal Constitution, Art 39(5)).

47 In this study, LGs include all levels of government which are structured below the State Government such as constitutional Zones/Special *Weredas*, *Weredas* (urban and rural), and *kebeles*. Note also Zones and Special *Weredas* in the SNNP have same powers and duties.

- Articles 51 and 52 of the Federal Constitution define powers and functions of the Federal Government and the States respectively. Moreover, residual powers are reserved for the States (Federal Constitution, Art.52 (1)). Taxation powers are classified into federal, state and concurrent categories (Arts. 96, 97 and 98). States' right to borrow from domestic sources is also ensured (Art.51 (7)).
- Undesignated tax powers can be assigned to the Federal Government or to the State or to both by a joint session of the HoF and HoPR with two- third majority of votes (Art.99).
- The Federal Constitution confers separation of powers among the three branches: the legislature, executive and judiciary (Art.50 (2)). The Legislative branch is the highest decision making body.<sup>48</sup> Head of the Executive (Prime Minister at Federal level) is elected among the legislators. Executive members and Federal Judges are also appointed by the legislative body upon the recommendation of the Prime Minister.  
The Constitution ensures the independence of the judiciary branch (Art 50.7 and 78.2). Similarly, the States and LGs have Council (legislative), Executive and judicial bodies. With regard to urban local governments (ULGs), they have a governance system which consists of the City Council, the Mayor, the Mayors' Committee, the City Manager and other Executive bodies and the City Court. Speakers and Heads of Administrations are elected from the Councillors (see the Revised States' Constitutions).

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48 Governance of the Legislative body is undertaken by a Spokesperson, a Deputy Spokesperson and a Secretariat, who are elected among the Council members. Note that until 2003, there was no separation of power between the Legislative and the Executive bodies. State Chief Administrators used to chair both the Council and the Executive Committee. Under such conditions, the Council hardly had the ability to control the Executive body.

- The Federal Legislative body is bicameral. The House of Federation (HoF) and the House of Peoples Representatives (HoPR) (Art.53). The HoF represents all NNP. There are two possibilities for electing members of the HoF. Either State Councils elect representatives of HoF among themselves or they are directly elected by the People (Art.61. (3)). Members of HoPR are directly elected by the people on the principle of proportionality. The Constitution protects the right of minority ethnic groups to be represented in the HoPR by reserving a minimum of 20 seats out of the maximum 550 seats (Art.54 (3)), although the minorities are not identified in the Constitution or in any Federal Law.
- The Federal Constitution adheres to Party pluralism. A political party alone or coalitions of parties which win simple majority seats in the HoPR can form a government (Art.56).
- People's self-rule at all levels is confirmed (Art.88 (1)). Identities of NNP are respected. Therefore, Government has to promote equality, unity and fraternity of NNP (Art.88 (2)).
- Any Federal Constitutional amendment is possible through the following procedure:
  - (i) Any initiation of Constitutional amendment has to receive support from the HoPR with a two-third majority vote, or the HoF with a two-third majority vote, or one-third of the State Councils, by a majority vote within each Council (Federal Constitution, 1995, Art. 104).
  - (ii) All the democratic and human rights specified in Chapter three and in Art.104 of the Federal Constitution can be amended through: (a) "when all State Councils, by majority vote, approve the proposed amendment"; (b) "when the HoPR, by a two-thirds majority vote, approves the proposed amendment" and; (c) "when the HoF, by two-thirds majority vote, approves the proposed amendment" (Art. 105).

(iii) Amendment of all provisions other than Art.105(1) of the Federal Constitution is possible: (a) when the two Houses ,in their joint session, “approve a proposed amendment by a two-thirds majority vote”; and (b) “When two-thirds of the Councils of the member States of the Federation approve the proposed amendment by the majority vote” (Federal Constitution, Art.105).

From legal terms, such a stringent procedure of constitutional amendment is supposed to deter any desire of centralization of power by the Federal Government.

### ***The Setting of the HoF***

One may identify, at least, three distinct features of the HoF:

(i) Unlike in the other federations where representation of states is on equal bases<sup>49</sup> State’s representation in the HoF of Ethiopia is based on principles of equality and proportionality. Representation of the States in the HoF is a function of two variables- number of indigenous NNP and the population size of a State. The HoF is labelled as a House of NNP because each and every NNP is supposed to be represented in the House. If two States have equal population size but differ in composition of indigenous ethnic groups, the one with more diverse indigenous ethnic composition has more representation in the HoF. Tigray and Somali are cases in point. Both States have similar population size but differ in the composition of ethnic groups. The former State comprises three ethnic groups (Tigray, Irob and Kunama), while the latter is a homogeneous ethnic state. Tigray has two more representatives in the HoF as compared to the Somali simply because of its ethnic composition. Similarly, Benshangul-Gumuz and Gambela are small, and less populated states with less than half a million each but they have five and four seats in the HoF respectively due to the number of indigenous ethnic groups that constitute the states. The ethnic composition factor guarantees the SNNP

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49 Germany is exceptional. Each Lander has a minimal of three and a maximum of six votes in the Bundestag, the Upper House, depending on the population size of the Landers. Each member votes in block in the interest of his/her state, not in his/her personal capacity.

to have a lion's share of representation in the HoF. Its ethnic composition explains 55 representatives out of its 66 seats.

Population size of a state also determines number of representations of a state in the HoF. The States have one representative for every one million population more. The population factor makes the state of Roomier to have 25 seats out of its 26 total seats followed by the State of Amhara. The population sizes of ethnic groups in the SNNP have generated six representations in the HoF out of the 61 representations it has.

The SNNP dominates the HoF. Currently, it constitutes 45.5 percent of the total 134 seats. This enables the SNNP to easily win simple majority votes (50+1) by forming a coalition either with Oromia or with Amhara or with combination of either any of Somali/Benshangul-Gumz/Gambel/Tigray. That is, legally speaking, , by design, the setting of the HoF and the simple majority rule empowers the SNNP, Oromia and Amhara to influence decisions on the distribution of federal subsidy, concurrent revenues among the States and resolutions of the Inquiry Commission in their favour or to reject, if they think the outcome of the decision will negatively affect them. Thus, the setting of the HoF has made the three big states "more equal States than the equals" as they are strongly represented in both Houses. Legally speaking, the remaining minority States have little influence in decision making of the HoF.

(ii), The HoF in Ethiopia is not a formal law making body. Unlike in other bicameral Houses, it does not have the power to approve or reject a law ratified by the lower chamber. Nevertheless, it has equivalent legislative power to interpret the Constitution through the Council of Constitutional Inquiry, to determine issues on identity, claims and right to secession, to resolve disputes between States, to design formulae for distribution of federal subsidy to the States and concurrent tax revenue of the Federal Government and the States (Federal Constitution, 1995 Art.62). All these legal acts are binding on all the States.

(iii) The HoF and the HoPR jointly determine undesignated taxation powers (Federal Constitution, 1995 Art.99). In reality, however, the HoF has no deterrence role in the joint session with the HoPR as it constitutes only 134 (19.7 percent) of the total 681 joint session seat. The HoPR can pass any resolution without the voting support of the HoF in the joint

session. Put it differently, the setting of the HoF fall the minority States at the mercy of Oromia, Amhara and the SNNP, because their representation in the HoF and in the HoPR give them to easily meet the simple majority by forming coalition each other.

Table 3 1. States' Representation in the HoF and HoPR

States and City Governments	No.of ethnic groups in each State	HoF		HoPR	
		Seats	Share in %	Seats	Share in %
Tigrai	3	7	5.2	23	4.20
Afar	1	2	1.5	8	1.46
Amhara	4	23	17.2	138	25.23
Oromia	1	26	19.4	178	32.54
Somali	1	5	3.7	23	4.20
Benshagul-Gumuz	5	5	3.7	9	1.65
SNNP	55	61	45.5	138	25.23
Gambela	4	4	3.0	3	0.55
Harari	1	1	0.75	2	0.37
Addis Ababa	-	-	-	23	4.20
Dire Dawa	-	-	-	2	0.37
Total	75	134	100	547	100

Source: HoF, and HoPR documents, 2010 .Shares of the Houses computed by the author

### ***The HoPR***

Like other parliaments, representation of the Ethiopian States at the HoPR is based on the principle of proportionality of Population. A populous State has more representation at the HoPR. Out of the total 547 parliamentary seats, Oromia constitutes 32.54 percent. The State of Oromia constitutes a lion's share followed by Amhara and the SNNP,

where both States have 24.23 percent each. Oromia can win a simple majority vote in the HoPR sessions by forming a coalition with Amhara or with SNNP or with the remaining States together.

### **3.2 Creation of the States (*Kilils*) and Local Governments**

#### **3.2.1 The Making of the *Kilils* (1992-1994)**

International experiences of federations reveal that there is no ‘one-size-fit-all’ process of demarcating a jurisdiction. For instance, in large part of the USA<sup>50</sup> and in Germany, States/Landers and local governments are mapped on territorial basis, while Regions in Belgium and the province of Quebec in Canada are demarcated on ethnic base for historical and political considerations. In Russia and to a large extent in India and Nigeria, identity interest is well applied (Elazar, 1987:244-45). In Spain too, the reorganization of Catalonia, Basque country, Galicia Autonomous Communities were made on identity basis (Laborda and Escudero, 2007:423-424). Given that Ethiopia is a home for about 86 ethnic groups, and Nation/nationality question has been a critical political issue, the territorial demarcation has been made predominantly on ethnic-basis.

The making of the Regions in Ethiopia has taken place in two periods. In 1992, fourteen *Kilils* (Regions)<sup>51</sup> were crafted out of the pre-existing provinces mainly on ethnic lines. As overwhelming of the ethnic groups have less than a million population, all ethnic groups cannot enjoy *Kilil* status and therefore several small ethnic groups with similar cultures and languages were put together to form one bigger *Kilil*.

There were claims and counterclaims for territorial domains among political organizations. Harari, Addis Ababa, Dire Dawa and Wollo Province were among the most controversial ones as OLF, an influential opposition group in the HoPR during the TGE, claimed that all these

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50 Note that the eastern states were created by colonial settlements in part religious.

51 The Proclamation lists the following *Kilils* (Regions): Kilil-1(Tigray), Kilil-2(Afar), Kilil-3(Amhara), Kilil-4 (Oromia), Kilil-5 (Somali), Kilil-6(Benshangul-Gumuz), Kilil-7 (Gurage, Hadiya, Kembata, and Alaba, Tembaro, and Yem), Kilil-8 (Sidama, Gedeo, Burji, Amaro, and Gicho), Kilil 9 (Wolaita, Dauro, Konta, Aydi, Gamo,...), Kilil10 (Baskito, Murssi, Ari, Hamar,...), Kilil11 (Kefficho, Dizo, Surna Bench, Sheko,...), Kilil 12 (Gambela), Kilil13 (Harari) and Kilil14 (Addis Ababa).



territories belong to Oromo land. OLF proposed the Cities of Addis Ababa, Harari, and Dire Dawa to be autonomous city governments within the sovereignty of Oromia *killil*, and for the establishment of a Wollo Oromo *Killil*. The Somali Fronts, Harari League and EPDM strongly opposed the OLF's claims on Dire Dawa and Harari and the establishment of Wollo Oromo *killil* respectively. OLF's claim over Addis Ababa was also rejected by all Members of the Council of Representatives (CoR) of the TGE. As an effect, the House passed a resolution that Addis Ababa City should stand on its own *Killil* (Region) and Wello province to be incorporated within *Killil 3* (Amhara Region) by guaranteeing the rights of the Wollo Oromos for self-government within the *Killil* (TGE, CoR Minutes, 1984 E.C).

The issue of Harari was more contested. On the one hand, the Harari League Party (HLP) strongly demanded the restoration of the past Harare's territories which has been occupied by Oromo. On the other hand, OLF strongly claimed the City as part of Oromo land. Withdrawal of OLF from the Transitional Government in 1992 had created new opportunity to peacefully resolve the Harari case. The HPL and Oromo People Democratic Organization (OPDO) discussed on the issue and reached a consensus that: (i) Harari is a state of its own but its territory shall be limited to the *Hundie Wereda* only and, (ii) the Oromos within the State shall have representations in the Council of the Harari State. Each political organization presented this compromise formula to their respective constituencies and organized a joint conference for final ratification <sup>52</sup>(TGE, CoR Minute, 1984 E, C). Thus, Harare has become a state which has been created through genuine consultation and dialogues between political parties and local people.

With regard to Dire Dawa, both the states of Oromia and Somali claimed the city of Dire Dawa. The CoR decided that Dire Dawa shall be

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52 HNL and OPDO jointly organized People to people conference, where 170 representatives, (85 from each ethnic group) and six observers attended to decide on the fate of Harari. The Parties presented their joint proposal to the participants of the conference that recognized the creation of Harari as a *killil* which include the Jegol Wall, the city of Harar and the Hundie Wereda. The decision was ratified by the representatives of Harari and Oromo. Lastly, the decision was reported to the CoR and it accepted the wishes of the people (CoR Munit, 55th Regular Meeting, page 00128-129).

accountable to the Central government as a “Provisional Dire Dawa Administration” until the problem gets permanent solution (CoR Minutes, 55<sup>th</sup> Regular Meeting).

### 3.2.2 Remaking of the States of the Federation (1994)

The Federal Constitution has redefined the States. It reduced the fourteen *Kilils* (Regions) of the TGE to nine States (Regions) by merging five *kilils* to create a giant State known as the SNNP.<sup>53</sup> Besides, the Federal Constitution recognizes the City Government of Addis Ababa as a seat of the Federal Government and accountable to the centre (Federal Constitution, 1995, Art.49 (3)). Dire Dawa has not been mentioned in the Constitution but remains accountable to the Federal government.

The territorial mapping of the States has ethnic as well as territorial features. The States are demarcated on the basis of settlement patterns, language, identity and consent of the people concerned (Federal Constitution, 1995, Art.46). The federal arrangement places ‘ethnicity’ at the centre<sup>54</sup> (EPRDF, 1991:26)<sup>55</sup>. It would be, however, wrong to

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53 *Kilil-7*(Guragie,Hadiya,Alaba,Timbaro,andYem); *Kilil-8* (Sidama,Gedeo,Burgi,and Amaro/ Koyra); *Kilil-9* (Welayta,Dawro,Konta,etc) ,*Kilil 10*(Biskito,Mursi, Hamer,...etc), and *Kilil-11*(Kaffico,Surna, Shekocho, and etc) were merged together to form the SNNP State.

54 In this dissertation, multiethnic federalism is used to describe the nature of the creation of the constituent members of the Federation instead of using the phrase ‘ethnic-based federalism’ for couple of reasons: first, all States are not created along ethnicity lines. Second, the ethnic-based federalism phrase belittles or undermines the spirit of the federal system.

55 TPLF/EPRDF is the architect of the multiethnic federalism in Ethiopia. Since its birth in 1975 T.P.L.F has been adherent to the right of Nations and Nationalities to self-determination up to and including secession (see TPLF’s political Programs). However, Until January 199, TPLF/EPRDF did not explicitly articulate what political system it would institute ( a unitary or federation) after the fall of the Derg regime. the Official documents including the political programs of the Fronts implicitly reveal the choice of some kind of association of nations and nationalities on free will in the form of federation or regional autonomy under “scientific socialism” with a Marxist Leninist party leadership. TPLF/EPRDF’s proposal for a federationl or confederation, under a democratic united Ethiopia, was declared for the first time at the First EPRDF’s Organizational Conference, held in Tigray, January 1991, just four months before it assumed power. The Conference passed a resolution that the provinces shall be restructured along the settlement of nations/nationalities on their free will and choice (EPRDF 1991:26).

generalize the reorganization of the states and local governments have been done only along ethnic lines. No uniform criteria was applied either in the creation of the States or in the establishment of local governments. Rather, two pragmatic approaches have been applied. In the states where there is a majority ethnic group among others, ethnicity is used as a prime criterion. For instance, the relatively homogeneous states of Tigray, Afar, Amhara, Oromia and Somali are formed mainly along ethnic lines, although there are minority ethnic groups within the states. In contrast, in the SNNP, Benshangul-Gumuz, and Gambela states, where numerous-ethnic groups exist but no one is dominant, a mix of factors like politics, economic, settlement pattern, culture and language similarity have been taken into consideration. Therefore, these States are formed through union of many 'indigenous' ethnic groups.<sup>56</sup>

The formation of SNNP is viewed differently by different political elites. On the one hand, the Southern Peoples Democratic Forces (SPDF), an opposition regional party in the SNNP, has strongly criticized the merging of the five states. It argues that the merging is not only undemocratic as the stakeholders were not consulted but also contradicts with the principles of the Federal Constitution as it denies the right of the merged *kilils* to form their own state.<sup>57</sup> It also challenges the merging policy that the five *kilils* are no less entitled to form own state than the Hareri people, who has secured recognition of state with less population size and economically not better than any of the merged *Kilils*. On the other hand, the South Peoples Democratic Union (SPDU) currently named as South Ethiopia Peoples Democratic Movement (SEPDM), a member of EPRDF, lauds the creation of the SNNP.

The creation of a giant State of SNNP might be seen from economic and political perspectives, although the political factor seems more critical. Given the ethnic groups which were incorporated into the SNNP are small in population size; it could be argued that forming many small

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56 The Preamble of the Constitutions of the SNNP, Gambela, and Benshangul-Gumuz identify and recognize the indigeneous Nations, Nationalities and Peoples who constitute respective Stats, while the Preamble of the remaining state constitutions name only the dominant ethnic group. For instance, the Preamble of the Oromia State begins with " We, the Oromo People..."

57 Among others, the Sidama Liberation Movement (SLM) demands for a statehood status.

states along ethnic lines would not be economically viable<sup>58</sup>. One may argue that the amalgamation of the small five *Kilils* would allow yielding benefits from economies of scale in providing public services and to minimize negative spill over effects. The economic argument alone may not fully explain the reality, unless the political factor is ignored. True, the States of Gambela, Benshangule-Gumuz and Harari, which enjoy state status, are neither in a better economic position nor they have higher population size than each *kilil* which were merged to constitute the SNNP. SPDFU's critics on the merging of the five *kilils* might be persuasive if the political factor is ignored. The political factor seems to have more weight than the economic ones for a couple of reasons:

(i), the idea of merging is likely an outcome of the formation of the SPDFU and SPDF, contending regional political forces in the south. These political forces were umbrella of various ethnic-based political organizations. They formed a Union or a Front to win a regional election by jointly mobilizing their resources and promoting similar political agendas in their respective domain areas; and

(ii), the idea of merging the five *Kilils* seems to have a political objective to deter OLF's long standing hegemonic political agenda over the small and weak States of the south by creating a giant counter balance State in the south.<sup>59</sup> Likewise, the small States of Gambela and Benshangul-Gumuz have been retained to abort OLF's hegemonic

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58 According to the population census of 2007, out of the 56 ethnic groups, 11(18%) have less than 5,000 people, 34 (56percent) between 5,000-100,000 people, and 5(8percent) between half a million and one million. Only Sidama, Welayta, Gurage, Hadiya and Gamo ethnic groups have population size between a million and 1.5 million each.

59 OLF and other secessionist Oromo political elites advance the North versus-South, the Orthodox Christian versus non-Orthodox, and the Cushitic versus Semitic (Habesha) dichotomy labeling the North, the Orthodox and the Semetic (Tigray and Amhara) as colonizers and the south, the non-orthodox and the Cushitic as colonized people since the turn of the 19th century . OLF political program perceives Oromia land to include all lands where oromos inhabit and "the joining of other nationality groups [non-semetic, except Harari and guragie]" (Lema 1997:97-98). OLF also claims more areas from the present Sidama, Kembata, Gurage lands, Wello and south Tigray (see CoR minutes, 1984; modern Oromo map in Assefa; 1993:6; Holcomb and Ibssa, 1990:71-74, and OLF's Oromia map, [www.oromo-liberationfront.org](http://www.oromo-liberationfront.org), visited March 2008). Thus, the creation of SNNP state in the south as well as Gambela and Benshangul in the west seem to abort the OLF's hegemonic political agenda.

political goal over these tiny nationalities because OLF considers the western tiny minority ethnic groups which have constituted the states of Gambela and in Benshangul-Gumuz as 'black Oromo' (Young, 1999).

Any reform on territorial mapping should be made on thorough consultations with stakeholders-residents, political parties, local officials, intellectuals, etc., albeit it consumes time and money. Unless it is argued that residents from the merged five *Kilils* (Regions) were represented at the Constitutional Assembly Conference, no referendum was conducted whether the residents of the merged *Kilils* (Regions) would like to form a giant state by merging together or to remain being a small state of their own. Failure to conduct referendum or ignoring the wishes and desires of the stakeholders in the process of making the giant state of the SNNP has caused the regional ruling party to unnecessarily pay a dear political price. In reaction to the merging measure, political entrepreneurs in the merged Region have rallied their ethnic groups behind them to strive for a higher status. They created grave instability in the SNNP which forced the regional ruling party to restructure the types and numbers of government tiers (Zones, Special weredas and weredas).

### **3.2.3 Redemarcation of the Local Governments (1995)**

Local governments are creatures of their respective States. Again, two pragmatic approaches have been applied in the redemarcation of local governments (the Zones, Special Zones, Special *Weredas*, and *Weredes*). Zonal Governments and Special *Wereda* Governments comprise several rural and urban *Woreda* Governments. In the heterogeneous states of SNNP, Benshangul-Gumuz and Gambela, Zonal and Special *Wereda* Governments are mainly established along ethnic lines regardless of their economic viability. In the SNNP, Zonal Governments (ZGs) and Special *Wereda* Governments (SWGs) are formed by breaking up heterogeneous Zone/*Wereda* Administrations. When a single ethnic group is found very tiny, two or more ethnic groups were brought together to form a ZG or SWG, often based on cultural and language similarities. Each ethnic group is fairly represented in the Council of ZG or SWG or WA. In Benshangul-Gumuz and Gambela, each founding nationality/ People is organized at Zone Government level. In contrast, in

the relatively homogeneous States of Tigrai, Afar, Amhara, Oromia, and Somali, the creation of LGs (*Weredas and Kebeles*) took into account administrative convenience, population size, and settlement pattern. Some minority ethnic groups within Tigrai, Amhara and Afar are exceptionally established on ethnic basis at Zone or Special *Wereda* or Kebele level. For instance, in Amhara, four minority nationalities, namely, Awi, Wag-Hamra, Oromia and Argoba have formed their own government at Zone level (The Revised Constitutions of Amhara, 2001). Minority ethnic groups in Tigrai, namely Irob and Kunama are structured at *Wereda* and at Special *tabia (Kebele)* level respectively. Similarly, the Argoba people in Afar exercise their self-rule right by forming a Special *Wereda*.

It is worth noting here the distinction between the Nationality-based Zonal Governments and the functional Zonal Administrations (FZA). The former are constitutional self-government entities. They are established on ethnic basis to guarantee the rights of minorities to self-government. They have elected Councils, Executive and Judiciary bodies. They have representation at the State level (see the Revised Constitutions of Amhara, SNNP, Benshangule-Gumuz, and Gambela). In contrast, the relatively homogeneous States of Tigrai, Oromia, Somali, and Afar have FZA. For instance, in addition to Nationality Administration, the state of Amhara has seven FZAs. They do not have Council and Judiciary bodies. Executives are appointed by and answerable to respective State Councils. They are established to serve as administrative links between the State bureaus and *Wereda* Governments.

Next to the Zone or special *Wereda* government unit, a *Wereda* (district) comes as a third government tier. *Wereda* Government can be rural or urban. *Wereda* Governments are recognized in the States' Constitutions. They have Council (legislative), executive and judiciary bodies. Kebele (commune) is the lowest administration unit and closest to the people. Both rural and urban *kebeles* have Council, executive and social court (judiciary) organs. The outreach of a government to the people would serve as an instrument to promote grass root participation in decision making, mobilization of resources for enhancing local social and economic developments.

It should be noted that the organization of government units of the States and the City Governments is not uniform across the States. Neither the City Governments have same governmental units. Constitutional Zone /Special Wereda Governments are peculiar to the heterogeneous States. Harari and the City Governments of Addis Ababa and Dire Dawa have structured their government units quite differently. The City Government of Addis Ababa is recently reorganized into 10 sub-Cities and 116 Wereda Governments. *Kebeles* are omitted to reduce administrative costs. Because of the smallness of their geographical size, Councils of Harari and Dire Dawa have omitted a *wereda* government tier believing they can easily reach their constituencies through the *kebeles*.

In summing up, the federal Government of Ethiopia has five levels of government, namely; the Federal, States, Zone/Special Wereda Government, Wereda Government and Kebele in descending order. The last three constitute a local government. All States do not have uniform LG tiers. They are established in a way to fit with their specific state circumstances. For instance, the States of Amhara, SNNP, Gambela, and Benshangul-Gumuz are structured into three vertical government levels, while Tigray, Afar, Oromia, and Somali have two levels of local government. Harari and Dire Dawa are of one local government tier.

Chart 3.1. Federal-Regional-Local Government Structures, 2010

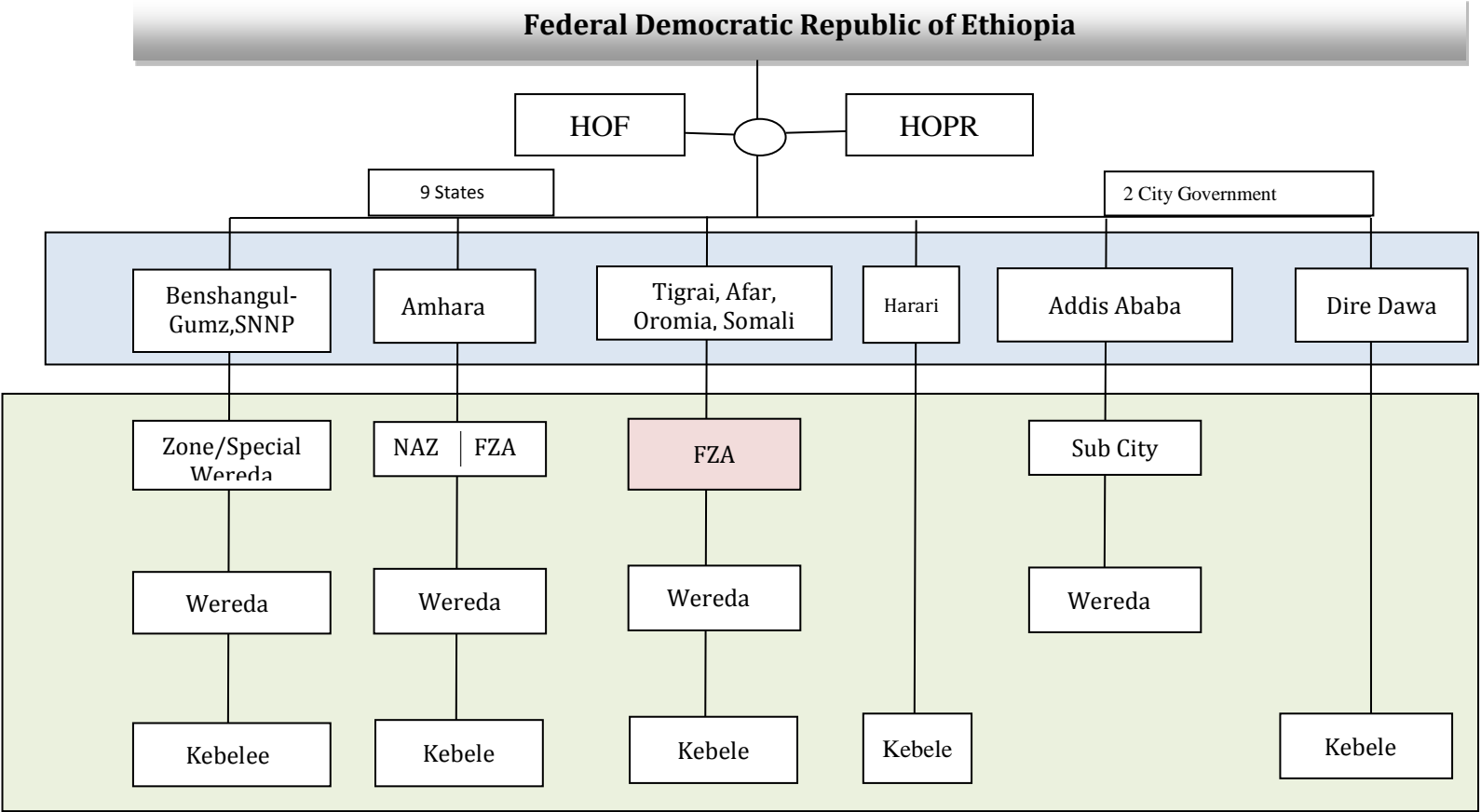




Table 3.2. Local Government Structure, 2011

	Tigray	Afar	Amhara	Oromia	Somali	B-G	SNNP **	Gambela	Harari	AA	DD	total
No. of constitutional ZAs SW	None	None	3	none	none	3	13	3	none	none	N	23
	1	1	3 1	none	none	2	8	1	none	none	None	12
No. of FZAs	6	5	7	18	9	none	none	none-	none	10	None	55
No. of RWGs	37	31	129	265	53	19	134	12	none	-	-	80
No. of RKAs	NA	NA	NA-	6,342	NA-	NA-	3,714	-	17	-	-	15,000
No of sub cities	NA	None	NA	NA	none	none	NA	none	none	10	None	10
No. of WULGs	12	3	29	39	1	2	22*	1	none	116	NA	226
No of UKAs		NA	NA	482	NA	NA	211*	NA	2	NA	NA	

Source: CSA 2007 Census Report, Central Statistics Agency,

\* Oromia National Regional State (2008) Socio-economic profile, BoFED, , [www.pcdp.gov.et/Or](http://www.pcdp.gov.et/Or)

\*\* SNNP, Proclamation No. 103/2006, The Revised Proclamation for the Establishment, Organization and Definition of Powers and Duties of Urban Centres of the SNNP

B-G= Benshangul- Gumuz, AA =Addis Ababa; DD=Dire Dawa; NA= data not available; RWGs= Rural wereda Governments

UWLGs= Urban Wereda local governments; RKAs= Rural Kebeles Administration; UKAs= Urban Kebeles Administration

## ***Fragmentation of the Local Government***

The Federal Constitution recognizes Federal-States intergovernmental relations only, leaving the establishment of local governments to the judgment of the States. In Ethiopia, the *wereda* local government (WLG) organization makes distinction between Urban Local Government (ULG) and Rural Local Government (RLG).<sup>60</sup> Two points justify such a distinction. One thing is that the Ethiopian economy is characterized by a mainly agrarian economy. Another is that there are marked differences in the local preference for public services between the urban and rural areas.

Delimitation of sub national governments should be stable. If redrawing of the existing boundary deems to be necessary, it should be based on research and be evaluated against the long term political implications, economic and administration feasibilities (UN, 2000). Looking through the Ethiopian local governments, this is not the case. Over the past two decades, there is a trend towards frequent reorganization and fragmentation process of local governments. Many factors explain this.

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60 Naming and grade of the ULGs vary from a State to state. For instance, the SNNP categorizes urban centers into two: Town administration and municipalities. The former, in turn, is sub divided into four ranks: Leading City, Second level Towns, Medium Level Towns and Lower Level Towns (SNNP, Proclamation, No. 103/2006). In Oromia, urban centers are categorized in four grades (Grade 1, 2, 3 and 4) solely based on population size of the urban centers (Oromia, Proclamation No.116/2006). The Amhara State classifies urban centers into City Administration, Municipal Towns and Emerging towns, in which City Administration takes the form of (a) City Administration, (b) Amalgamated City Administration, and (c) Metropolitan City Administration, while Municipality towns are sub divided into Lead Municipality and Sub-municipalities or Infant towns (Amhara, Proclamation No.91/2003). The State of Tigray categorizes urban centers into Metropolitan Municipal Cities, Municipal Towns and Emerging (Infant) towns (Tigray, Proclamation No.107/1998). Emerging towns in Tigray and Amhara, Grade 4 Towns in Oromia and Municipalities in the SNNP are transitional settlements from rural to urban.

In Tigray, urban LG classification considers mix of criteria: population size, territorial size of the urban centre, economic base, annual revenue capacity and residents' per capita income. An Emerging Town should host a minimum of 2,000 inhabitants engaged predominantly in petty trade and agricultural activities. Towns are urban centers with more than 20,000 dwellers and their economic base is mainly non-agricultural activities. Metropolitan are urban centers which comprises two or more town administrations. Metropolitan and Towns are independent legal entities. They have City Councils, and defined assignment of responsibilities. For purely economic efficiency reasons, however, Emerging Towns are not autonomous government units, rather they are integral parts of respective rural WAs (Tigray, Proclamation No. 107/1998).

Restructuring of local governments without detailed studies and its long-term impact is not an uncommon practice in Ethiopia. Altering or modifying or creating a new LG should be legitimized through referendum. In Ethiopia, however, this is an exceptional practice rather than a normal process.<sup>61</sup> Reorganization and delimitation of local governments are vested in the State's power. As illustrated in Chart 3.1 and Table 3.2 above, the heterogeneous states have established Zone/ Special *Wereda* immediately next to the Regional States, while the relatively homogeneous states have set *wereda* Governments.<sup>62</sup> Each Zone/ Special *Wereda* or *Wereda* Government comprises many *weredas*. Again each *Wereda* has many *Kebeles*.

In 1996, amalgamation of *Weredas* took place in the four relatively advanced states (Tigray, Amhara, Oromia and SNNP) to cut down the total number of their *Weredas* by half. Two entire or partial neighbouring *Weredas* were merged to form a 'bigger' *Wereda*<sup>63</sup> without consulting respective residents. The objective of the amalgamation was to make use of the available scarce public resources by minimizing administrative costs. The amalgamation of *Weredas* was not found popular mainly having a higher government tier is strongly associated with large amount of federal/state transfers, better public service delivery and better access to powers and privileges for local politicians. As a response to the reaction of the merging policy, the states were forced to revisit their policy. By 2010,

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61 There is a strong emerging demand for a higher government tier in the SNNP. So far Silte zone is the only successful outcome of a referendum. It was formed by splitting from Gurage Zone via referendum in 2004. Budget issue may preclude executing referendum for each and every public demand. Lack of political willingness to exercise participatory democracy at local level is also a serious attitude problem; although sometimes limited consultations with local people have taken place in the process of forming new LGs. There is a strong emerging demand for a higher government tier in the SNNP.

62 Note that in the Revised Constitution of Oromia, Zonal Administrations are recognized but they do not have a legislative body. Like in the other homogeneous states, Zones are agents of the state.

63 Tigray claims the use of combinations of various criteria like population size, agro-ecology (homogeneity is required), administrative suitability, ethnicity, settlement pattern, access to road and geographical factors, economic potential (capacity), and consent of inhabitants (Tigray, Proclamation No. 99/1998 E.C). In practice, however, consent of people and administrative convenience received less consideration. Population size and ethnicity were major criteria in forming the *Weredas*.

the numbers of ZAs /SWAs and rural WAs increased to 35 and 774 respectively as compared to 13 Constitutional ZAs/ SWAs and 552 WAs in the entire country in 2002. The SNNP, a home land for 56 ethnic groups, is a major contributor to such a sharp increase of the ZA/SW<sup>64</sup>. Oromia leads the multiplication of *Weredas* from 180 WAs in 2002 to 304 in 2010(see Table 3.2).

### **3.3 Debates on the feasibility of the federal arrangement**

The Ethiopian federal arrangement takes “settlement pattern, identity and consent of people concerned” (Federal Constitution, Art.46), as main criteria in creating the states. However, there is no consensus among the ethnic-based and ‘multi ethnic’ political parties and intellectuals on the principle, nature and possible outcome of the EPRDF’s multiethnic federal arrangement. It is praised by some and criticized by others. The debates for and against the EPRDF’s multiethnic federal arrangement revolve around non-economic and economic issues. The non-economic arguments include the issues of national unity, administrative feasibility, democracy and human rights, while economic arguments emphasize on economic disparities, and mobility of labour, capital and trade. All these debates are discussed below.

#### **3.3.1 Non-Economic Arguments**

##### ***National Unity and multiethnic federal arrangement***

The opponents of the multiethnic federal arrangement equate the system to tribalism. Aleme (2003) interprets the federal arrangement as a ‘system of apartheid’. Daniel (2002) views it as a ‘divide and rule tactics’

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64 Populous ethnic groups such as Gurage, Haiya, Sidama, Gedeo, Silte, Welayta and Dawro constitute own ZAs, whereas tiny ethnic groups form ZAs bymerging two or more ethnic groups. For example, Kembata-Timaro, South Omo, Keffa, Bench Maji and Gamo-Gofa Zones comprise various ethnic groups. The Special Weredas are often homogenous ethnic groups except Derashe, which encompasses Derashe, Debase, Kusumie and Mossiye ethnic groups.

aimed at fulfilling the aspirations of Tigrian hegemony over the others.<sup>65</sup> Tronvoll (2000:20); Aalen (2002:45); Aleme (2003); and Berhanu (2008:2) are of the same opinion. The opponents of the multiethnic federal arrangement strongly oppose institutionalizing ethnicity and guaranteeing the right of Nations, Nationalities and Peoples to self-determination up to and including secession. They view it as a risky business. It will destroy the collective identity, and the social glue of tolerance and harmony that have kept Ethiopians united for centuries, destroy and ultimately will lead the country to disintegration (Ottaway, 1995:244; Alemante, 2003; Sisay, 2004:82; Mesfin, 1996:96; Lidetu, 2002:320; Assefa, 2012). They argue that Article 39 of the Federal Constitution is an open-ended clause to easily manipulate ethnicity for controlling power and resource or to whip up secessionism by inventing pretexts. According to them, what guarantees a democratic united Ethiopia is respecting individual rights on the principles of liberal democracy not guaranteeing the right to self-determination including secession (Sisay, 2004; CUD, 2005; Lidetu, 2002 E.C). The Thesis does not recognize or gives less emphasis to collective rights of NNP.

With regard to what form of government would be feasible for Ethiopia, the opponents promote various political programs however. For example, AAPO and MOA-ANBESA adhere to a constitutional monarchy. *Semayawi* Party, Unity for democracy and Justice and All Ethiopia Democratic Organization are adherent to a unitary system. EDP promotes the USA style territorial (geographical) federalism and urges for de-ethnicization of the States and redrawing of the existing 'ethnic-based' states taking in to account a mix of both economic and non-economic criteria such as geography, population size, cultural and historical ties of communities, language, national identity, administrative efficiency, economic viability, settlement pattern, population mix, people's will, and other essential factors (UEDP, EDP-MEDHIN, 2009: Agenda12; Berhanu, 2008:20; CUD Manifesto, 2005:89). Daniel (2003) also denounces the present federal system and suggests a territorial federalism by reinstating the previous 'historic provinces' of Ethiopia.

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65 Many of the 'multi-national' political parties like EDP, ANDINET, AEDP, EPRP Ginbot 7 and Semayawi Party whose social base are predominantly Amhara ethnic group reject the multiethnic federal arrangement.

Ethnic-based political parties, who felt they were peripheral and were being treated as subjects, not as equal citizens in the past regimes, have welcomed the EPRDF's multiethnic federal arrangement. The lefts political forces also share the principles of EPRDF federal arrangement. For instance, Samarta (2004:1150) notes:

*"[R]edrawing the administrative regions of Ethiopia along ethnic lines had some immediate and apparent benefits for communities who were previously marginalized, demonized, or whose existence was denied ....One of the major benefits of the new order was the establishment of script for many languages and their use as medium of instruction in regional primary schools....It also demystified cultural basis of political domination. Recognizing this type of cultural diversity was a vital step in disconnecting political ethnicity from cultural identity and was therefore an essential step towards the creation of civic order."*

Others also consider the multiethnic federalism as an instrument for safeguarding the minority rights and an effective means of resolving ethnic conflicts. For instance, Kidane (1997) lauds the federal system as "*a new approach to state building in Africa and noble ethnic policy*," whereas Keller and Smith (2005:265) note that the Ethiopian federal arrangement "*...represents a novel approach to power sharing*." Furthermore, Assefa (2007:341-2) also argues: "[T]he delineation on ethnic-base has something to do with safeguarding those citizens who find themselves a minority within a sub national territorial unity....It could be wise to adopt ethnic line demarcation at local level to avoid inter ethnic tensions (in the choice of language) when there are several ethnic groups living together in a state and when none seems to be clearly dominant."

One of the pillar principles of the Ethiopian multiethnic federal arrangement is unity-in-diversity. EPRDF and other ethnic-based political forces argue that recognition of the rights of NNP to self-determination including secession, and guaranteeing rights to self-rule and shared-rule is an instrument to resolve the long standing nationality question in Ethiopia. The federal setting has not only uprooted the main threat for national unity but has also saved the country from the verge of disintegration. From mid 1970s to early 1991, the country was engulfed with civil wars between

political forces which were waging armed struggles for democracy and genuine autonomy or full independence against the central government. Insurgencies had reached at zenith in early 1991. Large parts of Eritrea were under EPLF since 1988 and it managed to create a *de facto* independent Eritrea in May 1991. TPLF had liberated the entire Tigray from the control of the central government and had established a *de facto* government during 1989 to 1991. More than five Oromo liberation Fronts and the Ethiopian Somali Fronts were waging for full independence from 'Abyssinian colonialism.' Afar liberation Front (ALF), Afar Nation Democratic Organization (ANDO), Gambela People's Democratic Movement (GPDM), Benshangul People's Liberation Movement (BPLM), and Sidama Liberation Front (SLF) were waging armed struggles for autonomy. There were more than a dozen armed political forces against the central government. All these had made Ethiopia at the verge of disintegration in early 1991. Nevertheless, the compromise deal among various political forces to devolve power to the Regions and affirmation of unconditional right of Nations, Nationalities and Peoples to self-determination including secession and respecting universal human rights in the Charter of the 1991, which later became part of the Federal Constitution, are believed to have defused substantially the ethnic entrepreneurs not to be inspired by secession of Eritrea.<sup>66</sup>

However, the multi-ethnic federal system has neither completely avoided ethnic-based insurgency nor has ended up inter-ethnic conflicts as it was hoped in the early 1990s. OLF, WSLF and ONLF, which had endorsed the Charter and joined the Transitional Government of Ethiopia in 1991, have resumed insurgency against the Federal Government demanding for

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66 The reconsideration of some ethnic-based fronts and top political figures against secession from Ethiopia could demonstrate the potential of the multiethnic federal arrangement in solving conflicts. Founder and Former Deputy Secretary General of OLF, Leencho Letta and other top former political figures of the Front have reconsidered the option for an "independent Oromia"(Leench, 2004). Political reconciliations between the Federal Government and the factions of OLF in 2008, as well as WSLF and ONLF in 2011 are cases in point. Furthermore, factional forces of the WSLF and the ONLF have declared the termination of insurgency for secession of Somali from Ethiopia and they have announced to work for the development of the Somali state in cooperation with the regional ruling party and the federal government(the Ethiopian Reporter, 2011). All these new developments have diminished, but have not eliminated, the threat of secession. The sustainability of the Peace deal is to be seen in the future, however.

full independence. To make the matter worse, other new ‘liberation movements’ have also emerged. Small scale sporadic insurgency in the north, south-west and south-east of the country are still issues of grave concerns<sup>67</sup>.

Why the federal system has not ended up the ethnic-based insurgencies and inter-ethnic conflicts? There are internal and external factors for the insurgencies spawn against the Central Government. One driving force for the sporadic insurgencies is the competition between ethnic groups to control political power at state/Zone/Special *Wereda* levels. Lack of good governance is another internal factor. The unstable and volatile politics in the Horn of Africa has also produced negative spill over effect on Ethiopia. The current ‘no peace, no war’ situation between Ethiopia and Eritrea and the crises in Somalia have created safe haven for insurgent groups in Eritrea and in Somalia against the Central Government. The Government of Eritrea hosts, trains and arms anti-government forces. Egypt also plays active role in destabilizing Ethiopia to weaken its strategic “rival” over the Nile River. Some political forces like OLF and Ginbot 7 also accuse the ruling party for narrowing the political space to struggle peacefully. The ability of the Ethiopian federal arrangement to completely preclude opposition forces from opting for insurgency, therefore, depends on the commitment of all political forces to protect and implement the Federal Constitution.

With regard to the debate on the making of the states, there is no golden rule as to how political mapping of states and local governments should be demarcated in a federal system. It should be pragmatically adapted on the basis of specific condition of a country in question. Therefore, the proponents of the multiethnic federal arrangement argue that neither de-ethnicization of the existing states as EDP and others argue, nor the restoration of the ‘historic provinces’ as Daniel (2003) recommends is a panacea to avoid the risk of secession in the country, because:

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67 Although animal raiding and counter raiding between pastoralist communities as well as inter-ethnic conflicts to control resources (grazing land and water points) have long history in Ethiopia, they have increased since 1991. Inter-ethnic conflicts are more serious in SNNP, Benshangul-Gumuz, Gambela; between Oromo and Somali, Afar and Issa (Somali), Oromo and Berta (Benshangul-Gumuz), Afar and Kereyu (Oromo).



(i) Whether using mix of criteria in redrawing the boundary of the existing state as suggested by the pro-territorial federalists above will address the right for self-determination of the NNP is doubtful. The ethnic-based political forces put first nation/nationality question to rectify the past core and periphery relationship between the oppressor and oppressed NNP. They also believe that reorganizing the States by blending various ethnic groups into one “optimal jurisdiction size” does not allow the NNP to preserve and develop their history, language, and culture to protect minorities;

(ii) In many instances, the demarcation took into account past and existing historical and political realities of the country. Before the complete unification of the country by Menelik II, the current States and the Nations/Nationalities were either enjoying wide autonomy under the central government or were independent territories;

(iii), a territorial demarcation of states does not necessarily ensure national unity.<sup>68</sup> The demarcation of the five Autonomous Regions and 24 Administrative Regions in the 1987 People’s Republic of Ethiopia took into account a mix of variables, but did not satisfy the ethnic based political organizations of the time.

It should be also noted that ethnic politics in Ethiopia is not EPRDF’s creation. It has been part of political game to control power since long time.<sup>69</sup> As Messay (2006) boldly notes, “*Ethnicity in Ethiopia is a reality that needs recognition*”. The multiethnic federalism seems irreversible and delegitimizing the system would be costly political business, because “*once ethicized politics is born, it will not go away for the simple reason that it*

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68 The former United Sudan is a typical example. States in the Sudan were created based on mix of economic and non-economic factors. But the territorial demarcation neither saved the Sudan from the separation of the South Sudan nor has brought political stability in Darfur and Easter Sudan (Beja State).

69 Ethnic politics implies using ethnic identity as an instrument for political mobilization in order to win political and economic powers over competing ethnic elites. In the political history of Ethiopia, ethnic politics is neither a new phenomenon nor an invention of EPRDF. What EPRDF has done is legalizing ethnicity. In Ethiopia, ethnic based power struggle can be dated to the Amhara revolt against the Zagwe dynasity in early 13th century. The *Zemene-Mesafint* was also characterized by ethnic-based politics. The powerful political actors of the time (Tigrrian; Amhara, Agew and Yejjju Oromo nobilities) used ethnicity as an instrument to control the Gondorian Palace. It is undeniable that the struggle for controlling central power among the regional nobilities from the fourth quarter of the 19th century to present-day revolves around ethnic politics.

*mobilizes strong emotional forces. Instead of confrontation, I maintain that it should be used to activate democratization and economic progress, the only way by which the emotional competent can be neutralized.”* (Messay, 2006). One has also to think the forceful remaking of the states on mix of criteria instead of ethnicity. Will the NNP be willing to lose the political, fiscal, administrative powers and cultural autonomy that the Constitution enshrines to them by reducing themselves to a lower status or by blending themselves with others? Will they satisfy with less political, fiscal and cultural autonomies? It is doubtful. Thus the best option seems to make use of ethnicity as an instrument of modernization, political equality and social change in a civilized way by promoting simultaneously supra Ethiopian nationalism and appreciating ethnic identity rather than de-legitimizing or concealing ethnicity. This is by no mean to say that the making of states on ethnic –base is immune from risks.

### ***Administrative feasibility***

Some scholars criticize the rationality of ethnicity in the making of the State from the perspectives of history and administrative feasibility. Bahru (2008:354) argues that reorganization of the States of the SNNP, Amhara and Oromia have been neither associated with history nor administration convenience. He notes, *“The kind of self-rule right granted to them [SNNP]... does not represent the history or language any of the constituent nationalities”* (Bahru, 2008:354). He also questions the designation of the Amhara state that has never been a region named by the name Amhara except the short lived one in the medieval period in the area of present South Wello and North Shewa<sup>70</sup>. He argues that the historic provinces of Amhara have been Gondor, Gojjam, Wollo, Shewa, etc. Nor there has been

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<sup>70</sup> Professor Bahru’s argument on the administrative inconvenience is well taken. But with due respect his historical argument that denounces the designation of the state of Amhara needs correction as there were provinces designated Northern Amhara and Central Amhara and Selale provinces during the first administrative restructure in the early 1930s (Asmelash, 1987:35). During the Italian invasion too, all Amharic speaking regions were structured under Amhara Region. Moreover, the existence of Amhara ethnic group is undeniable. The Amharic speaking ethnic groups proudly identify themselves as Amhara. For instance, Ras Imru , an eminent patriot and statesman during the first half of the twentieth century, claimed his identity to be an Amhara noting “from my father and mother side my local home is Shewa part of Amhara” (imru, 2001:1).

a centralized Oromo land. The Oromo regions<sup>71</sup> were Arisi, Bale, Lega, Jimma, etc As far as administrative feasibility is concerned, Bahru (2008:355) argues. “...*From the point of view of administrative convenience, too, it does not make sense to include within one unit the Amhara stretching from Ankober (in north eastern Shewa) to Armacheho(in north western Gondor) or the Oromo from Ginir(south eastern Bale) to Gidami (south western Wellega)*”.

Bekure (2007:74) also notes that the existing Zonal Administrations (constitutional or otherwise) are superior in creating better administrative convenience and in narrowing population and geographical size polarization to the present States. He suggests crafting out new states from the existing Zonal Administrations with some modifications by dividing the giant states and by amalgamation of the small States (Bekure; 2007:74).

True, the making of the States have not taken administrative convenience factor in to account. Citizens are forced to travel close to 1015 km from *Kibish Wereda* town of Surma, Bench Maji Zone, SNNP to Hawassa, Regional city; or to travel 1250 km passing through west Gojjam and West Welega from Pawe town, Metekel Zone to Asossa, Benshagule-Gumuz; or to spend days travelling by bus from *Bereket Wereda*(north eastern Shewa), Amhara state, to *Bahir Dar*; or from *Gidami* (south west Welega) to Addis Ababa, or from Somali Moyale, Liben Zone, to Jijiga for seeking public services which are provided at state level like referral hospital service, or appealing for Higher Court services, and business license permissions (say mining and investment related),or to attend region- wide meetings and training programs.

The proposals for breaking up the overstretched states of Amhara, Oromia, SNNP, and Somali into new smaller states either for the purpose of administrative efficiency as mentioned by Assefa (2007:266-7) or to avoid, if not to reduce political asymmetry in the HoPR, to narrow the existing population and geographical polarization among the states as suggested by Bekure (2007:83), or to avoid secession risk as argued by Lidetu (2002:303) would make sense. But, a word of caution is important here. The proposal to break up the vast states of Oromia, Amhara, Somali, and the SNNP or any

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71 True, there was no unified Oromo state in history. But it must be noted that the creation of Oromia State has aimed to accommodate the strong demand of Oromo nationalists for the right of self-rule and maintaining cultural autonomy.

other States would be workable if and only if it receives strong support from respective actors and gets significant majority vote through referendum. It should be noted that imposition from the above likely to breed political instability. Policy makers must be certain that the intention of splitting the existing overstretched states into smaller states for any reason does not repeat in one way or the other the mistake that led to the dissolution of the Ethio-Eritrea federation in 1962<sup>72</sup>.

### ***Issues of Democracy and Human Rights***

The Preamble of the Federal Constitution declares that “guaranteeing democratic order” (Federal Constitution, 1995 Preamble) by ensuring both collective rights and individual rights is one of the foundations of the multiethnic federal system. In line with this, the Federal Constitution enshrines extensive human and democratic rights of individuals<sup>73</sup> which are consistent with the UN Human Rights (Federal Constitution, Articles 14-44). Right to hold opinion, freedom of expression, and freedom of press are constitutionally guaranteed (Federal Constitution, Art.29 subarticle1-3).

As discussed above, the Federal Constitution guarantees the right of NNP to self-determination up to and including secession. NNP have the right to develop their own language, to express and promote their own culture, and preserve their history. They have the right to establish self-government within a particular territory they inhabit, and to have proportional representation at the State and Federal levels of government (Federal Constitution, art. 39 sub articles (2) and (3)). All these rights adhere to collective (group) rights and guarantee minority rights. Tronvoll,

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72 There are lessons that we should draw from the experiences of the Ethio-Eritrea federation (1952-1962) and the Biafra of Nigeria. Emperor Haile Selassie abolished the Ethio-Eritrea federation because he and some extreme Eritrean Unionists perceived the Federal Act as a stumbling block for a national unity of Ethiopia (Zewde, 1998 and Tekeste, 1997). Such a centralist mentality not only caused Ethiopia to pay dear price but also has led to loss Eritrea in the 1993 referendum. The Biafra declaration for independence was also a reaction to the decision of the Federal Government of Nigeria to split the East Region into three states (Aleman and Treisman, 2005:148). So, the proposals to break up the big States for any reason without the consent of considerable majority people's vote likely lead to high political and economic costs.

73 Out of the total 106 articles of the Federal Constitution, thirty-two of them deal with fundamental rights (see The Federal Constitution Articles 14 to 44).

(2000:20) levels the Federal Constitution as *“one of the most minority-friendly constitution in Africa, or even globally”* for being a NNP-centred.

In spite of the fact that all the human right bills and collective rights of the Federal Constitution are new chapters in the modern political history of Ethiopia, there is no consensus among Ethiopian Political forces on the essence and interpretation of democracy. The debates on democracy revolve around liberal democracy versus ‘revolutionary democracy’ and collective right versus individual rights. The rightists conceive democracy in the classic way of the western principles and values which include but not limited to: ensuring individual rights to assemble, to express ideas freely and the right to be heard, holding accountability of politicians, rotation of party power on competitive election basis, policy debates among parties etc. For the proponents of neo liberalism, putting first individual rights ensures collective rights, but the reverse is not true (Sisay, 2004:83; CUD, 20005, Ledetu, 2002).

For EPRDF and overwhelmed ethnic-based political forces, the question of democracy is beyond the version of liberal democracy. They associate it with collective rights of NNP to self-determination, to self-rule and shared rule through both elected representatives and through their direct participation, as well as to equitable distribution of national wealth. EPRDF and its partners plausibly argue that liberal democracy does not harmonize with the principles of collective rights. EPRDF is adherent to ‘revolutionary democracy’ ideology, although different definitions have been given to it at different periods. Initially (at end of the 1980s), it was associated with the Leninist concept of National Democratic Revolution or the Maoist New Democratic Revolution. It was conceived as an ideological instrument of transforming a pre-capitalist society to socialism by bypassing the conventional capitalist mode of production but developing a guided (state) capitalist system for a short duration of time with the intention to fulfil the material conditions that lead to socialism. It meant ensuring unrestricted all democratic political rights to all oppressed classes but discriminate the bourgeois and feudal classes. It presupposes proletarian/working party leadership (see various issues of Revolutionary Democracy Organ in 1989 and 1990; Daniel, 2003:261-262; ERPDF, 2002). After the 1991, revolutionary democracy was redefined referring to ensuring accelerated and radical political, economic and social transformations that would

benefit all citizens, promoting active participation of nationals in the decision making process; and building new democratic institutions by dismantling the old one (see EPRDF, 2002; Mol, 1994 E.C).

Opposition political elites accuse EPRDF for not upholding the Constitution (Merara, quoted in Aalen 2002). Leencho (1999; 66:7) also argues “...[The]formal process of democratization in Ethiopia, as it was conceived in 1991 and carried out in the following years was thus a failure”, while Paulos (2006:1) concludes that democracy is not EPRDF’s agenda, “except for employing the term as a palliative for the West’s aid package ...”. Furthermore, Merara (2003) argues that what EPRDF utters is a pseudo democracy not a genuine one.

The Federal Constitution does not see collective rights and individual rights in isolation and they do not contradict each other. As mentioned above, the right to establish self-government within a particular territory they inhabit, and guaranteeing the right of NNP to have proportional representation in various government units are basic principles of the Federal Constitution. In line with these principles, the States of Amhara, Tigray, and Afar have ensured the rights of minority ethnic groups by establishing self-government at Zonal, at *Wereda* and *Tabia/Kebele* and at Special *Wereda* level respectively. The Revised State Constitution of Gambela (Art.46 (3)) also recognizes the rights of ‘non-indigenous’ peoples who are territorially inhabited to self-government at Kebele level, and to have direct representations at Zonal and State government levels. Likewise, the Revised Constitution of Benshangule-Gumuz affirms, “Representation of other People [non-indigenous] who reside in the Region shall be treated on specific case” (The Revised Benshangul-Gumuz Constitution, Art.48, 1995E.C). The Afar state also grants Special *Wereda* status to Argoba People to exercise their self-rule and shared rule rights.

Paradoxically, the Constitutions of Oromia, the SNNP, and Somali are silent about the collective rights of the ‘non-indigenous’ or minority ethnic groups who reside in defined geographical territories for generations collectively. They have not guaranteed the right to self-government of the minority in any level of government.

The States/Zones put indigenous language proficiency criterion as a requirement to run for *Wereda* /Zone/ State Council. The language proficiency requirement is justified to promote cultural autonomy and to

protect the minority 'indigenous' ethnic groups not to be overwhelmed by mass settlers or 'non-indigenous' communities. The denial of rights to the non-indigenous minority ethnic groups, however, has generated unintended majority tyranny over the minorities as well as, in some cases, minority tyranny over majorities. The minority ethnic groups of Geode, Somali, and Berta, to mention some, who are demarcated within the Oromia state have fallen under the Oromo majority tyranny as they are denied their self-rule and shared rule rights. Likewise, minority Oromos in the SNNP and Somali are denied their rights to self-government and do not have representation at any level of government. It is absurd to exclude the Gedeo and Berta communities in Oromia, or the Oromo who reside in the continuum between the Sidama Zone and Gedeo Zones by labelling 'indigenous' versus 'non-indigenous' communities. Many of the minority ethnic groups who reside in the dominant ethnic group State have been there in a defined territory for generations. They are incorporated into the dominant ethnic group States not on their will but dictated by the 50+1 formula<sup>74</sup>. Collective rights are legitimated by a democratic process, which in principle runs on the basis of majority decision. Minority rights will remain suppressed, unless the ethnic groups who collectively reside in defined geographical areas are allowed to institutionalize in special *wereda* or special Kebele level of government, depending on their population size.

Taking the political reality of Ethiopia, both collective and individual rights are inseparable, and one cannot stand exclusively. Thus, the question is not a choice for individual rights by favouring for collective rights at the cost of individual rights. It is equally true that individual rights need not discard collective rights. Ignoring either would not democratize Ethiopia. Nor, it serves as a tool for holding together the constituent States of the federation.

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74 In the process of creating the *killils* in 1992, *weredas* were incorporated to a certain *killil* on the simple majority (50+1) rule based on the result of of 1984 *Wereda* population Census. That is, if the 1984 population census result showed that *Wereda-X* comprised three ethnic groups, say, A, B and C with 51 percent, 35 percent and 14 percent respectively, then the entire *wereda* was incorporated with a state that belongs to ethnic group A. That is, based on the simple majority rule, ethnic groups B and C of the *Wereda X* has been structured within a *Killil (Region)* that belongs to ethnic group A, even if there is a neighboring *killil* which belongs to the ethnic group of B or C.

Party pluralism is ensured in the Federal Constitution (Federal Constitution, Art.56). In the contemporary political thinking, fair and free elections, dialogue and consultation between ruling party and oppositions, existence of strong opposition party, critical media and independent civic societies are taken as core manifestations of democracy. These values have not yet get rooted as ought to be, even though it is understandable that democracy is a process.

For internal and external factors, strong opposition parties have not yet come out to the forefront. Large numbers of the relatively influential opposition political forces tend to be rejectionist and promote hatred politics. At the same time the ruling party has exhibited exclusiveness tendency. Dialogue and consultation on national issues between the dominant ruling party and the opposition groups are not common practices, but an exception. Such a political culture is a stumbling block to build a consensus-based governance system. A democratic federal system can be installed on durable foundation if a political culture for negotiation in 'give-and-take' political game between the ruling party and the opposition groups in general and with those which opts peaceful power competition in particular is in place. The ruling party is expected to take the initiative for political bargaining and dialogue with the opposition groups. Moreover, the political commitment of EPRDF to see a prosperous, united and democratic Ethiopia has to be evaluated against creating enabling conditions for coming out strong opposition party (ies) adherent to the federal arrangement as well as building a national consensus among the political forces on national agendas.

### **3.3.2 Economic Arguments**

#### ***Economic disparity across the States***

Abu (2003), and Alemante (2003) contest that the Ethiopian multicultural federal arrangement hinders national economic development and polarizing economic disparity among the states. For instance, Abu (Abu, 2003:14) notes the federal arrangement hinders not to meet "...a full realization of the economic and political potentials of the country" and it embodies high economic development risks. Although there is no study



about the impact of the federal arrangements on economic performance of the country, the economic performance records of 1992-2012 do not support the critics. Rather, the experience is quite the opposite. During 1992-2012, Ethiopia registered, on average, a 7 percent GDP growth per annum and an average of 11.5 percent annual GDP growth from 2004 to 2011, which has made the country one of the fastest growing non-oil economies (MoFED, 2012), as compared to 4 percent and 2 percent economic growth during the imperial era (1940-1974) and the Dergue regime (1974-1991) respectively (EEA, 2005).<sup>75</sup>

In terms of access to public services, the current regime inherited the lowest level of public goods and services delivery by the standards of the SSA countries. For example, primary education and secondary education gross enrolment rates were 19 percent and 9 percent respectively in 1991 against the 94.5 percent for primary and 45 percent gross enrolment for secondary school education in 2012 (MoE, 2012). Access to Primary health care was about 19 percent in 1991 and clean water supply for about 10 percent in early 1990s as compared to 90 percent and 61.5 percent respectively in 2010 (MoH, 2010 and MoWRD, 2010). There are remarkable achievements in improving access to rural road, and power too. Convergence trend in the distribution of public services is visible not only across the States, but also among urban and rural areas (Ghebrehiwet, 2010). New industrial zones, business and tourism centres have also flourished outside the traditional Addis Ababa-Adama, and Dire Dawa-Harar manufacturing and business corridors.

Assefa (2012:115) recognizes the the overall social and economic developments but notes “ Development in Ethiopia over the last two decades indicate that the positive gains of ethnic-based divisive hegemony are outweighed by their negative impacts” Alemante (2003:81) plausibly argues that the federal arrangement has created skewed distribution of economic base (labour, infrastructural development and natural resources) among the States. The critics implies a wide economic disparity among the States would create only a few wealthy states but also develops a sense of economic chauvinism and an attitude of “We are subsidizing the ‘poor

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<sup>75</sup> Examining the link between the fiscal federalism and economic growth is not the focus of this study.

states''' among ethnic entrepreneurs of the wealthy state(s). This would eventually breed secessionist tendency to fully control over economic resources (Alemante, 2003:89).

As far as economic capacity of the states is concerned, the multiethnic federal arrangements have created three categories of States. Category A includes the relatively advanced States of Tigrai, Amhara, Oromia, and SNNP. Category B encompasses the development lagging States or Emerging States of Afar, Somali, Benshangul-Gumuz, and Gambela. Category C refers to the small City State of Harari, the City Government of Addis Ababa and the Dire Dawa Administrative Council. There are visible disparities in population and geographical sizes as well as in economic base among the States (see Table 3.3 below). The States of Category A comprise 86 percent of the total population and 65 percent of the total territorial area of the country. The asymmetries are glaring when State-by State comparisons are made. For instance, Oromia comprises 37 percent and 31 percent of the total population size and geographic area respectively. In contrast, Harari's share is 0.03 percent in population and in total area size. Economic bases of the States also significantly vary. Among the nine states, five of them have population size ranging from 183,000 (Harari) to 1.4 million (Afar) (CSA, Population Census, 2007).

Taking gross value added production and investment as indicators of economic base, Oromia stands next to Addis Ababa City Government. It hosts about 27 percent of the country's total number of the manufacturing firms (Oromia, 2010). By 2009/2010 fiscal year, Oromia attracted about 22 percent of the total national domestic and foreign investments (MoFED, 2009/10b). Its geographical position, natural resource potential, skewed public investments<sup>76</sup> are believed to contribute to such a relatively better economic base.

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76 Since the 1950s, central government's public investment on mining, agricultural development, physical infrastructures, military training centers, state farms, higher education colleges etc have been concentrated in Oromia, although the Oromos were not direct beneficiaries of the projects in the previous regimes. The Federal Government perpetuates similar public investment policy. It allocates huge capital investments on sugar plantations, engineering and chemical plants, large scale irrigation schemes, express highways and road transport networks, industrial zones, inland ports, etc in Oromia.

The City Government of Addis Ababa and the relatively advanced States have better revenue potential than the relatively development lagging States. Institutional and managerial capacities to design and implementation of plans among the States vary also widely. The Category A and Category C states have relatively developed institutions, with better trained manpower and infrastructure, while States of Category B suffer from weak institutional and managerial capacities partly because they were historically marginalized and have started from scratch and partly because their social formations are dominated by traditional life style. The small states are more vulnerable to spill over effects and reap less from economies of scale than the relatively big states.

Although, economic disparity among the States is a reality, there is a stereo typed perception among the public and politicians about the economic resource potential of the States in general and the Emerging States (Category B) in particular. Preliminary natural resource inventories of the Category B States do not demonstrate their poorness in natural resources. They have vast arable lands, accompanied by international rivers crossing them, potential for mechanized agriculture development. Benshangul-Gumuz has huge bamboo, gum and incense resources. In terms of mineral resource, the state is endowed with gold and marble deposits. The Afar State, the home of Lucy, has huge tourist attraction potential. It is also known for its salt and potash minerals. Recent geological surveys indicate great mineral potentials in Somali, Gambela, and Afar (Solomon, 2009: 256-280). The geographical proximity of Afar and Somali to the Red Sea coast gives them a comparative advantage to become future business and industrial Zone areas. Likewise, Gambela and Benshangul-Gumuz have potential to be gate ways not only to the South Sudan, the youngest African state and emerging oil producing economy, but also connecting Ethiopia with the central and western parts of Africa in the future. Therefore, if the backlog infrastructural developments are addressed, the States have potential to attract both domestic investments and foreign direct investment.

A federal system has potential to exacerbate horizontal economic asymmetry because it leaves member states with different degrees of fiscal

capacity. All federations encompass rich and poor States, small and big jurisdictions, and large and small populations<sup>77</sup>.

With regard to the relation between economic chauvinism<sup>78</sup> and secession in a federal system, global experiences are mixed. In many federations, economic asymmetry among states is not associated necessarily with secessionism; rather the rich states look for a bigger market and collective security issues. For instance, in Canada the threat for secession neither comes up from Alberta, the richest oil-producing province, nor from Ontario province, the second highest in terms of per capita GDP with nearly 38 percent of the population and a GDP little more than 41 percent of all provinces (Rangarajan and Srivastava, 2004:1897 and 1898), but from Quebec mainly associated with history, language and cultural reasons. Neither California State, the richest State in the USA, nor Zurich Canton, the financial centre in Switzerland has evidenced politics of secession. In contrast, the balkanization of the former Yugoslavia was mainly instigated by the economically developed regions of Slovenia and Croatia which used to subsidize the poor regions of Bosnia-Herzegovina, Kosovo, Macedonia, and Montenegro by transferring to the federal fund and to the federal budgetary grant. The rich regions felt that they would be better-off on their own than keeping on subsidizing the poor regions<sup>79</sup> (Aleman and Treisman, 2005: 151).

No doubt, the wide asymmetry in economic base together with elites' perceived "most endowed in natural resource/ economic base" has created economic chauvinism in Ethiopia. The claim of Eritrean nationalists, Oromo and Somali liberation movements for full independence had been associated partly with this perceived economic chauvinism. As far as Eritrea is concerned, Eritrea had possessed relatively better infrastructural

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77 For instance, the states of California and Wyoming in the USA; the Landers of Northrhine-Westphalia and Bremen in Germany; Swiss Cantons of Zurich and Appenzell Inner-Rhodes; and the States of Uttar Pradesh and Sikkim, India, are cases of illustration (Boadway, 2007:100; Feld and Von Hagen, 2007:126; Rao, 2007:154; Kirchgassner, 2007:519 and Fax, 2007:345).

78 Here, economic hegemonism (chauvinism) is defined as concentration of economic bases and natural resources within a single state or in a few states and associated with the mentality of 'we are economically supreme' among political elites'.

79 Besides the economic factor, there were also problems of religion between Islam and Orthodox christianity, and language identities, for example the Albanian community (Albania, Kosovo and the Macedonian part of Greece).

development, urbanization growth, and manufacturing base in the 1940s to mid-1970s as compared to the remaining Ethiopian provinces partly because of the Italian legacy and partly due to better central government budget allocation in line with the appeasement policy of the Emperor. In 1960s-1990s, Eritrean liberation Fronts pronounced that Eritrean socio-economic base was by far advanced than the 'colonizer's economy [Ethiopia]<sup>80</sup> and imagined an 'independent economically viable Eritrea'. Eritrean intellectuals also echoed that an independent Eritrea would be economically viable (Araia, 1981). Berhe, (1993:42-43) claims Eritrea has "sizable skilled manpower" that will make it a production hub, distribution hub, corporate HQ and technical service hub in the Region<sup>81</sup>. In addition to

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80 Italian colony made immense investments on infrastructure (railway, sea port, road, buildings, rope way, etc.) on small and medium scale mechanized agriculture, on establishments of small and medium manufacturings as well as on urban development (Tsegai, 1981). True, all these had laid down necessary conditions for emergence of a capitalist mode of production in Eritrea, which hardly existed in the remaining Ethiopian provinces. It is worthnoting that the 'Eritrean modernization' has not brought about visible social changes or structural transformation. The Eritrean economy still relies on subsistence agriculture.

81. Eritrean nationalists used colonial experience and exposure to Italian technology "as the basis of imaging a modernity, 'developed Eritrea'" (Abbay, 2001:479) and "Eritrean identity distinct from that of their kin to the south of the Mareb" (Abbay, 2001: 490).

In terms of economic progress, the 1960s-to mid 1974 years were a golden period as Eritrea was investment preference area for Italians investors, Yemeni and Indian traders. The Emperor's appeasement policy towards Eritrea as compensation to the unilateral dissolution of the Federal Act, also contributed to channel relatively higher public budget in the province. The arguments of economic viability of an independent Eritrea has remained controversial. At least, the experiences of the past two decades do not support the economic viability argument or a 'Singapor Eritrea'. It is worth noting that one of the justifications for the federation of Eritrea with Ethiopia was that the Eritrean economy cannot survive alone (see UN Resolution 390 A (V)), and Abay (2001). Unlike the 1960s- 1990s Eritrean nationalists, the political elites of the 1940s and 1950s were sceptical about the economic viability of Eritrea. For instance, Walde-Gabriel Dabassai (1947) expressed his grave concern on the revenue capacity of Eritrea saying that, "The idea [of independence] looks good. But, if [Eritrea] becomes independent, how will it be administered . . . Does it have revenue deposits or is there any one out there to lend it money to manage its hospitals, courts, schools, agriculture and industries ... Yes, it is good to yearn for [our] own government, but [we] have to have confidence in our revenues and the wealth of [our] country. I think, our land is the poorest, the most barren [in the world] ... and [it] can not support itself". (Walde-Gabriel Dabassai,1947).

the political factors (dissolution of the federation), these imaginations seemed to seal the eyes of Eritrean nationalists not to see for a genuine autonomy, or federation or confederation arrangement under a united democratic Ethiopia. Eritrean elites and the fronts perceived Eritrea will be better-off alone and staying with Ethiopia would slow the progress of Eritrea (Sewed, 1998). They think only Ethiopia needs Eritrea for its port services, although the post- independence period does not attest an economically advanced Eritrea and a backward Ethiopia<sup>82</sup>.

There is also a widely spread imagination among ardent Oromo nationalists that “Ethiopia mainly depends on Oromo economic and labor resources” (Asefa, 1997: ix) and pronounces “*Oromia’s resources are siphoned by the Federal Government*” (Assefa, 1997: 16). Marera, (2003:175) also claims that Oromia generates coffee which contributes 60 percent of the country’s hard currency but “*receives disproportionately [federal subsidy] the least from the national treasury,*” With regard to the Ethiopian Somali nationalists, the oil and natural gas resources potential in the Ogaden have allured the secessionist groups to claim for full independence.<sup>83</sup>

Economic chauvinist (hegemonic) mentality is a serious potential threat to the national unity of Ethiopia. The OLF and Ethiopian Somali secessionist groups are not receptive to unity under a democratic Ethiopia on free will of peoples rather they are inspired by Eritrean nationalist. For instance, Asefa (1993:181) notes,” The EPLF demands for a referendum to determine Eritrean political destiny was recognized while that of Oromo suppressed.” But this is by no means to diffuse the arguments of Berhanu, (2008), UEDP-MEDHIN, (2009: Agenda 12) and Lidetu, (2002: 306) that propose for replacing the multiethnic federal arrangement by a territorial-federalism to

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<sup>82</sup> The reality is that Ethiopia and Eritrea need each other for the prosperity of their citizens, economic development and regional security issues. Eritrea needs large market to sale for her products at lowest transport cost nearby. It also needs Ethiopia to supply her hydroelectric power and raw materials for its manufacturing sector, as well as consumable agricultural products. Equally, Ethiopia needs Eritrea for its short distance port services, market and to have a dependable regional security partnership.

<sup>83</sup> The marginalized policy of the past regimes, the ‘Greater Somalia’ project of the Somalia Republic (until 1991) had also contributed to develop secessionist mentality.

curb the threat. The danger of economic hegemony could be neutralized by pursuing an effective and balanced regional economic development policy, designing fiscal equalization and by integrating the States' economy with each other. Promoting horizontal co operation among the states and building solidarity spirit among the peoples and the states would also serve as effective instruments.

**Table 3.3. Some Indicators of Asymmetries among States in Ethiopia**

Indicators	Tigray	Afar	Amhara	Oromia	Somali	SNNP	B-G	Gambela	Harari	AA	DD
Population size, '000 2007 census <sup>a</sup>	4,314 (5.8%)	1,41 (2%)	17,214 (23%)	27,158 (37%)	4,439 (6%)	15,043 (20%)	671. (1%)	307 (0.4%)	183 (0.3%)	2,738 (4%)	343 (0.5%)
Area size In Km <sup>2</sup> <sup>b</sup>	50,078 (4.4%)	96,707 (8.5%)	156,960 (13.8%)	353,632 (31%)	279,252 (24.6%)	112,343 (9.9%)	50,248 (4.4%)	25,802 (2.3%)	374 (0.03%)	530 (0.05%)	11,733 (1%)
Real state GDP per capita at constant price, in Birr	834 <sup>c1</sup> (1998/9)	6,149 <sup>c2</sup> (2011)	689 <sup>c3</sup> (1998/9)	1323 <sup>c4</sup> (2008/9)	NA	NA	NA	NA	NA	3,479 <sup>c5</sup> (1994/5)	
Financing recurrent expenditure from own revenue in %2007/8 <sup>d</sup>	32.3	13.7	16.4	18.8	13.6	17.6	24.9	10.4	32	NA	41.2
Private capital investment in million Birr, approved projects 2008/09 <sup>e</sup>	10,919	4,880	12,208	63,598	56	4,510	644	704	NA	120,543	8,079

Source: <sup>a</sup> National population Census 2007 Report, Central Statistical Agency, Addis Ababa,

<sup>b</sup> CSA Oromia National Regional State, Regional Economic Accounts Statistics 1882-2002 EFY Estimates, Part IV, Bureau of Finance and Economic Development, 2011

<sup>c1</sup> Tigray National Regional state (1999) Estimates of Regional income Accounts for Tigray Region (1994/5-1997/98, Final Report, BoPED

<sup>c2</sup> Afar National Regional state, 2013, BoFED Regional Domestic Product Estimation, 2004EFY

<sup>c3</sup> Amhara National Regional state, (2001) Estimation of Regional Gross Domestic Product of ANRS ((1993/4-1998/99), Bureau of Planning and Economic Development,

<sup>c4</sup> the National Regional States of Oromia, Regional Economic Accounts Statistics Part-III [www.bofed.oromia.org](http://www.bofed.oromia.org), visited on March 2009

<sup>c5</sup> Addis Ababa City Administration, A GDP study of Addis Ababa, Estimation for 1986 & 1987 EFY Economic Account Team, 1998

<sup>d</sup> FDRE, MoFED data base<sup>e</sup> FDRE, MoFED2008/9 Annual Report on Macroeconomic Development



## ***Mobility of People and Capital***

Alemante (2003:89), Sissay (2004:82) and Daniel, (2002) are of the opinion that the federal arrangement impedes inter-regional competition and limits the ability of the national government to create a common economic sphere. The criticisms presuppose that the multiethnic federal arrangement is a stumbling block for free mobility of labour, capital and trade across the states. The next sub sections investigate if the federal arrangement has hindered inter-state mobility of productive resources (labour and capital) by examining the push and pull factors of migration under different regimes.

### ***Mobility of People***

According to Todaro's (1994 :265) theory of migration, people leave their areas of residence to a jurisdiction where they think their expected income from migration is better than the current earnings. Boadway (2005:30) also notes that in a federal system, difference in net fiscal benefit (NFB)<sup>84</sup> causes mobility of productive resources, because federalism leaves sub national governments with different degrees of fiscal capacity to raise revenues and variations in cost of public services delivery. In other words, people migrate if they believe the gains of public services from migration overweigh their tax burden. These theories of mobility are more relevant in a homogeneous society and/or in advanced countries than heterogeneous societies and in developing countries. As labour mobility is more influenced by social factors, in societies where diversity in ethnicity, culture, language, religion are visible like in Ethiopia, fiscally induced inter-regional migration is expected to be low.

There is a wide spread perception among the public and intellectuals that the multiethnic federal arrangement has impeded mobility of people and capital across the States. To evaluate the relevance of this criticism, one needs to examine the pull and push factors, and compare the trends

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84 Net fiscal benefit (NFB) is defined as difference between citizens' tax burden and the public services they receive in return.

of inter-state mobility under the previous regimes to the current federal arrangements. According to the 1984 Population Census report, during the Imperial regime (1974), inter-regional labour mobility constituted only 9.7 percent (2,716, 243) of the total population, of which 3.3 percent was inter-provincial migrants (CSA, 1991:276). During the Dergue period (1974-1984), mobility of people comprised 16.4 percent of total population, of which only 5.1 percent was inter-provincial migration (CSA, 1991:246), showing a higher level of labour mobility than the previous regime. There is no precise data on inter-state migration for post-1991 period<sup>85</sup>. However, 16.6 percent over-all migration rate was registered at the country level, (CSA, 2007:355); almost the same rate with that of the 1984 Population Census Report, although the current mobility rate presumably is dominated by intra-state migration.

During the imperial period, the major pull factors for the very low level of labour migration included low developmental level of modern economic sectors (industrialization and mechanized agriculture) and urbanization,<sup>86</sup> low level of educational attainment at national level (literacy rate was less than 10 percent) and the high migration cost associated with social affection to local area, to mention few. Frequent local and provincial level droughts (1957, 1973-74), and the land tenure system were among the push factors for migration.

The relatively higher labour mobility rate during the Dergue regime was mainly contributed by (i) the large size of armed force deployment from different parts of the country to the turmoil areas of north and east provinces, civil service job transfers into the various state farms (mainly south, south west), and mass displacements due to the civil war between the central government and guerrilla fighters in Eritrea and Tigray, and (ii) the forced resettlement program of the 1984/5 that dislocated about 600,000 people from the drought-prone provinces of Tigray and Wollo, as well as the densely populated areas of Kembata and Hadiya, Shewa

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85 The 1984, 1994 and 2007 population censuses inquire informants where they have been living before 10 years. Nevertheless, the Central Statistics has not released the inter state movements of people to the public.

86 In 1974, out of the estimated total 27,800.8 million, the urban population constituted only 10.9% (CSA, 1975, Statistical Abstract).

provinces. Migration to urban centres seeking for higher education and jobs were also among the push factors.

The requirement to have a pass permit from respective *kebele* Administration to move from residential area to other places the chronic shortage of housing in the urban areas and the land policy that had granted the '*gebar*' (tenant) were pull factors. (Mberu, 2006:513) argued that the right to use land had served as a pull factor to keep people in their local areas too. Moreover, social cost is expected to be a more pressing factor as people are traditionally rooted to their local areas for language, culture and social attachment reason. Even before the introduction of the multiethnic federalism, data reveal that inter-regional migration tended to a province of the same ethnic group (CSA, 1991:261), where migrants do not feel social shock due to differences in language, culture and/or religion<sup>87</sup>

The impact of the multiethnic federal arrangement on labour mobility has a mixed effect. In line with the Peace and Reconciliation Charter of the 1991 and later in the spirit of the Federal Constitution, the States have adapted local language proficiency as requirement for civil service recruitments and for political appointments. The states of Tigray, Oromia, Harari, and Somali have introduced own local language as office language and medium of instruction in schools. Public services are also provided in local languages. Even though the SNNP, Benshangule-Gumuz, Gambela, and Afar have adopted Amharic as working language, as long as indigenous skilled labour supply is available, they give employment opportunity priority in the civil service to the 'son-of-the-soil'. The states recruit 'non-indigenous' when they do not find indigenous skilled manpower in the labour market. All these have contributed to the existing low level of inter-states labour mobility.

But, this is by no mean to say there is no inter-state labour mobility at all. Addis Ababa has continued to be a destination city for professionals, businessmen and labourers as it has better job and

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87 For example, Tigrians used to make Eritrea their first choice of migration for seeking jobs, not only for proximity reason but also they share same language and culture. Similarly, Tigray was also a second destination province, next to Addis, for Eritreans. Likewise Gonder province was first destination for Gojjameis (CSA, 1991:261), who belong to the same ethnic group.

business opportunities and ethnic identity is not an official requirement for getting a government employment. Urban settlements in Afar, Gambela, and Benshangul-Gumuz are dominated by migrants from Amhara, Tigray, Oromo, Gurage, kembata, and Hadia (CSA, 2007 census). Professional occupations (like teaching, health, engineering, accounting, etc) and office clerk positions also are carried out by migrants.<sup>88</sup> More over the urban centres in the Emerging States are overwhelmed by migrants, called as highlanders or Habesha. For instance, in Afar, among the total urban dwellers of 185,135, the Afar constitute only 5 percent the Amhara dominant followed by Tigrians, Oromo, Welayta and Hadiya in descending order (CSA, 2007 Census). Moreover, the federal mega projects such as sugar development, constructions of power plants, irrigation dams, road and rail way constructions, etc have also created temporary large inter-state labour movements from north to south<sup>89</sup>. Apart from military deployment, there is hardly movement of labour from south to north.

The EPRDF land tenure policy has made the rural population to stick around his/her farm lands. Because maintaining land use right or transferring the land use right in the form of inheritance or donation from parents or close relatives require permanent residence in a rural *kebele* where the farm land is located. A land use right holder who left his/her residence *kebele* for longer than a year loses his/her use right of agricultural land (Getnet and Mehrab, 2010).

Positive interventions of the Federal and States Governments in enhancing access to public service at local level are also believed to contribute to the existing low inter-state mobility. That is, unlike the past, migration to neighbouring state(s) for seeking education opportunity is no longer a cause for inter-state mobility. Currently there are public universities and many state and private colleges in each states. The states receive federal transfers to provide minimum national standard public services. The Productive Safety Net Program (PSNP),

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88 The dominance of migrants in the civil service in the Emerging states does not seem last long. For instance, the introduction of Afar language as an official language of the state and using as a medium of instruction in primary schools systematically aside the migrants from the civil service sector.

89 For instance, the Grand Renaissance Dam has created about 85,000 job opportunities; almost all employees are migrants from other state.

which contributes in reducing household vulnerability and food insecurity in the rural areas, has also served as pulling factor to the needy people to stay around home area.

The Federal Constitution guarantees the liberty of Ethiopians to choose their residence (Federal Constitution, Art.32 (1). In practice, however, this is not fully respected. Neither spontaneous inter-state rural migration nor inter-state resettlement is welcomed by the states. States/Zonal politicians are reluctant to accommodate inter-state migrants in rural areas for fear of competition over resources and not to control their political power in the future<sup>90</sup>. On the one hand, local language proficiency is a requirement to running for state/and wereda Council. The politics of discouraging spontaneous inter-state mass migration and/or inter-state resettlement is strongly associated with the fear of indigenous minority ethnic groups not to be demographically overwhelmed by the “non-indigenous” migrants. From this perspective, the fear of the indigenous minority has rationality<sup>91</sup>.

In other words, there is link between language policy and mobility of productive forces. The state’s language policy to use in offices and schools has pulled out non-natives and hinders labour and capital mobility. There are political and economic rationales to promote inter-

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90 From my field trip, I observed that many of the migrants (often called highlanders or Habesha) in Afar, Gambela, Benshangul-Gumuz, and SNNP do not feel secure. There is a sentiment among the indigeneous peoples that the highlanders exploit their resources. There are many instances where the properties of migrants have been confiscated with out any compensation. *Gurafarda Weredais* a point of illustration. Amhara origins, who migrated from Wello, Gojjam North Shewa, (Amhara State), had engaged in agricultural activities at Gurafarda Wereda, Bench Majji Zone, SNNP, were forced to leave the area by the order of the State and local officials. The President Office on an official letter dated *Sene* 30, 2001 (July 7, 2008) dispatched to the Bench Majji Zone Administration, ordered to secure residency right for the migrants who have settled in the area before *Nehassie* 30, 1999 (September 06, 2006) and to be granted two hectares of land for agricultural activities as a means of their livelihood and 1000m<sup>2</sup> for housing and side farm activities. But those who settled at the Wereda after *Nehassie* 30, 1999 were considered as ‘illegal settlers’. As an effect to this decision they were ordered to leave the area. The displaced people accused the officials for forcing them to leave the area without any compensation for their immobile properties (built in and perennial trees on the land) (The Reporter, 2004EC). There are similar cases in Benshangul-Gumuz and Afar.

91 Currently, in Gambela, and Benshangul-Gumuz, the migrants are already more than the indigeneous people.

state mobility: Labour movement from the densely populated States to the scatter settlement states not opens employment opportunity. It is also critical to the hosting states in enhancing entrepreneurship skills, promoting local economic development and technological transfer. At national level, it promotes social integration and tolerance as well as minimizes separation sentiments of political entrepreneurs. These arguments need caution, however. The southward mass migration must not threaten the political, economic and cultural autonomy of the indigenous minority ethnic groups.

Balancing these contending interests of liberties of Ethiopians to choose their residence (Federal Constitution, Art.32 (1) and reaping the benefits of labour mobility on the one hand and protecting the right of self-rule as well as self determination of the indigenous minority ethnic groups are real challenges of the multiethnic federal arrangement.

From the above discussion, one might infer that the federal arrangement has contributed to the existing low inter-state labour movement, but it is not the only factor. In addition to the language policy and preferential privileges to the 'son-of the-soil' in the public services other factors such as land tenure policy, welfare policy and social factors are strong pulling factors that has kept citizens in their local areas.

### ***Mobility of Capital***

Investors consider many variables before they make choice of location for investment. Market size, transportation facilities and cost, supply of inputs including managerial competence, tax policy and rule of law are among the criteria for choosing investment location. Prior to 1974, capital and trade movements were concentrated in Addis Ababa, East Shewa, Eritrea and Hararge provinces for their relatively better infrastructural development and urbanization levels.<sup>92</sup>The 1965-1974 period has witnessed relatively better capital mobility outside the urban centres mainly because of the establishments of new agricultural developments such as cotton plantations along Awash valley, sesame in Humera (west Tigray), coffee plantations in Jima, Illubabour, Sidama,

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92 Bahir-Dar, Gonder, Jimma, Dessie, Combolicha had one or two establishments each.

Harer, etc., During the Dergue regime, private capital mobility was almost none owing to the then socialist economic and trade policies.<sup>93</sup>

When EPRDF assumed power in 1991, as a component of its economic and trade reforms, it has lifted up capital ceilings and restrictions of business registration. EPRDF also encourages a decentralized industrialization policy and free movement of capital across the states. In practice, however, private investment flow is 'mother-state' oriented. For example, large amount of domestic investments in the States of Amhara, Tigray have been made mainly by the "son-of-the-soil" investors. Though, investments by non indigenous and FDI are visible in SNNP and Oromia, considerable investments derive from the son-of-the-soil<sup>94</sup>. Investors often opt to invest in their mother-state partly because of nationalism element and partly there is wide spread perception among non-indigenous investors that state bureaucrats practice open and systematic favouritism to the son-of-soil investors (Daniel, 2003 EC: 211).

The situation in Afar, Benshangul-Gumuz Gambela and Somali is quite different. With the exception of a few FDI and domestic investment, private investments are characterized by small and medium business activities. The Emerging States have not yet built-up the 'son-of-the soil' investors. The clan-based social structure with pastoral or semi-pastoral economic base and past marginalized development policies are major factor. It should be emphasized that Somali and Afar have attracted least large scale private investment. Security problem is a prime reason for Somali state. Afar has failed to attract the hearts and minds of long-term private investment, because non-indigenous investors do not feel secure to make big investment as rule of law is less respected and ethnic favouritism is more open. For instance, in mid 1990s and early 2000s, significant investment had been made along the Awash Valley, however, the failure of the State to respect rule of law in relation to land use right and the requirement of clan leaders to have

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93 Maximum private capital Investment was restricted to Birr 500,000 equivalent to (USD 241,545) only. Issuance of business licenses was highly centralized and it was on quota basis. The Central Government was not only the sole investor but also wholesale trader as well as major retailer.

94 Both proximity to the centre and availability of better infrastructural development factors have granted Oromia a comparative advantage for investment.

free equity right in the investment and the meddling in the decision making have caused many investors to leave the State.<sup>95</sup>

The establishments of big Sh.Cos and PLCs tend to take ethnic lines. The private Banks, private colleges/university Colleges, real estate development companies, agro-industry processing plants, and trans-state transportation companies, to mention few, are formed mainly along ethnic lines. Such a trend is likely to open for ethnic favouritism.<sup>96</sup> It likely opens a flood gate to ethnic entrepreneurs to defame their market rivals owned by other ethnic groups within a state. Consumers would also likely tend to favour companies owned by same ethnic group. Moreover, private companies established on ethnic-line systematically favour in hiring towards own ethnic group. All these likely impede healthy competition, free movement of trade and capital across the states in the future.

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95 My Informants conversation with officials, non-indigenous residents and civil servants in Afar and Somali states revealed that rural lands and sub-urban lands are completely controlled by clan leaders. Investors who want land for investment have to first deal with a local clan leaders on the land size, land lease payment and terms of payment. Rates vary from one area to another depending on location, proximity to water resource, infrastructural development, negotiation skill of the clan leader and investor as well as personal relation between a clan leader and the investor. The role of the States or LGs is to legalize the result of the negotiation, issuing license, approve working plans, and collection of taxes. Clan leaders are governed by community practices and hardly respect Federal and State laws. Relations between clan leaders and investors are too personalized and often lead to misunderstandings and irregularities. When disputes arise between a clan leader and investors, a clan leader may order its fellowmen to destroy the harvest by letting their livestock into the fields. AI –Mesh Company was a typical example.

96 Business establishment along ethnic line involves risk as it likely hinders business competition. Ethnic entrepreneurs can easily spread animosity against those establishments owned by non-son-of-the-soil investors, who they think compete market in their State. politicians may also use for their election campaign. The blackmailing against the Endowment Fund for the Rehabilitation of Tigray (EFFORT), strongly associated with TPLF, could be a practical example. In the 2005 National election, some opposition parties had made EFFORT as election campaign mobilization instrument. Rumors were widely spread out that the products of Mesobo cement and Addis Pharmaceuticals, subsidiaries of EFFORT, were substandard. Such rumors had made EFFORT difficult to enter into the national market. Aftermath of the 2005 national election, CUD, an opposition coalition, officially called its supporters to boycott consuming the products of EFFORT and MEDROC-Ethiopia (see Menelik, Ethiopis, Hadar, etc News papers). As long as establishments of big Sh.Cos are kept along ethnic line, there is no guarantee that such animosity against potential competitor (rival) will not happen in the future.



Despite the states have power to set tax rate, the most powerful instrument to influence investors' choice of investment location; they apply uniform tax rates. Alternatively, they use land lease fee and modality of payment, agricultural income tax and non-monetary instruments to influence investment flow to their state. The Addis Ababa Surrounding Special Zone of Oromia is a typical example (see more discussion in 7.4.2 of this dissertation).

### **3.4 Conclusion**

EPRDF is the architect of the multicultural federalism in Ethiopia. The constituent member States of the Federation are created mainly on ethnic-lines, although other variables are also considered. The feasibility of the Multicultural federal system in Ethiopia is a debatable one. Ethnic-based political forces are in favour of the federal arrangement, while multinational political forces strongly reject the EPRDF Thesis and its federal arrangements. Both sides have arguments for and against the federal system. For the proponents, ensuring self-rule and shared- rule responsibilities as well as guaranteeing the right of self-determination up to and including secession are durable foundations to promote unity-in diversity. In contrast, the opponents of the system believe that the ethnic politics exacerbates ethnic conflicts, violates individual rights, arrests the economic progress, and may lead to the disintegration of the country.

In the context of Ethiopian reality, federalism is a necessary condition to remain the country untied. It cannot also be seen in isolation from accommodating diversity, promoting democracy, human rights, equality and development. Therefore, the feasibility of the Ethiopian federal arrangement has to be measured in its capacity to end insurgency for secession and maintaining national unity through willingness of the people. Ignoring ethnicity or concealing diversity does not guarantee national unity at any rate. National unity can be maintained only when the root cause of the national question is properly addressed, when self-rule and shared rule are genuinely exercised, when democracy and equality of all ethnic groups are ensured in all spheres, and when equitable regional development is realized.

The Charter of the Transitional Government and the Federal Constitution were designed to address the long standing National/Nationality question and to hold the unity of the country. Nevertheless, the Federal system has not yet completely prevented insurgency. Still, OLF and ONLF factions demand full independence.

There is a broadly held perception that the multiethnic federal arrangement impedes free movements of people, capital and trade. The critics have some grain of truth, albeit the federal arrangement is not the only determinant factor to the existing low mobility of resources in Ethiopia. The local language proficiency requirement for civil service employment, favouritism to “the son-of-the soil” in acquiring land for business, in awarding bids (Daniel, 2003EC:211), imposing systematically discriminatory tax burden to non-indigenous ethnic groups and States’ reluctance to inter-state resettlement have arrested mobility of productive resources. But it is by no means to say the federal system is the only determinant factor. Besides, these factors, government land tenure policy, welfare policy and social factors also serve as strong magnetic forces for rural people to stay in their local area. Nevertheless, it should be noted that fiscally induced migration to Addis from all corners of the country is quite visible for couple of reasons:

(I) the Addis Ababa City Government has allocated huge public resources on subsidized housing development project to its residents as well as on MSE to create job for the unemployed youth and women,

(II) There are better business and career development opportunities, and

(iii) The City being a melting pot, ethnic conflicts are hardly visible.

The problem of migration flow to Addis will persist and will be a social burden to the City unless the City makes a quest for a coordinated action with the major producers of migrants in the long-run. Promoting inter-state mobility of labour and capital is necessary for enhancing local socio-economic development, for achieving efficient allocation of resources, for building single common economic community and for strengthening social cohesion.

The hypothesis of ‘voting-on-own-feet’ is said to be an effective instrument to promote responsiveness of politicians to local demands, although it is believed more applicable in advanced economies and

homogeneous society. It has less relevance in ethnically diverse societies like Ethiopia as people are less mobile, among others, due to language and cultural barriers. The creation of the States and Zone/Special *Wereda* Government along ethnic lines has further weakened citizens' position to influence or alter State policies or punish predator State officials by applying 'voting-on-own-feet' or 'exit' strategy as a last resort of expressing a reaction against unsatisfactory/unmet public service(s) delivery. The local language proficiency requirement for civil service employment and delivery of public services in local language are among the factors that hinder movements of people from one States to another. Breaking up the existing overstretched relatively homogeneous States, therefore, mean creating two or more States with same languages and cultures. This will give citizens of cousin States an opportunity to migrate to another State without facing language and cultural barriers in reaction to irresponsive officials to local preferences. Thus, creating smaller states from the overstretched one may make the sub national governments more accountable to their constituents and responsible to local preferences. As competition among firms increase consumers' welfare, creating smaller and manageable states from the overstretched states would also enhance healthy competition among the States in providing public services in quality and quality.

**Table 3.4. Summary of non-economic and economic arguments**

**National unity**

Generic	Arguments	Proposals
for more Unity, towards centralization	<p>Ethnic-based territorial division is bad because it causes:</p> <ul style="list-style-type: none"> <li>▪ ethnic animosity</li> <li>▪ Secession</li> <li>▪ Collapse of the federal system</li> </ul>	<ul style="list-style-type: none"> <li>▪ De-ethnicization of the states and apply broad based criteria like geography, language, Population size, cultural and historical tie of communities, economic, political factors, etc,</li> <li>▪ Promote individual democracy rather than collective rights</li> </ul>
For ethnic-based territorial political division	<ul style="list-style-type: none"> <li>▪ Promotes unity-in-diversity</li> <li>▪ Resolves ethnic conflicts</li> <li>▪ Guarantees the right to exercise , and develop own language, and values</li> <li>▪ Protects minority rights</li> </ul>	Guarantee the self-determination of NNP

**Democracy and human rights**

Individual rights	Collective rights
<ul style="list-style-type: none"> <li>▪ local language proficiency discriminates employment opportunity</li> <li>▪ Exit: "join the mother state"</li> </ul>	<ul style="list-style-type: none"> <li>▪ Knowledge of native language proficiency is a MUST requirement to be elected;</li> <li>▪ Exercise self rule and shared rule</li> </ul>

## Economic Arguments

Variables	Content
Skewed natural resources and economic base distribution	<ul style="list-style-type: none"> <li>Elites of rich regions feel they would be better-off on their own than keeping on subsidizing the poor regions(economic chauvinism)</li> <li>Causes economic hegemony and may instigate secession mentality</li> </ul>
Population	<ul style="list-style-type: none"> <li>ethnic-based boundaries has caused population polarized states,</li> <li>no economy of scale in providing public services</li> </ul>
Geographical size	<ul style="list-style-type: none"> <li>The overstretched states of Oromia, Amhara, SNNP and Somali have created administration inconvenience,</li> </ul>
Mobility of resources	<ul style="list-style-type: none"> <li>In addition to the other pulling and pushing factors for migration, the multiethnic federal arrangement hinders free mobility of labour, capital and trade across the states</li> </ul>
Hinders inter-region competition	<ul style="list-style-type: none"> <li>Causes establishment of enterprises on ethnic lines.</li> </ul> <p>Tax rates , tax base , deductions are uniform</p>

## Mobility factors

Pushing factors	Pulling factors
<b><i>Of persons</i></b>	
Better Job opportunity	Social costs: language, culture, ethnicity
drought	Favouring for son-of-the soil in civil services
conflicts	Land tenure system and PSNP
landlessness	Access to public services (education, social assistance)
<b><i>Of economic activity</i></b>	
Availability of vast land water resources	Favouritism and lack of rule-of-law
	Lack of skilled labour
	Lack of basic infrastructure (water, roads)



Generation Theory of Fiscal Federalism (SGTFF)<sup>98</sup>. The FGTF is based on the Tiebout's (1956) 'vote-by-own-feet' hypothesis, Olson's (1969) principle of fiscal Equivalence, Musgrave's (1959) trio of public sector functions, and Oates' (1972) decentralization theorem. The theory takes only economic variables as determinant factors in assignment of responsibilities to different levels of government. In contrast, the SGTFF is an innovative and a contemporary school of fiscal federalism that has enriched the theories and practices of fiscal federalism by incorporating new disciplines such as the Principal-Agent problem, the economics of information, organization theory, theory of contracts and political choices.

This chapter comprises two sections. The first section reviews the theories of fiscal federalism on assignments of macroeconomic stability, income redistribution and allocation of resources among different levels of government in a decentralized system. The second section reviews Dafflon's (2006) (de)centralization matrix which serves as a general framework of assignment of responsibilities.

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98 Tiebout (1956); Olson (1969), Musgrave (1959) and Oates (1972) are the founding fathers of modern public finance, known as the First Generation Theory of fiscal federalism (FGTF). Dafflon (2006:275) also calls it a TOM model, by taking the first letters from the fathers of the modern theory. It is also known as traditional/normative theory. In this study, FGTF, or TOM model or traditional normative theory is interchangeably used. Note that Oates (2005) in his work entitled "Towards a Second-Generation Theory of Fiscal federalism" acknowledges the arguments of the contemporary theories of fiscal federalism and the emergence of the so-called Second generation theory of fiscal federalism (SGTFF). Wiseman (1989; 1990) and Dafflon (1977) were the first to develop a logical construct capable of embracing the complexity of objectives endemic to federal countries in the real world. The method has been further developed over the last 30 years and has been applied to many issues, first at the local, cantonal, and federal levels in Switzerland. It has also been experimented in several country cases where Prof. Dafflon has been active: for the Council of Europe in the Balkan area particularly in Albania (Dafflon 2011), for the Swiss Cooperation and Development Agency in several Indian states, including Sikkim (Dafflon 2009) and Nepal; and for the World Bank in Senegal, and Cameroon (World Bank 2011). The method emphasises toward the practical and implementation-related problems of decentralization.

## **4.1 Theories of Fiscal Federalism on Assignments of Responsibilities**

### **4.1.1 Macro-economic Stabilization Function**

Policy makers apply expansionary or contractionary monetary and fiscal policies to achieve sustainable economic growth and stability by altering aggregate demand, output, and employment. Monetary policy refers to matching the supply of money being circulated in the market with growth rate of real national income of a country, designing appropriate maximum and minimum limits of interest rates as well as bank reserves, prescribing, and evaluating exchange rates, and credit policies, whereas fiscal policy implies the use of government's spending, taxing and borrowing policies for achieving macroeconomic stabilization and inter-personal equity.

Monetary policy is effectively done by the centre only. The central argument for the exclusive assignment of monetary policy to the centre is that maintaining monetary equilibrium between the supply of and demand for money requires, above all, monopoly power of a National /Central Bank.<sup>99</sup> A decentralized monetary policy cannot be successful, if sub national governments were bestowed with monetary authority, each sub national government would have incentive to finance its expenditure needs by printing money as much as it needs, which, in turn, leads to a hyper inflation and unstable exchange rate in a country. This logic automatically constraints sub national governments from using monetary instruments for the purpose of macroeconomic management (Oates 1972:4; and 2005:251; King, 1984:37-38). The FGTF asserts that to maintain macroeconomic stabilization Central Governments have to have power over monetary policy and fiscal policy instruments. For instance, Oates (1972:4), in his decentralization theorem, demonstrates the following three potential weaknesses of a decentralized fiscal policy.

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<sup>99</sup> A central government delegates the dynamics of monetary policy to a National/Central Bank. The latter is supposed to be an autonomous body, guided by an independent Board and directed by a Governor, answerable to a Parliament. Note that in some countries it might be accountable to an executive body, where its autonomy to formulate prudent monetary policies is compromised.



(i) **Local governments are small and highly open economies.** When an economy exhibits a downturn, an injection of additional finance or cutting tax by a local government for the purpose of macroeconomic stabilization leads to a financial outflow in two ways. First, injection of financial asset through purchasing a large quantity of goods and services yields quite small multiplier effect to the local government. It brings about positive income and expenditure effects to the local government in the short run, but it can raise demand for imported goods and services and can end up creating deficit trade balance in the long run. Second, since capital is a mobile resource, income generated through economic activities in one state/LG leaves out easily to others. Quite a small proportion of capital accumulation remains within the local government. Thus, the problem of capital flight due to smallness and open economies make local governments sub-optimal to perform countercyclical fiscal policy (Oates, 1972:4-5)

In addition, local public fund injections to stimulate local economy might flow out of a local jurisdiction due to national regulation or regional business treaty for open tender requirement above certain level of domestic public investment. Hence, there is no guarantee that a “son-of-the-soil” enterprise will win an open tender in undertaking a certain project initiated to stimulate local economy (Oates, 1972).

(ii) **Free riding behaviour-** Local governments are exposed to a high degree of spill over effects. When a local government takes unilaterally macro stabilization measures (for instance, spending considerable public fund to reduce unemployment rate), the benefits of the policy may spill over to neighbouring jurisdictions. In such a situation, neighbouring jurisdictions will develop a strategic fiscal behaviour to benefit from other jurisdiction’s expenditure policies without internalizing the costs. Therefore, a state/LG does not have incentive to take part in stabilization functions that cause spill over effects to others (Oates, 1972).

(iii) **Deficit financing-**States/LGs are supposed to operate on a balanced current budget, although capital budgets are not often balanced if states/LGs have the right to borrow from financial institutions or from higher levels of government. States/LGs might end up with debt burden if they become reluctant to raise local taxes for debt repayments. Such a situation develops lobbying behaviour among officials to ask the

central government to come to their rescue for bailing out their debt (Oates, 1972). Furthermore, local borrowing may exacerbate inflationary pressures as more money is injected to the local economy.

For the above mentioned three reasons, Oates (1972:30 and 2005:351) stresses macroeconomic stabilization function “must rest with the central government.” The above arguments would be “correct” in “normal” circumstances, but not macroeconomic stabilization policy which needs rapid answers in a short time. Dafflon distinguishes between the concepts of macroeconomic management and macroeconomic stabilization policies. The former has long-term objectives (economic growth, creation of new jobs, stable exchange rate and price); while the latter aims at curbing the consequences of short term economic ups and downs. Distinguishing these issues is important since one may have State governments joining macro policy but not able to or not in a position to have stabilization policies.

Prud'homme (1995:205) and Tanzi (1996: 305) argue that a decentralized fiscal policy aggravates macroeconomic problem. King (1984: 38) notes sub national governments are not in a position to increase public spending for raising aggregate output, aggregate demand and full employment unless they borrow. Neither they can cut spending nor raise taxation when the economy heats to check inflation. According to King, if sub national governments attempt to deal with stabilization policy by borrowing from domestic institutions, it will cause raise in interest rates and may negatively affect investment or crowds out private investment. If the public spending is financed from abroad, it will disturb the current balance of payment. If it is financed from taxes, it causes to raise living costs and destabilizes industrial peace leading to wage negotiation by trade unions (King, 1984:295, and 303).He also argues increasing state spending for the purpose of stabilization policy attracts migrants from other jurisdictions (King, 1984:38).

The arguments for the exclusive monetary power to the central government are not contested. However, Dafflon (1977 and 2006: 277), Gramlich (1997:398-401), Shah (1997:10) and Boadway and Shah (2009) have questioned the conventional wisdom of an exclusive central government responsibility over macroeconomic stabilization policy. True, sub national governments do not have monetary policy instruments to

monitor macroeconomic management. But, according to the SGTF, provided that sub national governments have sufficient budget resource, they can have a role in macroeconomic stabilization efforts through manipulating fiscal policy instruments. The shared responsibility calls for vertical and horizontal policy co-ordination, although coordinating all states and LGs for a common objective is really a challenging task. Because all stakeholders might not have equal interest in the outcome of the policy coordination or each state/ local government might have other specific local agenda(s) that they would like to give priority.

The Swiss experience is typical evidence. Dafflon (2006:277) notes that the budget size of the Confederation is too small at the margin to successfully perform stabilization policy alone, because about 82 percent of the Confederation's total budget is allocated to rigid budget categories (personnel, interest payment, grant-in-aid, revenue sharing written in the constitution). Only 11 percent of the total budget is spent on consumption and investment, which is suitable to modify in the short term for the purpose of stabilization policy. Looking through the public expenditures pattern of the Swiss Cantons, 79 percent of the total budget is allocated to rigid budget categories (personnel, debt interest, revenue sharing and grant-in-aid). The remaining 21 percent (of which consumption and investment constitute 12 percent and 8 percent respectively) of the total Cantons' budget can be manoeuvred for short-term counter-cyclical measures. In contrast, Swiss Communes spend 33 percent (21 percent on consumption and 12 percent on investment) of their total budget on non rigid budget categories. The relatively higher consumption and investment budget size of the Swiss cantons and Communes attests their capacity to take part in the macroeconomic stabilization in the short term (Dafflon, 2006:277).

Dafflon (2006:277) further argues that investment expenditures at the federal level are in fact investment grants and not direct expenditures. At the Cantonal and Commune levels, planning and democratic decision procedures for investments, including possible referendum delay, make it difficult for short term adjustments. Dafflon concludes,

*"The actual distribution of expenditure responsibilities between the three layers of government in Switzerland, and the very*

*nature of these outlays, do not mean that any macroeconomic policy through fiscal instruments is impossible at least from a conceptual point of view. Yet, because of the difficulty of acting on personnel expenditures and transfers in the short term, one must recognize that any macroeconomic policy cannot be driven by and at the centre only. It requires some form of consensus and vertical cooperation between the three government tiers. This is not an easy matter because the (26) cantons and (around 2550) communes can conduct their own fiscal management, in line with objectives not necessarily compatible with those of the federal government". (Dafflon, 2006:277).*

It is worth noting that regional development planning which aims at attaining economic growth, stable prices, and employment creation, poverty reduction in the medium term and long-terms are shared responsibilities of the centre and sub national governments. The Canadian provinces, Australian states and German länders too, together with their respective federal governments, take part on the long term regional development endeavour (King, 1984: 45).

#### **4.1.2 Redistribution function**

The concept of redistribution has two dimensions: interpersonal (individual) equity and inter-regional (horizontal) equity. The former aims at ensuring a minimum level of living standard of citizens, without the competition of 'public versus private goods'. The later aims at meeting a certain degree of fiscal capacity equalization across states/LGs so that poor sub national governments would be able to provide a minimum standard of public goods and services to their constituents. Here, the discussion focuses on interpersonal redistribution dimension, because mobility of people and capital are more affected by differential interpersonal redistribution policies.

Interpersonal redistribution function is a collective good that needs government intervention. Governments often engage in interpersonal equity function by applying three interrelated instruments, namely;

- (1) tax-side redistribution policy (transfer of resources from rich people to lower income earners by imposing progressive tax rate on personal income),
- (2) expenditure-side redistribution policy through selective free access to public services, and
- (3) Public budget allocation on education, health and the like which mainly target at low income groups and introducing various forms of social welfare interventions (Bahl, Martinez-Vazquez, et.al; 2002; and Oates, 2002:723-724).

Now, the question is: should such redistributive tasks be functions of the centre only?<sup>100</sup> Or should they be sole functions of states/LGs or shared responsibilities of all levels of government? Like the assignment function of macroeconomic stabilization, there are divergent views on the assignment responsibility of redistribution function, ranging from a local public good to a sole function of the central government. The FGTFP prescribes redistribution function should be reserved to the centre only (Musgrave 1959; Oates 1972:8 and 2005:251; King 1984:33; Sinn, 1990:503). The central argument is: if a state/LG unilaterally carries out ambitious redistribution programs by imposing higher progressive tax rates on well-to-do individuals and business firms, two unintended effects will flow. On the one hand, other factors remaining constant, wealthy people and business firms may leave out to escape the excessive and highly progressive income tax jurisdictions and choose their residence and business areas in a lower tax jurisdiction. Similarly, poor people are bound to move to a relatively more generous welfare jurisdiction. On the other hand, a decentralized redistribution policy leads to under provision of and variations in redistribution programs across states (Brown and Oates, 1989 op.cit King 1992:25). In other words, decentralized income redistribution also results in negative fiscal externality for a welfarist jurisdiction. Because, immigration of poor

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100 Under a centralized unitary government system, the issue of inter-personal equity is taken for granted. That is to say, uniform tax rate on the principle of “equal treatment for equals” can be applied all over a country. To this effect, interpersonal redistribution function is carried out by the centre only. However, this is not the case in a decentralized federal system, because states and local governments have tax powers to apply a differential tax policy either for equity purpose or to attract investment into their jurisdiction.

people to a relatively 'better' welfare jurisdiction causes a higher local cost for redistribution programs and a positive fiscal externality for jurisdictions which do not have similar redistribution programs. A central government, however, has a capability to establish efficient and equitable income redistribution programs without causing distortion of productive resources, because mobility of people and business firms is, by far, less nationwide than at local level (Wildasin,1991). Prud'homme (1995:202) also notes that a decentralized redistribution function is ineffective because nation-wide income disparities cannot be corrected by local governments. Even in low mobility situation centralized redistributive policies could be argued for equal access and national cohesion.

Dafflon, (1977:30 and 2006:279); Wallisch, (2000:145), Boadway and Shah (2009:73) plausibly argue that the function of redistribution of income need not be a sole task of the centre; rather, it is a shared responsibility of the centre, states and LGs. States and LGs can design effective, specific and complementary redistributive policy packages by coordinating their policies. States/local governments would form a forum to consult each other and reach a consensus on what and how they can pursue common redistribution policies. They can also negotiate with the central government to narrow differences if the States' joint redistribution policy deviates much from the central government distribution policy <sup>101</sup>(Dafflon, 1977:30). A coordinated redistribution action among various levels of government would increase social welfare, whereas "an uncoordinated regional redistribution program leads to substantially low degree of redistribution between mobile and immobile residents."(Wallisch, 2000:145).

When mobility of resources is believed to be significant, there are two practical options of carrying out the redistribution function. (i) If inter-regional mobility has a national dimension, centralized

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101 However, King (1984 33-34), questions Dafflon's coordinated redistribution responsibility. He points out two objections. One, formulation of 'common policy' through negotiation could be unpopular for the majority of the population at lower levels of government and its cost ineffective. Uniform policy is by far more cost effective when it is done by the centre rather than by a group of sub national governments on negotiation basis. Second, redistribution schemes demand adopting progressive tax rate, which is hardly liked by the rich people.

redistribution is more effective , or (ii) If mobility is limited to a few states/LGs, carrying out horizontally coordinated redistribution function among the immigrant hosting jurisdiction(s) and emigrant producing jurisdiction(s) is recommended, although horizontal coordination is not an easy task.

Padovano (cited in Oates 2004: 359-360) believes that regional governments are superior to central government in establishing efficient redistribution function. According to his Italian political economy model, central “politics” creates inefficient inter-regional redistributive programs and it causes exploitation of a (some) region (s) by others. Padovano argues that an exclusive assignment of redistribution function to the regions may avoid the problems and each region may rely on its own resources for redistribution. However, it should be noted that replacement of inter-regional by intra-regional redistributive policies does not solve the issue. It is more efficient in the sense that a rich region may spend less for its own poor beneficiaries but it leaves out the question of the financial resources or poor regions to help its own poor.

In contrast, Pauly (1973:41) considers redistribution as a local public good and concludes that a local level redistribution policy may be more Pareto optimal than a centralized distribution one as utility for the poor people and disposable income of rich people (businessmen) increase simultaneously. Two assumptions have led Pauly to such a conclusion. (i), rich people in each jurisdiction are concerned about the wellbeing of poor people in their own community, and (ii), households are immobile. Wellisch (2000:145) argues that Pauly’s conclusion would be correct only if poor people are immobile, not households entirely. King (1984:34-35) also criticizes Pauly’s households immobility assumption for its inconsistency with the Tiebout’s ‘Voting on own feet’ argument.

SGTFF challenges the FGTF’s mobility argument for a centralized redistribution function. The SGTFF argues that mobility of labour may not be a deterrent factor to carry out a decentralized redistribution function for the following reasons. First, people are rooted to their local areas and migration has social cost. Strong social attachment and psychological feelings (both rich and poor people) towards the origin local area may make people stick around in their native place. There are situations in which the Tiebout “voting-with-feet” hypothesis makes a weak argument

for a centralized redistribution function. In a country where states/LGs are characterized by ethnic, linguistic or cultural, religious diversities, Inter-state labor mobility is less. Quebec is a typical case in point. Quebec, being a high tax province, attains lowest out-migration rate of all the Canadian provinces, because 80 percent of its population is French speaking, while the Canadian labor markets outside Quebec are English (Vazquez et al. 2006:17). Second, local governments are superior to the centre in identifying target groups who are encompassed in some social assistance schemes. They are cost effective in managing redistribution function as well. Third, social group targeted redistributions are often undertaken by local governments with time specific and defined eligibility criteria. Such a system ties the poor people to stay in their origin jurisdictions (Dafflon 2006:278-279); Vazquez et al 2006:17). Fourth, effect of difference in tax rate on net income would be less acute, provided that sub national taxes are credited against central government tax liability. Fifth, in countries where housing market is a serious problem, mobility of people is constrained (McLure, 1999:17)

Moreover, higher business profit tax may not necessarily lead to capital migration for a couple of reasons. (I) Business firms might not perceive a local progressive tax rate for redistribution purpose as a painful burden. They may understand that such a policy will create positive spill over effects to them in reducing crime, in increasing directly or indirectly the demand for their products and in supplying trained labour (King, 1984:34) and, (II), if sink cost of the business appear to be high, exit for higher tax rate reason may not be an ideal choice, at least, in the short term.

#### **4.1.3 Allocation of Resources**

There are three items in the assignment of responsibilities to States/LGs: (i) Responsibility for the supply (offer), but without necessary production or delivery which can be externalized; (ii) the production as such, that is; the State/ LG unit hiring the factors of production in order to produce certain public services/goods itself without externalization of the production, and; (iii) the delivery of the service. In small sized jurisdictions, LGs externalize the production in order to grasp economies



of scale. For example, for solid waste collection and disposal, small LG units do not have to buy a special vehicle for garbage collection and hire their own personnel: if so, they would use it only one or two days to fulfil the function and the vehicle would be on the stand for the rest of the week, which is a waste of public resource. Thus two solutions are possible: joint forces in horizontal cooperation with other municipalities. Or hire the service of a private entrepreneur. In the latter case, the LG would be responsible for the offer and the delivery (in term of service to the population), but not the production.

With regard to efficient allocation of resources<sup>102</sup> both FGTF and SGTF<sup>103</sup> use economic criteria as guidelines to determine whether a certain public service should be centralized or decentralized. The following subsection discusses how the economic criteria serve as centrifugal or centripetal forces in designing assignments of responsibilities among different levels of government. Oates (1972) identifies the following economic criteria and prescribes how the (de)centralization assignment of public services should be.

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102The concepts of economic allocative efficiency and productive efficiency are different. Whereas the former is “a broad concept relating to the economically optimal allocation of resources throughout the economy”, the latter “relates to the production of outputs at the level of the firm or organization” (Bailey, 1999:24)

103 But, there is a minor difference. The FGTF Prescribes that an ‘optimal’ assignment of responsibility can be designed by reorganizing the existing political territories or establishing functional territories as many as the numbers of local public services to be delivered, while the SGTF takes the existing institutional territory because the SGTF, in addition to the economic argument, considers political factors.

**Table 4.1.Economic criteria for (de)centralizing public services**

Economic criteria	Prescriptions
Preference	<p>If preferences are heterogenous nation-wide and homogeneous communities are distributed in a defined territory, decentralized decision making in smaller community groups would help to provide public services tailored to local preferences. The policy prescription is, therefore, redrawing as many precincts as the numbers of local public services to be provided will maximize the welfare of like-minded communities' preference. If preferences are homogeneous nation-wide, then centralization leads to optimal efficiency (Oates, 1972).</p> <p>An alternative policy is to empower local governments to provide local public services by maintaining or modifying the existing institutional territory and support them through equalization scheme and/or shared tax arrangement if their fiscal capacity is found weak to provide local public service.</p>
Information and cost of collective decision making	<p>Establishing as many small local governments as the number of public services would enable consumers to make decisions what they would like to consume. Thus participatory democracy or collective decision making maximizes welfare. Oates (1972:48) prescription is that a separate authority for each local public service that would be consumed jointly by a group of consumers maximizes welfare.</p> <p>Collective decision making in multiple service precincts generates greater welfare but it is not costless. It requires detail information. Communities need to exert efforts to negotiate and compromise among themselves until they reach to consensus or majority vote. All these imply costs of consensus based decision making (Dafflon, 2013: 204-210).</p>

Economic criteria	Prescriptions
	<p>Decision makers are confronted with making trade-off between enjoying participatory democracy at higher costs of information and participation on the one hand, and reducing the levels and number of local governments by giving up decision powers on the other. Therefore, gains from participatory democracy and collective decision making costs need to be weighted each other. The compromise solution is looking for the 'right' levels and numbers of governments that would minimize information and participation costs by scarifying some values of participatory democracy.</p>
Economies of scale	<p>Some public services require certain minimum threshold to produce/provide at or close to the lowest average unit cost. That is, for certain public services, unit cost falls as the number of beneficiaries increase and reach at the turn of <b>U</b> curve.</p> <p>The policy prescription is that if production or provision of a public service yields cost- saving because of economies of scale; centralization of the assignment of a local public service is prudent policy. And, decentralize the assignment of responsibility, if cost-saving from centralization is absent (Oates, 1972:37).</p> <p>The policy prescription implies trade-off between maximizing welfare from economies of scale and having many small jurisdictions to enjoy participatory democracy. Therefore, decision makers are in an ambivalent situation to make a choice enjoying participatory democracy or establishing a higher level of jurisdiction to benefit from the economies of scale.</p> <p>There are alternative policy options that would balance, to some degree, the benefits of economies of scale and gains from collective decision making: (I) in some cases purchasing the desired quantity of public</p>

Economic criteria	Prescriptions
	<p>service from the private sector or NGOs, or contracting out a public service to a higher level of government or a private sector or NGO, where their production organizations allow to attain economics of scale in production would be efficient without the need to merge in order to reap benefits from economies of scale (Oates,1972:45); (ii) cooperating and coordinating LGs efforts with others to jointly produce/ supply the service by forming associations of LGs to establish functional territories for each public service that require scale of economies (Slack, 2006;Shah,2006:7) and; (iii) merging of local governments to form a bigger jurisdiction also allows to benefit from economies of scale but causes lose of community welfare from collective decisions.</p>
<p>Spill over effects or inter-jurisdictional externalities</p>	<p>Spill over effect/inter-jurisdictional externality takes place when an outcome of unilateral policy action (say on education, health care, road service, etc....) of state<sup>A</sup> affects other states. One has to make distinction between production externality and consumption externality. The former takes place when State<sup>A</sup> invests, say, on human development program, its citizens benefit from the program but some of them might migrate to other States to seek for a job and the hosting states benefit from the human development policy of state<sup>A</sup> without incurring public spending. Consumption inter-jurisdictional externality occurs If educational policy of State<sup>A</sup> benefits to students who come from other states without paying study fee to State<sup>A</sup> either directly by the beneficiary individuals or by their mother state. Inter-jurisdictional externality can be positive or negative. Negative inter-jurisdictional externality implies when state<sup>x</sup> action reduces the welfare of residents of other state(s) or causes to incur</p>

Economic criteria	Prescriptions
	<p>additional cost, for example, if it dumps its sewage into a river that crosses more than one jurisdiction.</p> <p>Therefore, the policy prescription is “...each public service should be provided by the jurisdiction having control over a minimum geographic area that would internalize benefits and costs of such provision” (Oates, 1972).</p> <p>Theories of intergovernmental transfer assert that states/LGs would not have incentive to invest more on public services that spills over the benefits from their boundary if they are not compensated for the cost of externalities through some sort of matching grant (Oates, 1972:75; Boadway and Shah, 2009:326) or by individual beneficiary state. If it is a negative externality, the polluter state has to pay for the cost of the environment.</p> <p>If the benefit has regional or national impact, designing appropriate matching grants by a higher government level in favour of the victim jurisdiction would off-set the spill over effects. If the benefit spills over to a single or to a few jurisdictions, both the beneficiary and the producer of positive externality should reach to mutual understanding on the means and ways of compensation mechanism, albeit inter-jurisdictional bargaining is not easy. If they fail to reach into agreement, the central government has to find a solution. Appropriate Compensation system stimulates local governments to allocate more resource to local public goods that yield spill over effects.</p> <p>Another way of internalizing the externalities is merging territories or moving boundaries so that the territory includes all of the beneficiaries of the specific public service (Slack, 2009:335). This can be possible if the spill over effect takes place between neighbouring</p>

Economic criteria	Prescriptions
	<p>jurisdictions.</p> <p>Likewise, global scope externalities which are caused by multi-governments (example global warming) could be internalized by making it a shared responsibility of the members of the UN and by designing global financial indemnity system in which the polluters bear the cost (like the carbon trade fund).</p>
Congestion cost	<p>Commuters cause congestion cost on the existing residents for non-exclusive local public services, when there are capacity limits in the production/supplying of a certain public service. The utility an individual derives from its consumption is negatively affected, among other things, by the number of additional entrants who compete out the public service. When the number of new entrants cause welfare loses of a community, the policy prescription is to apply discriminatory pricing policy against commuter beneficiaries or to prohibit commuters from using the service (Oates, 1972).</p>

One can conclude from the above discussion that heterogeneous national and territorially homogenous preferences and congestion costs favour for a decentralized provision of public services. Costs of information and collective decision making, economies of scale, as well as spill over effects/ inter-jurisdictional externalities are pro-centralization. For the FGTF, economic efficiency is the only parameter applied to determine what public services to assign to which level of government. But for SGTF, decentralization of public local services is more than the issue of economic efficiency. It is about political and fiscal powers. It is about maintaining social and cultural values, including the right to exercise local democracy (Dafflon, 2006:285). For this reason, in addition to the economic criteria, the SGTF considers non-economic factors like history, political traditions, equity issue, public choice, social and cultural values, demographic variables, subsidiarity principle, etc. in the process of assignment of responsibilities among different levels of government.

## 4.2 (De) Centralization Matrix for Assignment of Responsibilities

Assignments of responsibilities between different levels of decentralized governments are not uniform. They vary by country due to historical and political realities, social diversities, economic determinants and geographical size, fiscal capacity, and principle of subsidiarity, etc.

Dafflon (2006:301) formulates a comprehensive (de)centralization matrix that could serve as a guideline for policy makers and practitioners to design the assignment of responsibilities between different levels of government in a federal fiscal setting. The matrix is composed of two pillars as shown in Table 4.2 below.

(i) A set of economic and non-economic assignment criteria are listed on the first vertical column. The list of assignment criteria is not exhaustive. It is left open-ended in order to give freedom for adding or deleting any criterion specific to the country under examination. Assignment criteria should be decided through participation, consultation, and negotiation among stakeholders. Definition and common understanding of concepts and terminologies among the stakeholders and reaching to consensus are essential conditions to avoid any confusion and misunderstanding. Otherwise stakeholders may interpret the concepts and terminologies differently and open up for manoeuvre (Dafflon, 2006:302).

(ii) Various institutional levels of government are enumerated on the top of the horizontal columns. All provisions of public services may not correspond with the commonly known levels of government (local, state and centre). Taken into account the specific government tier under examination of a country, it is possible to think more intermediate levels of government between the local government and the states as well as between the states and the centre or a supranational-state. Simple or multi-purpose associations like Special Purpose District Associations of communes in the USA, or Zone or Special '*Wereda (district)*' levels of governments in Ethiopia are typical examples of intermediate governments between the State and LGs. It is also possible to think of a government level formed by merging two or more states (regions) together or a union of states like the EU. The levels of government, therefore, can be organized in

a way to approximately reflect existing institutional territory, which have consonance with culture, social psychology and administrative tradition, etc. It is also possible to re-delineate the existing level of government and create a new jurisdiction to accommodate minorities' preferences (to preserve identity, language, cultural and religious values) as well as to form indigenous political institutions based on history, political choices and, economic symmetry among other factors, if necessary.

Major stakeholders, namely legislators of different levels of government, constitutional lawyer, economist and representatives of concerned line Ministers and others are core stakeholders to form the Task Force. The stakeholders are expected to fill each corresponding cell in the matrix, but with the technical advisors. The role of Constitutional lawyer and economist is to provide professional advice in delivering expertise on legal and economic arguments respectively, leaving political choice to the politicians. Checking the coherences of the political decisions, and alerting the stakeholders about the implication of their choice when inconsistencies occur are also the task of the economist (Dafflon, 2006: 302).



**Table 4.2. (De) centralization Matrix**

Assignment criteria	Institutional Government Level				
1. Macroeconomic Policies	Local	...	Regional	...	central
Openness					
Free riding					
Deficit financing					
2. Redistribution					
Mobility					
Guaranteed access					
Targeted eligibility					
Minimum service level					
3. Allocation					
Preferences					
Economies of scale					
Spillovers					
Congestion					
Decision cost					
4. Managerial Capacities					
Political					
Institutional					
Administrative					
Technical					
Social capital					
5. Socio Political Arguments					
Subsidiarity					
Participative democracy					
Information					
Control					
Accountability and transparency					
Solidarity					
6. Other criteria					
Poverty alleviation					
Fiscal competition					

Source: Dafflon (2006:301)

The matrix is not a prescription but only a framework for assignment of responsibility among different levels of government in a federal setting. It ensures participation of stakeholders in the process of determining assignment of responsibilities. It is a political economy process because officials can be cross-checked for comprehensiveness. It is a learning-by-doing process as well, because once it is understood for any function (say 'primary education') it can be repeated and adapted for other functions too (Dafflon, 2006:303).

Since the variables stated on Table 4.2 (items 1 and 3 as well as item 2) are discussed earlier in the text of this chapter, for illustration purpose, some non-economic variables are briefly discussed below.

#### **4.2.1 Subsidiarity principle**

The philosophical premises of subsidiarity principle are:-

(I) the sources and the very bases of legitimacy of all powers are people; hence, adequate political, economic and social powers have to be reserved at government levels closest to people. Put differently, LGs deserve powers to decide in all areas that affect their life. Reassignment of any public function to a higher level of government can take place based only on LGs consent and when they believe that it is beyond their production function (Dafflon 2006:290; Inman and Rubinfeld, 1998:19). Subsidiarity is a bottom-up policy process. It is worth noting that the principle of subsidiarity is inconsistent with the concept of economies of scale. Hence, in the process of assignment of responsibility, decision makers are compelled to compromise between the two.

(II) A government closer to people has a comparative advantage to "read" local preferences and demands than a higher government level. Such information advantage would help LGs to be responsive to local preferences in a more accountable manner than by any government level (Dafflon, 2006:290; Oates,

2005:35). Subsidiarity corresponds to the “preference” criteria discussed in Table 4-1 above. Therefore, subsidiarity principle maintains power at lower levels of government.

#### **4.2.2 Minimum national standard of public service delivery**

In a situation where disparities in economic bases and socio-economic developments among sub national governments are glaring, a decentralized system might cause wide horizontal fiscal disparity. Less endowed states/LGs cannot provide comparable public services at comparable tax rate to their residents. If they are to provide comparable public services they have to impose a higher tax rates otherwise residents will consume lower quantity and/or quality of public services. Such disparities are likely to result in fiscally induced labour migration and /or instigate secession feelings among those who perceive they are being marginalized. Setting a minimum national standard public service, which is the task of a central government, addresses the problem of public service disparity among states. How to produce/distribute/ deliver public services can be either left to the discretion of states/LGs or be an exclusive power of the central government or be a shared responsibility of different levels of government. Therefore, minimum national standard public services delivery is a centripetal force. Basic public services delivery might be decentralized but the central government has to finance the States/LGs through matching or non-matching grant system so that citizens will be able to get access to national standard minimum public services at comparable tax burden regardless of their choice of residence.

#### **4.2.3 Administrative capacity**

If states/LGs are to maximize the well founded advantages of decentralization, they need to have adequate administrative

capacities. Availability of professional and well experienced technical and managerial labour force in quality, quantity and composition is crucial for deepening decentralization process as well as to yield the advantages of decentralized system.

With regard to the role of administrative capacity on efficient decentralization, there are two opposing views. Prud'homme (1995) argues that lack of managerial capacity impedes decentralization efforts and pursuing decentralization where managerial capacity is a serious problem and leads to a failure. For Prud'homme, building a competent administrative capacity is a precondition for making a decentralized system work. Oates, (1994:351), however, contests Prud'homme's argument and assert "*decentralized political institutions play an important role in developing skilled public administrators by allowing more widespread and direct participation in the affairs of government.*" For the SGTF, administrative capacity is important to make decentralization work but it is not a precondition to decentralize power. Lack of administration capacity should not be an excuse not to devolve functions and responsibilities downwards, because it can be addressed through conducting aggressive short, medium and long term training programs and through learning by doing.

#### **4.2.4 Institutional capacity**

Institutions imply rules of games in a society or country to shape human and organizational behaviours in developing incentives or disincentives in the process of implementing decentralization. Institutions can be formal or informal. As far as the relationship between institutional capacity and decentralization is concerned, there are different views. Proponents of the institutional approach take the existence of well developed institutions as a precondition for success of decentralization (Litvack et.al, 1998; Azfar et al., 1999), whereas Dafflon (2006:295) and others who belong to the school of the SGTF argue that existence of advanced institutions are key

factors in achieving the objectives of decentralization, but they can be created and developed during the process of decentralization through launching capacity building schemes.

#### **4.2.5 Accountability and transparency**

Accountability and transparency are necessary conditions to make decentralization work. Accountability is of two dimensions: top-down and bottom-up. Politicians have to be accountable to their constituencies. Competitive electoral election process, consultation with citizens as well as civic societies, and responsiveness to local preferences refer to top-down accountability, whereas officials' or agencies' accountability to their immediate higher superior body refers to bottom-up accountability. Transparency implies the how rules of game or the way laws, regulations and procedures are applied. Accountability and transparency are effective instruments to enhance local participation and maximizing benefits of decentralization.

Accountability should be associated with discretion on political, administrative, social and economic matters that affect the interests of local people. Political accountability implies separation of powers between the legislative, executive and judiciary branches; party pluralism, existence of checks and balances of power among the branches, strong legislative body, competitive, fair and free election process, recall of politicians including removing inefficient and/or corrupt officials from office, and councillors' freedom to vote on each motion independently regardless of his/her party stand on the motion all manifest better political accountability.

Designing an effective administration, limited/small bureaucratic hierarchy, transparent civil service rules and procurement procedures; defining objectives, goals and tasks of decentralizing public sector promotes administrative accountability.

Social accountability is linked the degree of citizens' participation in preparing local planning and deciding budget; controlling expenditure, monitoring and evaluation of local public investments, and citizens' right to access information and citizens' feedback for service delivery in a Citizens report card, etc.

### **4.3 Conclusion**

Literatures on fiscal federalism reveal that there is no golden rule of assignment of responsibilities that fit for all federations. Rather, it varies from one country to another. The FGTF is adherent to a centralized macroeconomic stabilization and interpersonal equity functions. The arguments for centralization of macroeconomic function are: (i) sub national governments do not have power to create money, which is the most powerful instrument of monetary policy. Assignment of monetary power to sub national governments means allowing them to print money independently to finance their local programs. This causes messing up the national economy, and (ii) sub national governments are not capable of using fiscal policy efficiently as they are highly open economies, vulnerable to free riding problems and may cause budget deficits. The SGTF, however, argues that macroeconomic stabilization might be a shared responsibility of the centre, states and LGs implying that sub national governments can contribute to the macro economy stabilization policy through spending and/or taxation policies.

With regard to interpersonal redistribution, the argument for centralization is that decentralized redistribution function leads to inefficient allocation of resources as it causes influx of low-income groups to a more generous in welfare sub national government. Also businesses and rich people would select their place of residence a lower corporate income tax (CIT) and personal income tax (PIT) jurisdiction. Here again, the SGTF argues that the sub national governments might play role in interpersonal equity function, notably through providing free or easy access to basic services like education, health and social aid. Furthermore, people

are less fiscally induced, particularly in a diverse society. Social cost and housing problems in urban centres also hinder migration of people. With regard to the location choice of business firms, higher CIT does not necessarily hinder mobility, if investors think that it yields comparative advantages in quantity and quality of inputs in the production process and/or take advantage of market size from immobility of citizens.

In the process of assignment of responsibilities, the FGTF uses economic variables only. There are centralization (centripetal) forces and decentralization (centrifugal) forces. On the one hand, participatory democracy, principle of subsidiarity, political choices, heterogeneous preference for public services, etc serve as centrifugal force. On the other hand, inter-jurisdictional equality, economies of scale, spill over effect, etc are centralization forces, because they call for coordination, cooperation, and policy harmonization between functions of vertical and/or horizontal levels of governments. Hence, effective assignments of responsibilities require balanced judgment between the decentralizing and centralizing forces.

The SGTF believes that economic criteria alone cannot suffice for assignments of responsibilities between different levels of government. History, political choice, social traditions, managerial capacities and other criteria may play greater role in the assignment of responsibilities among different levels of government. The decision matrix approach has been developed in reference to the SGTF. It offers process in order that stakeholders can themselves find the best solution.





economic and non-economic principles taken into account in the separation of powers and functions between the Federal Government and the States. It also tries to link the well founded economic principles of assignment of responsibilities with the practice in Ethiopia. The third section investigates the extent to which the States and LGs in Ethiopia enjoy budgetary autonomy.

## 5.1 Vertical Separation of Powers in Ethiopia

Art. 51 and 52 of the Federal Constitution define competences of the Federal Government and the States respectively. Table 5.1 below provides a political economy reading of the assignment of responsibilities between the Federal Government and the States, as well as the State of Tigray and respective *Weredas* (ULGs and RLGs)<sup>104</sup>. Functions are listed in the first vertical column, in line with the IMF's standard classification of functions. The top rows depict levels of government, namely the Federal, the States, ULG and RLG of Tigray. Zone, Special *Wereda* and *Kebele* levels of government can be included on the top row when one examines the assignment of responsibilities of States having such government tiers.

Looking at the Federal Constitution, public sector functions are either exclusively assigned to the Federal Government or to the States or shared between the Federal Government and the States.

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<sup>104</sup> Tigray has been selected for two reasons: It is the only state that has, so far, defined (i) the responsibilities of rural wereda government, and (ii) taxation powers of urban wereda governments.

**Table 5.1 Assignment of Responsibilities between Different Levels of Government in Ethiopia**

Functions	Federal powers and function (Federal Constitution, Art. 51)	States' powers and functions (Federal Constitution, Art. 52]	State of Tigray	
			ULGs powers (Tigray Proclamation No. 65/1995)	RLG powers (Tigray, Proclamation Nos. 45/1994, and 100/1998]
		"All powers not given expressly to the Federal Government alone or concurrently to the Federal Government and the States are reserved to the States" (52/1)	ULG has all powers on urban affairs. The powers include all authorized by law and all unrestricted powers by law (10.1 Proclamation 65/1995)	The right of every Wereda to self-rule and local development and to determine its local affair is respected (72.2, 45/1994);
General Public Service	"Protect and defend the Constitution"(51/1)	"to protect and defend the Federal Constitution"(52/2a)		
	"determine and administer the utilization of the waters, or rivers or lakes linking two or more States or crossing the boundaries of the national territorial jurisdiction" (51/11)			

Functions	Federal powers and function (Federal Constitution, Art. 51)	States' powers and functions (Federal Constitution, Art. 52)	State of Tigray	
			ULGs powers (Tigray Proclamation No. 65/1995)	RLG powers (Tigray, Proclamation Nos. 45/1994, and 100/1998)
	"Administer and expand all federally funded institutions that provide services to two or more states" (51/13)			
		"To establish a State administration that best advances self-government, a democratic order based on the rule of law" (52/2a)		Administers institutions which are defined by law to <i>Wereda</i> (72.3, 45/1994)
		"enact and enforce laws on the State civil service and their condition of work; in the implementation of this responsibility it shall ensure educational; training and experience requirements for any	"Consistent with the law, administer civil servants" (10.2d, 65/1995), i.e. appointing management staff, hiring, assigning, promoting, transferring; and taking disciplinary measures in accordance with law.	Administer civil servants within a <i>Wereda</i> .

Functions	Federal powers and function (Federal Constitution, Art. 51)	States' powers and functions (Federal Constitution, Art. 52)	State of Tigray	
			ULGs powers (Tigray Proclamation No. 65/1995)	RLG powers (Tigray, Proclamation Nos. 45/1994, and 100/1998)
		job, title or position approximate national standards;" (52/2f)		
National Defence and security	"Establish and administer national defence and security forces "(51/6)			
Police and security	"Deploy, at the request of a State administration, Federal defence forces to arrest a deteriorating security situation within the requesting State when its authorities are unable to control it" (51/14 )			
	"Establish and administer federal police force"(51/6)	"to establish and administer a state police force and to maintain public order and peace" (52/2/g )	"Ensure the maintenance of peace, security and order as well as observance of law."(65/1995, 11.A V)	issue directives and ensure the maintenance of peace and security (74.2h, 45/ 1994);recruit, train and lead militia (Proclamation No.100/1998 (8.1); coordinates police force within the Wereda (100/1998, 8.8)

Functions	Federal powers and function (Federal Constitution, Art. 51)	States' powers and functions (Federal Constitution, Art. 52]	State of Tigray	
			ULGs powers (Tigray Proclamation No. 65/1995)	RLG powers (Tigray, Proclamation Nos. 45/1994, and 100/1998]
Fire protection		Care for protecting and controlling fire accident,(pursuant to52/1)	"Care for protecting and controlling fire accident"(65/1995,11A V)	
Justice and Law	"determine matters related to nationality;" (51/17)			
	"determine and administer all matters relating to immigration, the granting of passport, entry into and exit from the country, refugees and asylum"(51/18)			
	"patent inventions and protect copyrights" (51/19)			
	"Establish uniform standards of measurement and calendar" (51/20)			
	"Enact laws regulating the possession and bearing of arms "(51/21)			

Functions	Federal powers and function (Federal Constitution, Art. 51)	States' powers and functions (Federal Constitution, Art. 52]	State of Tigray	
			ULGs powers (Tigray Proclamation No. 65/1995)	RLG powers (Tigray, Proclamation Nos. 45/1994, and 100/1998]
	Enact laws on historical sites and objects" (51/5)			
	"Determine and administer the utilization of the water or rivers, lakes linking two or more States crossing the boundaries of the national territorial jurisdiction" (51/11)			
	"Enacts, in order to give practical effect to political rights provided for in this Constitution, all necessary laws governing political parties and elections" (51/15).			
	"Declares and lifts national state of emergency and states of emergencies limited to certain parts of the country" (51/16).			
Inter-state commerce	"Regulates inter-State and foreign commerce"( 51/12)			
Economic	"formulates and implements the	"To formulate and	"Issue policies,	Determine social services and

Functions	Federal powers and function (Federal Constitution, Art. 51)	States' powers and functions (Federal Constitution, Art. 52)	State of Tigray	
			ULGs powers (Tigray Proclamation No. 65/1995)	RLG powers (Tigray, Proclamation Nos. 45/1994, and 100/1998)
and Social Policy	country's policies, strategies and plans in respect to overall economic and development matters "(51/3 )	execute economic and development policies, strategies and plans of the State" (52/2/c )	formulate plan of action that help direct, execute and support the urban development" (65/1995, 10.2b)	public administration, and implement States' policies, and laws" (45/ 1994, 72.1A)
Land and natural resources	"Enacts law on the utilization and conservation of land and other natural resources" (51/5 )	"To administer land and other natural resources in accordance with Federal laws";(52/2d)	"Administer, the lands and natural resources found within an ULG"	Administer rural lands and natural resources within Wereda;
Agriculture	Establishes and administers National Agricultural Research Institutes and conducts R&D activities and disseminates new agricultural research findings to the public and States (Pursuant to 51/13)	Establish and administer state level Agricultural Research Institutes and conduct R&D activities, and disseminate research findings within the State ((Pursuant to 52/1)		"Undertake basic agricultural development activities in the Wereda"(45/1994, 74.2B);

Functions	Federal powers and function (Federal Constitution, Art. 51)	States' powers and functions (Federal Constitution, Art. 52)	State of Tigray	
			ULGs powers (Tigray Proclamation No. 65/1995)	RLG powers (Tigray, Proclamation Nos. 45/1994, and 100/1998)
Mining	"Issues reconnaissance, exploration and mining licenses other than those to be issued by a State; issues a certificate of discovery for strategic minerals; issues a certificate of professional competence for professionals who wish to engage in consultancy services in the mining sector, and conduct testing and give permission for the export of samples of minerals"(FDRE, Mining Operation Proclamation No.678/2010	"Issue artisanal mining <sup>105</sup> license; issue to domestic investors for reconnaissance, exploration and retention licenses with respect to construction and industrial-minerals; small scale mining licenses for industrial minerals and small and large scale mining <sup>106</sup> licenses for construction minerals; and certificate		Issues license for artesian mining and micro construction business (100/1998, 15.9)

<sup>105</sup> Artisanal mining refers to any mining operation carried out by individuals or cooperatives of manual operated and does not involve the engagement of employed worker ( FDRE,Mining Operation Proclamation No.678/2010)

<sup>106</sup> Small scale mining means any mining operation of which the annual run-off mine ore does not exceedthe limits stated in sub Article 35 of the ProclamationN<sup>o</sup>.678/2010. Large scale miningmeans any mining operationof which the annual run-off mine ore exceeds the limit stated in sub-article 35 of this Article with the exception of precious and semi-precious stones (Federal Proclamation N<sup>o</sup>.678/2010 and Federal Proclamation N<sup>o</sup> 812/2013).



Functions	Federal powers and function (Federal Constitution, Art. 51)	States' powers and functions (Federal Constitution, Art. 52)	State of Tigray	
			ULGs powers (Tigray Proclamation No. 65/1995)	RLG powers (Tigray, Proclamation Nos. 45/1994, and 100/1998)
	Pursuant to 51/5)	of discovery for minerals other than those specified above.” (Pursuant to 52/1 and FDRE, Mining Operation Proclamation No.678/2010)		
Transport, postal and Communications	“development, administration and regulation of air, rail, waterways and sea transport, telecommunication and postal services” (51/9 )			
Roads	“Responsible for development, administration and regulation for major roads linking two or more states” (51/9)	Construct, upgrade and maintain link, and feeder roads within States; administer vehicle and driving license, vehicle safety inspections, (Pursuant to 52/1)	Engage in construction of intra-city roads; provide terminal service, carry out security of traffic safety (65/1995, 10.1)	Construct and maintain intra- <i>Wereda</i> feeder road (100/1998,17.7)

Functions	Federal powers and function (Federal Constitution, Art. 51)	States' powers and functions (Federal Constitution, Art. 52)	State of Tigray	
			ULGs powers (Tigray Proclamation No. 65/1995)	RLG powers (Tigray, Proclamation Nos. 45/1994, and 100/1998)
Monetary and financial policies	"Formulates and executes the country's financial, monetary and foreign investment policies and strategies"(51/4)			
	"Administers National Bank, print and borrow money, mint coins, regulates foreign exchange and money in circulation" (51/7 )			
	"Determines by law the conditions and terms under which States can borrowing money from internal sources" (51/7)			
International relations	"Formulates and implements foreign relations, it negotiates and ratifies international agreements" (51/8)			
Revenue collection and budgeting	"levies taxes and collects duties on revenue sources reserved to the FederalGovernment"51/10)	"To levy and collect taxes and duties on revenue sources reserved to the States"	Consistent to the law, collects, amends tax and user fees and levy new taxes and user	Collect land use fees, agricultural income taxes and similar other taxes as determined by law(45/1994, 74.2f)

Functions	Federal powers and function (Federal Constitution, Art. 51)	States' powers and functions (Federal Constitution, Art. 52)	State of Tigray	
			ULGs powers (Tigray Proclamation No. 65/1995)	RLG powers (Tigray, Proclamation Nos. 45/1994, and 100/1998)
		(52/2e)	fees(65/1995, 10.1c)	
	"draws up, approves and administers the Federal Government's budget" (51/10)	"to draw up and administer the State budget" (52/2e)	Determine budget and utilize revenues other than those that fall within the domain of the Regional State	Determine budget and utilize revenues other than those that fall within the domain of the Regional State( 45/1994, 74.2g);
Environment protection	"Formulates nationwide environmental protection policies and strategies, carry out environmental impact assessment for those entail inter-regional effect (Federal Proclamation No. 299/2002. pursuant to 51./5	Formulate state scope environmental protection and carry out environmental impact assessment within a State (Pursuant to 52/1)		
	"Formulates policies on environmental pollution control" (pursuant to Art. 51/3)	Ensure the establishment of an integrated waste management system, carry out recycling treatment, environmental pollution	Engage in construction of drainages, and sewerages; manages solid waste disposal, protect environmental pollution, and control flood; abattoir (65/1995,	Engage in preservation, maintenance and development of natural resources in the <i>Wereda</i> ( 45/1994, 74.2B);

Functions	Federal powers and function (Federal Constitution, Art. 51)	States' powers and functions (Federal Constitution, Art. 52)	State of Tigray	
			ULGs powers (Tigray Proclamation No. 65/1995)	RLG powers (Tigray, Proclamation Nos. 45/1994, and 100/1998)
		control (Pursuant to 52/1)	11AI)	
Housing development	"Initiates policies and laws on housing development programs" (Federal Proclamation No 471/2005 and Pursuant to 51/2)	Formulate housing development policies and strategies of a state (Pursuant to 52/1)	Improve and causing the improvement of the supply of houses(65/1995, 11AII)	
Water supply		Set State water resource development policy; Construct water supply projects (Pursuant to 52/1)	Provide water supply Service (65/1995, 11AIV)	Construct and manages hand Dug wells, develop springs and ponds (100/1998, 15.3)
Street light			Provide street lights service(Pursuant to 65/1995, 10.1)	
Recreation and culture	"Establishes and implement national standards and basic criterion for the protection and preservation of culture" (51/3)	Establish and administer parks, sport frequenting sites such as stadium (Pursuant to 52/1)	Establishment and administer recreation centres, gardens; public libraries, museums, monuments squares, sport frequenting sites,	Cause to expand sports, and sport frequency sites, (100/1998, 9.5 and 9.8)

Functions	Federal powers and function (Federal Constitution, Art. 51)	States' powers and functions (Federal Constitution, Art. 52]	State of Tigray	
			ULGs powers (Tigray Proclamation No. 65/1995)	RLG powers (Tigray, Proclamation Nos. 45/1994, and 100/1998]
			theatre halls (65/1995, 11AIII)	
Preservation of culture and historical legacies	"Establishes and implements national standards and basic policy criteria for the protection and preservation of culture and historical legacies" (51/3)	Implement national standards, formulate policy criteria for the protect and preserve state culture, historical legacies (Pursuant 52/1)		
Science and technology	"Establishes and implements national standards and basic policy criteria for science and technology" (51/3)	Implement national standards policy for science and technology and promote the development of science and technology (Pursuant to 52/2)		
	Establish and implement national standards and basic policy criteria for health " (51/3)	Set minimum health service standards; formulate policy to control and prevent communicable diseases	Expand health care service; regulate food, beverages and pharmaceuticals; and environmental sanitation	

Functions	Federal powers and function (Federal Constitution, Art. 51)	States' powers and functions (Federal Constitution, Art. 52)	State of Tigray	
			ULGs powers (Tigray Proclamation No. 65/1995)	RLG powers (Tigray, Proclamation Nos. 45/1994, and 100/1998)
Health Service		in line with the Federal standards. Pursuant to 52/1)	on the basis of standards issued by the State(65/1995, 11All and V)	
	Constructs, administers and provides Specialized Federal Referral hospital administer medical and nutrition research institutes (pursuant to 51/13),	Construct and administer State referral hospitals and Zonal hospitals; Health Centres and Health Posts; Provide public health services (pursuant to 52.1)	Expand and administer health services up to Health Centre, and provide ambulance service, (65/1995, 11All).	Construct and administer Health centres, Health Posts;
	sets minimum health service standards and coordinate national immunization and HIV/Aids programs (Pursuant to 51/2)	establish health training institutions, train Health personnel; carryout immunization and HIV/AIDS programs (pursuant to 52.1)		coordinate primary preventive and curative health care activities; control and prevention of HIV/AIDS and malaria; administer health personnel(100/1998,12.3)
Education	"Establishes and implements national standards and basic policy	Prepare and implement education plans and	establish and administer nursery and Primary	administer primary schools and adult education; facilitate the

Functions	Federal powers and function (Federal Constitution, Art. 51)	States' powers and functions (Federal Constitution, Art. 52]	State of Tigray	
			ULGs powers (Tigray Proclamation No. 65/1995)	RLG powers (Tigray, Proclamation Nos. 45/1994, and 100/1998]
	criteria for education" (51/3)	standards in line with the Federal education policy (Pursuant to 52/1)	schools, administer secondary/ preparatory schools; deploy teachers (pursuant to 65/1995, 10.1)	expansion of preparatory schools (100/1998, 10.3)
	Establishes and administers public universities (pursuant to 51/13)	Establish and administer higher education institutes (Pursuant to 52/1)		
	Develops curricula for Secondary, Preparatory schools, and TVET (Pursuant to 51/3.	Develop curriculum for primary schools); decide medium of instruction; (Pursuant to 52/1)		
		Publish text books and coordinate the supply of teaching aid materials for all levels of education; (Pursuant to 52/1)	Distribute text books, (Pursuant to 65/1995,10.1)	Provide educational materials (100/1998, 10.3) distribute text books to schools;
Social	"Formulates and implements the	Pursue policies that	Implement social	

Functions	Federal powers and function (Federal Constitution, Art. 51)	States' powers and functions (Federal Constitution, Art. 52]	State of Tigray	
			ULGs powers (Tigray Proclamation No. 65/1995)	RLG powers (Tigray, Proclamation Nos. 45/1994, and 100/1998]
Protection	country's policies ,strategies and plans in respect of social matters" (51/2)	would expand job opportunities for the unemployed and indigent; provide rehabilitation and assistance to the physically and mentally disabled , the aged, and orphans (Constitutions of the States, Economic, Social and Cultural Rights)	welfare policies of the State; take care and provide free health services for the poor and provide assistances to aged people, handicapped, abandoned, and orphaned children (65/1995, 11All)	

Source: Federal Democratic Republic of Ethiopia Constitution, 1995;  
 FDRE, Proclamation No 299/2002, FDRE, Proclamation 471/2005,  
 FDRE, Proclamation No. 553/2007;  
 FDRE, Proclamation No.678/2010,  
 Tigray, Proclamation No. 45/1994 E.C,  
 Tigray Proclamation No. 65/1995 E.C , Tigray Proclamation No. 100/1998, and  
 The Revised Constitution of Tigray National Regional Government



### ***Exclusive assignments of responsibilities***

When column 3 remains empty, the powers and functions listed in column 1 are exclusively assigned to the Federal Government. For instance, defence and national security,<sup>107</sup> finance and monetary policy, international affairs, immigration nationality, and refugee issues; water bodies that link two or more States, to mention few, are exclusively assigned to the Federal Government. In the Ethiopian case, decentralizing these functions would cause spill over effect and/or inefficiency because it does not allow the states to reap benefits from economies of scale.

Regulations of inter-State and foreign commerce are also exclusive powers of the Federal Government (Federal Constitution, 1995, Art.52 (12)). The rationale is to avoid any tax and non-tax barriers that would impede free movements of capital, trade and goods including double taxation or practicing discriminatory taxation entering into a State. Regulating inter-state and international trade is also a necessary condition to build single economic community at national level.

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107 Constitutionally speaking international relations and national security rest with the Federal Government. In practice, however, the States do engage in cross-country security and trade cooperations. For instance, four Ethiopian States, (Tigray, Amhara, Benshangul-Gumuz, and Gambela) and three Sudanese counterpart States have established a Joint Border States Cooperation with the objective to promote border trade development and to check security problems along their common borders (conflicts over grazing lands, banditry activities and illegal arms smuggling). They hold annual meetings at High States Officials level. Besides, each Ethiopian State signs cooperation agreements with its Sudanese counterpart. For instance, the Gambela state and the South Sudanese Upper Nile state signed cooperation on areas of security, trade and education in 2008 Similarly, Tigray state and Sudan's State of Gadarif signed to boost regional cooperation on areas of trade, controlling communicable human and animal diseases, culture, environmental protection and border security in Gadarif, Sudan(Sudan Tribune, 2009).So did Amhara state with its Sudanese counterpart. The State to State co operations and agreements on trade, security, controlling communicable human and animal diseases have national character. The Federal Government informally delegates its power to the States on an ad-hoc base because in a situation where ethnic identity based mobilization is more efficient and effective, the cross border related conflicts cannot be left to the centre only. The states and Weredas have a lot to do in maintaining peace and order related to cross border conflicts.

Similarly, if a matrix cell along column 3 is filled but remained blank along column 2, then the power and function is exclusively assigned to the States.

### ***Shared functions***

When matrix cells along column 2 and 3 are filled, the powers and functions are shared between the Federal and State Governments. Agriculture, public health, land and natural resources, and road services are some examples of shared responsibilities between the Federal Government and the States. By the same token, if matrix cells in column 3, 4 and 5 are filled, the functions are shared between the state and the *Weredas* (rural and urban).

The responsibilities of formulating social and economic development policies, strategies, and plans are also shared between the Federal Government and the States. The Federal Government carries out on areas which have national scope, while the states limit themselves to specific needs (Federal Constitution, Art.51 (2) and 51(3)).

Education is another example of a shared responsibility among different levels of government (see Box 5.1 below). A shared responsibility does not mean that each level of government is jointly involved in all aspects of the total service. If one distinguishes among production, supply, and service delivery, one can see that the Federal Government is responsible to establish national standards and the basic education policy. The States and the LGs are responsible for delivery of education. But the production function is disaggregated in several items, with each government level being exclusively responsible for specific items.

Shared functions among levels of governments are likely to generate overlapping problems, if the production, supply and service delivery functions of the shared responsibilities are not explicitly defined. Governments may set various vertical coordination arrangements to avoid overlapping problems of production, or distribution of public good/service. If the centre is responsible for the production function of a certain public goods/services, then it may delegate or deconcentrate the function of production/distribution and delivery to the states (for more

discussion on deconcentration and delegation, see 5.3 below). Agricultural R&D and dissemination is a point of illustration. The The Ethiopian Agricultural Research Organization (EARO), a Federal Agency, conducts agricultural R&D activities on areas that have nationwide impacts and it disseminates new agricultural research findings to the public (States and the private sector), whereas the scope of the States' agricultural R&D is limited to specific state activities. Under such separation of responsibilities, some sort of vertical coordination and co-operation are in place.

### ***Residual powers-***

Like in the USA and Swiss constitutions, the residual power rests with the States of Ethiopia. By virtue of Article 52(1) of the Federal Constitution, *“All powers not given expressly to the Federal Government alone or concurrently to the Federal Government and the States are reserved to the States”*. The residual power to the States is not made after exhaustively assigning the powers to the Federal Government. The intention of reserving the residual power for the States is to create strong states by devolving meaningful powers. Furthermore, the residual power is supposed to prevent any encroachment overtly or covertly attempted by the Federal Government.

### **Box 5 1 Decentralization of Education Service in Ethiopia**

Education function is a shared responsibility among the Federal Government, the States, and Local Governments (Zones, Weredas and Kebeles). There is clear separation of responsibilities among these various levels of government.

The Federal Government sets national standards and basic criteria for education, formulates educational policy and strategy, prepares national examinations for Grade 10 and 12, designs curricula for secondary schools and junior colleges, administers quality assurance of education, and accredits levels and competences of higher education institutions (Council of Ministries Regulation No.197/1994). It establishes and administers public university.

The States formulate and execute education development plan specific to their situation, establish and administer Teachers Training Colleges/Institutes, train, hire and deploy teachers, administer educational radio broadcast centres. They may establish and administer Higher Education Institutions (colleges and universities). They run Special schools which provide services for more than one Wereda Governments. They design curricula for primary schools and KGs. The states also design curriculum of local language for secondary schools (for example 'Afan Oromo' in Oromia and Tigrigna in Tigray) in cooperation with the Ministry of Education, publish pupils text books and teachers' guide for primary school, decide medium of instruction for primary education and KG. The states carry out grade 8 State examinations and fix passing mark. All these responsibilities give the opportunity for the States to design the education service on their preferences and relevance.

Zones/Special Weredas, coordinate educational activities. In ethnic-based levels of government, Zones/Special Weredas decide medium of instruction for First cycle primary education (1-4 grade) and KG, with the consent of respective State. They also administer TVET.

Wereda Governments are responsible to determine and administer KG, and primary education (1-8), to provide with teaching infrastructure (construction, and maintenance of primary school buildings), to implement educational development policy and plan in line with respective State's and Zone's educational policies and strategies, to

deploy and administer teachers including administration personnel. They are also delegated to administer secondary education, and preparatory education.

Kebeles Administrations determine direct contact of parents and teachers, and hire community teachers, when necessary, sets by-law that would govern management of local education services, ensure school level Community participation in decision making process through Education and Training Board (EaTB), and Parents- Teachers Associations (PTA). EaTB and PTA decide flat rate school fee for financing stationary supplies of the schools, approve operational expenses of school offices, and mobilize community resources for school expansion and maintenance of capital, and evaluate school performance.

Primary education is further decentralized to homestead level. A kebele administration may establish a satellite school of grade 1 or 2 so that children who are unable to register school because of distance from homestead receive education nearby.

### ***Symmetric assignment of responsibilities among the States-***

Unlike in Canada, India, Spain, and Russian Federation, assignments of responsibilities to the States are symmetric in Ethiopia, although there are economic arguments (economies of scale and inter-jurisdictional externalities) that may support for asymmetric assignment of responsibilities to the States.<sup>108</sup>. The symmetric assignment of responsibilities among the states is a political choice, because the Ethiopian federal arrangement is a federation of NNP where “All sovereign power resides in the NNP” (Federal Constitution, 1995:Art.8 (1)). Treating the NNP unequally is not only against the spirit of the Federal Constitution but it would also cause high political cost.

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<sup>108</sup> Addis Ababa and Dire Dawa City administrations enjoy same assignment of responsibilities with the states.

## ***Local Government's Powers are derived from the States***

Article 50(4) of the Federal Constitution in reference to the LGs reads,

*“State government shall be established at State and other administrative levels that they find necessary. Adequate power shall be granted to the lowest units of government to enable the People to participate directly in the administration of such units.”*

Since LGs are subordinates of the States, what powers and functions the States would like to devolve to respective LGs is left to an individual State. The four relatively big States (Tigray, Amhara, Oromia and SNNP) introduced *Wereda* level decentralization (WLD) in 2002. The remaining states adapted the WLD latter. The States either devolve, or delegate powers and functions to respective *Weredas*. The States have devolved some powers and functions downward. *Weredas* provide a range of public services such as primary education, primary health service, and intra-*Wereda* road service, soil and water conservation, agricultural development and extension services, and First Instance court service, to mention a few. Administration of personnel is devolved to the *Weredas* too. They hire, promote, transfer and dismiss. Functions of secondary education (9-12), health centre and Zonal hospital service, administration of rural lands are delegated functions to *Weredas*. Police service is a deconcentrated function.

The ULGs carry out municipal services such as solid waste management, sewerage service, street light, market place, public libraries, recreation parks, terminals, slaughterhouses, intra-town road services, administration of urban lands, distribution of water supply and fire protection. In addition, they carry out state functions such as education, health, maintaining peace and order, court service.

The States have shared a large part of their responsibilities with respective *Weredas*. Shared responsibility does not mean that states and respective LGs are jointly in charge of a specific task. With regard to the tasks of supply, production and service delivery, the state may be responsible in defining the supply whereas the LGs may be responsible for delivery. But the production function would-be disaggregated in several

items, with each government level being exclusively responsible for specific items. In that way, one knows the level of government that is responsible for delivery of what public service(s).

In the process of decentralization, the States may devolve powers and function into two ways. (I) they may completely devolve all responsibilities to the LGs in accord with the principle of subsidiarity and leave the discretion to the LGs what powers and functions to pass upward to a higher level of government, or (II) they may apply a top-down approach and share some of their authorities with respective LGs. In practice, applying option (I) without taking into account the economies of scale does not allow the LGs to efficiently provide public services. Neither corrects inter-jurisdictional externalities.

In principle, the process of assignment of responsibilities to LGs should be a product of dialogue and negotiation between stakeholders. Representatives of State and Zone/Special Wereda/Wereda Councils and executive body should sit and decide together how the separation of responsibilities between the State and respective LGs with the technical assistance of constitutional lawyers and economists. But in practice, the assignment responsibilities of Weredas are the outcome of experts' desk work or decisions from the above (States). Thus, in Ethiopia the assignment of responsibilities between the States and LGs is a top-down out-put. The framers neither consulted LG Councillors and officials about what competences they would like to carry out efficiently nor took into consideration the nature of production functions of local public services. Powers and functions of the Weredas slightly vary across the states not on the consent of the Weredas but depending on the generosity of the individual State. The assignments of preparatory education, TVET, Zonal hospital level health service, by *de-facto*, are uniformly carried out by Zone/Special Wereda Governments although their economies of scale vary from Zone to Zone.

### ***Functions and powers of urban and rural LGs are asymmetric***

The assignments of responsibilities to Wereda Governments make a distinction between the RLGs and ULGs. Such a distinction is justifiable for a couple of reasons:

(I) In spite of the fact that both ULGs and RLGs have common preferences for education, health, water supply etc. they do not have homogenous preferences for all local public services. Public transport, street light, well developed inter-city road net work, and sewerage system are most common public services preferences of ULGs, while for RLGs agricultural extension services, feeder roads, soil and water conservation activities are among the front line preferences.

(II) ULG and RLG also widely differ in their technical and institutional capacities to produce/distribute public services. ULGs are concentrated in small areas. This puts them in a position to take advantage of economies of scale for some public services better than RLGs.

It should be also noted that all grades of ULGs do not enjoy equal powers and functions. Higher grades of ULGs are granted higher powers and functions than the lower grades of ULGs. For instance, Metropolitan/Towns and Emerging Towns in Tigray or City Administrations and Municipality Towns in Amhara, or 1<sup>st</sup> to 4<sup>th</sup> grade ULGs of Oromia do not have symmetric powers and functions. The same is true in the remaining States. The rationale behind this are, presumably, economic arguments such as economies of scale, spill over effects and decision costs as well as institutional and managerial capacities to properly carry out responsibilities.

### ***Symmetrical powers and functions of RLGs within a state***

Pastoral/semi-pastoral rural *Weredas* and Weredas with sedentary communities have assumed identical powers which include formulation of local policies, determination of the quantity and quality of primary education, primary health care, intra-Wereda roads, soil and water conservation activities, etc, although there are issues of economies of scale<sup>109</sup>.

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109 There are glaring administrative, institutional and financial capacity gaps between the pastoral and sedentary settlements too. Nevertheless, these variables should not deter the process of decentralization as they can be solved through aggressive capacity building schemes and intergovernmental transfers.



It is understandable that pursuing asymmetric assignment of responsibilities in the States where LGs are reorganized along ethnic lines is politically unwise. But, one may question the wisdom of applying “one-size-fits-all” assignment of responsibilities approach to the pastoral and sedentary communities of a rural Wereda within the homogeneous States and Zonal Administrations, where minority right is not of a concern. Neither the production functions of pastoral community dominated RLGs are in a position to provide health centre, primary education, and rural roads nor their local market allow outsourcing the service.

Here, the argument is not for centralization of power at State level. Rather, it is to emphasize the need for considerations of economies of scale, technical and institutional capacities in designing assignment of responsibilities to homogeneous LGs for efficient public service delivery. In reality, the pastoral dominated LGs hardly exercise the power they have been given due to managerial capacity problems they have been encountering. As an effect, a great deal of local decisions is made at *Zonal* level.

***Zonal and Special Weredas assignment responsibilities are not defined***

Constitutions of Amhara, SNNP, Gambela, and Benshangul-Gumuz enshrine political and cultural powers to respective indigenous Nationalities with Zonal or Special Wereda Government status. However, the Constitutions of the States do not explicitly define the assignment of responsibilities of the Zonal/Special Wereda Governments. In the absence of clearly defined responsibilities of Zonal /Special *Wereda*, one has to derive responsibilities of Zones/Special Weredas from the powers and duties of Zonal Council and Special Wereda Councils, which includes, but not limited to, determine local language and medium of instruction for First cycle primary education (grade1-4) level, to preserve and develop own culture and values, to determine budget and formulate local economic and social development plans (see the Revised Constitutions of Amhara, SNNP, Gambela, and Benshangul-Gumuz). Public services which are provided in more than one Wereda such as preparatory school (11<sup>th</sup>-

12<sup>th</sup>), TVET, Zonal level hospitals, and inter-Wereda rural roads are carried out by the Zonal/Special Wereda Governments.

### ***Voluntarily Abandoning own powers or taken away?***

Whose responsibilities are the establishment and administration of higher education institutions (universities), specialized hospitals, roads that connect two link roads within a state, and construction of irrigation dams that benefit a single state? Some may argue that these responsibilities fall under residual power of the States; while others may contest that they should fall under the Federal powers and functions of Article 51(13)<sup>110</sup>. One may also pose a question if there is a clear border line between the Federal Government and the States in the protection and preservation of culture, historical legacies and historical sites.

With regard to the road services, the Federal Government is responsible for development, administration and regulation of major roads linking two or more States (Federal Constitution, Art.51/9). But in practice, the Ethiopian Road Authority (ERA), a Federal Agency, has engaged in construction of roads, administration, maintenance and upgrading linking roads, and Main Access roads within a State, which are predominantly State/ local in scope.<sup>111</sup> The engagement of the Federal

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110 The Article stipulates, “it [the Federal Government] shall administer and expand all federally funded institutions that provide services to two or more states.” Accordingly, the Federal Government establishes and administers government universities in all states. It also establishes and expands specialized hospitals in Addis Ababa which serve as referrals at national level.

111 According to the Federal Constitution, the Federal government is responsible to develop and administer “...major roads linking two or more States...”, but the question is how major is major? The Ethiopian Road Authority classifies the road system into five categories (Classes) and has interpreted the responsibilities of constructions and administrations of roads between the Federal Government and the States.

Trunk roads are roads that connect two or more States and they are linked with Addis Ababa.

Link roads are road networks that connect two trunk roads.

A Main Access road connects two link roads.

A Collector road links centres of Main Access between each other

A Feeder road is a labour intensive and often dry weather road that links two or more collector roads.

Government on road services that link *Weredas* within a State is an administrative decision of the ERA. My discussion with the Head of Planning and ICT Department of the ERA revealed that it engages in building Main Access roads (i) to enhance the national economy by linking *Weredas* within a State to a sea port, or to economic growth pole areas (such as cash crop areas or mining sites) or to potential tourist destination sites and; (ii) to assist the states as they lack technical and financial capabilities to construct, maintain and rehabilitate Link roads, and Main Access road categories within a State.

The Ministry of Water Resource Development has also carried out construction of irrigation dams and water reservoirs or dams for in selected states. But, the question is: what is the legal and economic ground of the Federal Government to engage in the construction of big irrigation dams that benefit a single state and in supplying clean water in some urban local governments?

The states seem to welcome the intervention of the Federal Government. They do not have incentive to engage themselves in these public services either they believe these responsibilities are beyond their production function, or some of the functions have high degree of inter-jurisdictional externality effects and require vertical and horizontal coordination, or they do not have sufficient money to finance such high cost public services. The issue of financing could have been resolved through introducing close-ended federal matching grant system and carrying out intensive capacity building schemes. The centralization of university education and specialized hospital service, at least, for the foreseeable future, can be justified from the perspectives of inter-jurisdictional externality and economies of scale.

It should be noted that the intervention of the Federal Government in the road, water supply, and construction of dams for irrigation have creating overlapping. There is no clear demarcation line, at least in practice, how the Federal Government selects a given state(s) to engage in these overlapped functions. Such practices open a loophole for unfair allocation of off-budget federal public to state and undermine

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According to the road classification of Ethiopian Road Authority (ERA), the first three road classes are responsibilities of the Federal Government, while the States are responsible for the last two categories.

transparency and accountability. No one is certain about the fairness of the selection criteria or it is immune from lobbying and/or biasness of the top decision makers towards own mother state / local areas.

## 5.2 The Criteria for Assignment of Responsibility in Ethiopia

There is no “optimal” assignment of responsibilities that fits-all. Rather, assignments of responsibilities are governed by economic criteria and non-economic factors of a specific country. This section examines if the States and LGs in Ethiopia have a role in macroeconomic policy and stabilization policy; whether the states and LGs deal with interpersonal redistribution, and how the well founded economic variables are applied in the separation of the powers and functions between the Federal and State Governments. It also discusses some non-economic variables that are considered in the power separation.

### 5.2.1 Macroeconomic management responsibility

Macroeconomic management deals with achieving stable price, reasonable national economic growth and high employment, etc. Economists use monetary and fiscal policy instruments to achieve stable macroeconomic environment. Now, the question is do the States/LGs in Ethiopia have any role in long-term macroeconomic policy, and short-term stabilization policy? To answer these questions, one has to examine the nature of the monetary and fiscal policies.

**Monetary policy** authority rests with the federal Government through the National Bank of Ethiopia (NBE). The Bank uses supply of money as the main and effective instrument of monetary policy to ensure stable price<sup>112</sup> and to attain sustainable economic growth of the country. The Bank exercises its monetary policy by restricting the growth of money

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<sup>112</sup> The role of a National Bank in ensuring price stability is highly associated with independence of the Bank. The National Bank of Ethiopia is governed by a Board of Directors, the highest decision making body, and accountable to the Prime Minister. This raises an issue of institutional autonomy. The capacity of the Governor to take independent monetary decisions that would refrain the Executive body from excessive expansionary monetary and fiscal policy is questionable.

supply not to be more than the annual nominal GDP growth rate. The Bank also sets reserve requirement for commercial banks, and fix floor deposit interest rate as instrument of monetary policy (NBE, 2009:3). If monetary policy were to be decentralized, the States would print money as much as they would like to finance their deficit. Understanding that this definitely would result in hyper inflation and macroeconomic instability, by design, all financial and monetary policies, administration of National Bank, printing money, and mint powers are centralized. This is consistent with the theory and global practice of monetary policy.

***The fiscal policy***-Maintaining stable macroeconomic environment is not an outcome of monetary policy only. It is also a result of prudent fiscal policy.<sup>113</sup> Governments use public spending and taxation tools for macroeconomic stabilization purpose. The States<sup>114</sup> in Ethiopia take employment generating schemes and poverty reduction as their core functions. The Ethiopian states manoeuvre the fiscal policy for the purpose of long term macroeconomic policy using the following instruments:

***(i) The expenditure side***-States in Ethiopia have constitutional responsibilities to “pursue policies which aim to expand job opportunities for the unemployed and the poor and shall accordingly undertake programs and public work projects” (Federal Constitution, Art.41 (6)). Moreover, the States have powers and functions “to formulate and execute economic, social and development policies, strategies and plans of the State” (Federal Constitution, Art.52(c)). These powers and functions empower the states to take part in the long-term macro and regional development policies.

States’ public financial expenditures from 1998/9 to 2009/10 indicate that the states’ own revenue covered only 54 percent of their recurrent

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113 Even though there are differences in views and preferences between monetarist and fiscal economic schools on the effectiveness of the monetary and fiscal policies in attaining macroeconomic stabilization, often mix of monetary and fiscal policy measures are taken, depending on the root cause(s) of the problem. An Economic Advisory Council of a country is likely to recommend a series of monetary and fiscal measures to be taken by a government.

114 So far the LGs do not have taxation power. The discussion is therefore limited to the role of the States on long term and short-term macroeconomic management using fiscal policy.

expenditure or 31 percent of their total public expenditures. The balance was financed through Federal transfer (see Appendix 8.2). This reveals that the states are weak in fiscal capacity let alone to shift money for short-term macroeconomic stabilization purpose from their own revenue sources.

However, one can reckon from Appendix 5-2 that the Federal Government and the states incurred 70 percent and 30 percent of their total expenditure on Economic, Social and General capital expenditures respectively<sup>115</sup> aimed at ensuring access to basic public services, agriculture and rural development, creating jobs, enhancing local economic growth, which are vital components of long term macroeconomic management. Furthermore, the States have invested huge public funds through borrowing from the Federal-owned banks on housing development programs (construction of condominium), and on Micro and Small Enterprises (MSEs)<sup>116</sup> with the objective to create jobs and combat poverty targeting residents. For instance, in 2011, the microfinance institutions lent Birr 7,157,811,913 for 2.5 million borrowers (AEMFI, 2013). Therefore, taking into account such engagements of the states, one may argue that the macroeconomic stabilization is not a sole responsibility of the Federal Government, but a shared responsibility of the Federal and the States.

However, it should be noted that the role of the States in long-term macroeconomic management is highly influenced by the state's fiscal capacity, size of fund available for lending through the MFI, Federal Government transfer size to the states and states' access to borrowing. The pool of money for lending by the micro finance institutions has grown fast. There is no law that compels the Federal Government to set the floor Federal subsidy size.<sup>117</sup> Other variables remaining constant, the smaller

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115 Economic development expenditure includes Agriculture and natural resource, mines and energy, Trade, Industry & tourism; urban development and housing, road construction and transport and communication. Social development comprises expenditures on education, health, social welfare, and culture and Sports. General Development includes public Administration buildings, mapping, statistics, etc

116 All the states have MFI, but Afar and Somali for religion reasons. Currently about 28 MFI share companies are operating across the country

117 The Federal Government may cut the size of transfer pool when it faces fiscal stress or when it undertakes grand public investments at national level. For instance, during the Ethio-Eritrea border conflict (1998-2001), the Federal Government did cut the

the size of Federal transfers (conditional and unconditional), the less is the role of the States on long-term macroeconomic management because the States' capital allocations on pro-poor projects are heavily dependent on the size of unconditional and conditional federal transfers. Similarly, States' autonomy to borrow for capital investment depends on the whim of the Federal Government (see more on chapter 9).

There is an opinion among economists that engagement of states in long-term investment projects financing through borrowing to create employment would raise interest rate, adversely affect private investments and destabilize macroeconomic environment. It is worth noting that financing the MSEs from Microfinance Institutions (MFI) and the housing development programs from the federally owned commercial banks have not so far caused to raise interest rates and hence have not negatively impacted the national investment although the programs have crowded out the available deposited money for lending. Lending opportunity to MSE is restricted to residents and thus the states' policies towards employment creation and poverty reduction have not developed a free riding behaviour of the states. To the knowledge of the writer of this dissertation, there are no research outputs about the impacts of the programs on deficit trade balance and inflation. But no doubt the injection of billions of *Birr* into the economy has an effect on increasing the income of citizens and aggregate demands for consumption, which has contribution to the existing hyper inflation rate (34 percent) in 2010-12. The housing development program has raised demand for imported intermediate construction goods (iron bar, glass sheet, cement, etc) and contributed to deficit trade balance at national level.

**(ii)The Revenue side-**Tax power is another tool of fiscal policy. Governments can take expansionary or contractionary policy against business cycle through reducing or increasing taxes. Taxation powers of the States are discussed in detail in Chapter seven. Here, we briefly assess if the States have a role in short-term macroeconomic stabilization using taxation as an instrument of fiscal policy.

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size of federal unconditional grant as the war had demanded to shift the available scarce resources to the defense sector.

The States have taxation powers to levy personal income tax (PIT), business profit tax (BPT), Value Added Tax (VAT), excise tax and Turn over Tax(TOT) on sole proprietorship business organizations, rental income, agricultural income tax, and land use fees, to mention some. In practice, however, the States' hardly have the capacity to use tax revenues as instruments of fiscal policy for short-term macroeconomic stabilization policy, partly because the States' revenue generation capacity is too weak to finance their recurrent and capital expenditure needs and partly they apply uniform tax rates. No State is in a position to save funds in good periods from its own revenue and use it to smoothing its expenditure needs or to swift its capital expenditures for the purpose of stimulating the economy for short-term.

Therefore, unlike the Swiss cantons and communes, the Ethiopian states and weredas are unable to shift capital resources (allocating more spending) for the purpose of short-term macroeconomic stabilization policy as they have hardly any surplus budget. But this by no mean to say that the states do not take long term fiscal program measures to promote the economic growth through allocating considerable portion of their revenue from the Federal unconditional transfer and/or borrowing on capital investment, say for construction of condominiums. Cooperation of the Federal Government and the States is necessary for an effective long-term macroeconomic stabilization. The Federal Government alone cannot pursue prudent long-term macroeconomic management policy. Because, all instruments of fiscal policy are not completely in its hands. For example, PIT is predominantly in the hands of the States/LGs. Besides, BPT, VAT, and excise tax, derived from sole proprietorship are beyond the control of the Federal Government. Moreover, BPT, excise tax, VAT derived from Private limited Cos, and share Companies are concurrent revenue of the Federal Government and the States (see Table 7.1). All these, limit the ability of the Federal Government to unilaterally carry out macroeconomic stabilization function. Therefore, the long-term macroeconomic management function is a shared responsibility of the States and the Federal Government. However, it must be emphasized that the states do not have the capacity to engage in the short-term stabilization policy (in countering business cycle), because they have no fiscal capacity to shift capital resources for such a purpose.



## 5.2.2 Political economy of redistribution policy

With regard to interpersonal equity and promoting welfare, the Federal Constitution reads:

*“The State shall, within available means, allocate resources to provide rehabilitation and assistance to the physically and mentally disabled, the aged, and to children who are left without parent or guardian” (Art.45.5).*

*“Government has the duty to ensure that all Ethiopians get equal opportunity to improve their economic condition and to promote equitable distribution of wealth among them” (Art. 89.2).*

*“To the extent the country’s resources permit, policies shall aim to provide all Ethiopians access to public health and education, clean water, housing, food, and social security” Art.90(1)).*

These redistribution functions are replicated in the states’ Constitutions. In the Ethiopian context, interpersonal equity is beyond the scope of moral or humanitarian assistance. But it is also an issue of right to live. Hence, it is linked to meaningful poverty reduction by conscious political and policy choices. The States and LGs are involved in Interpersonal redistribution tasks through various ways:

**(i) Redistributive income revenue**-The States impose progressive tax on PIT and rental income tax<sup>118</sup> to mobilize resources from the ‘haves’ on the principle of the ability to pay. The states’ PIT collection comprises about 20 percent of the total national PIT revenue as compared to 2.3 percent PIT contribution of the Federal Government (see Table7.4 in Chapter 7 of this Thesis).In Ethiopia, FGTF’s argument against a decentralized progressive tax on PIT has no impact on influencing residence choice of the rich people or migration of the poor people to a

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118 PIT and Rental income tax are imposed progressively which goes 10 %, 15%, 20 %, 25 % and 30 % for PLC and Sh.Cos, but are fixed at 35% and regressive taxation on taxable income above Birr 5000 per month.

more generous welfare state. First and foremost, so far, PIT is uniformly applied across the states. They apply uniform tax base, tax rate and deductions; although they have constitutional power to vary (see more discussion in Chapter 7). Second, even if we assume the states apply their constitutional power to vary the tax base and tax rate, at least in the foreseen future, the variation will hardly induce entrepreneurs to move to a lower tax rate jurisdiction because of the language, cultural diversity social affiliation and favouritism towards the son-of-the soil.

Like the PIT, rental income tax is decentralized, and progressively taxed. The rationale for decentralizing the tax is that the relatively immobile nature of tax base creates less fiscally induced migrations. Nevertheless, because of the visible variations in rental income tax deduction between Addis Ababa and the States,<sup>119</sup> real estate development companies have made Addis Ababa their prime choice for real estate investment.

Given the States have tax power on PIT and they are major collectors of PIT, the Federal Government cannot carry out effectively interpersonal equity by ignoring the States. Therefore, interpersonal equity is a shared responsibility of the Federal Government and the States.

**(ii) Redistributive public expenditures**-All levels of government engage in redistributive public expenditures through carrying out the following programs:

**Pro poor development programs**-There is no single definition of pro-poor public spending. It varies from country to country. In Ethiopia Pro-poor public expenditures were initially defined to include development of agriculture and natural resources, primary health service, primary education, rural water supply, and rural road development. Later on, the definition was modified and capacity building programs of LGs, food security and rural electrification expenditures have been added.<sup>120</sup>The

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119 The Addis Ababa City Government applies 50 percent deduction from gross rental income for land leasers who do not have book keeping records, while all the states apply a 20 percent deduction from rental gross income tax. (see Personal income Proclamations of the States and the City Governments).

120 In this study, only food security program, access to water supply, rural road, primary education and primary health are considered as pro-poor, believing that these services have strong association with poverty reduction, redistribution effects and availability of reliable data. Capacity building and rural electrification programs are not also considered because they are mainly undertaken by the Federal Government.

States and LGs allocate considerable public expenditure on pro-poor development programs with the objectives to guarantee citizens equal access to publicly funded social services, to substantially reduce poverty, and to enhance local economic development.

**Table 5.2 . Pro-poor public spending by SNG, 2008/09, (in million Birr)**

Description	State	LGs	State and Wereda	Share in percent	
				State	LGs
<b>Economic Development</b>					
Food security	2,195	859	3,054	72	28
Rural water supply	187	358	545	34	66
Rural Road	1,933	69	2,002	97	3
<b>Social Development</b>					
Primary school	58	2,974	3,032	2	98
primary health	148	496	645	23	77
Total pro-poor spending	4,521	4,756	9,277	49	51
Total expenditures	10,992	14,397	25,389	43	57
Share of pro-poor to total SNG expenditure	41	33	37		

Source: Computed from MoFED, 2001EGY (2008/9) Annual Report

As can be seen from Table 5.2 below, the States and LGs respectively have allocated 41 percent and 33percent of their total expenditures on pro-poor economic sectors<sup>121</sup>. Such a pro-poor expenditure policy of the States and LGs has resulted in an overall fair distribution of primary education, primary health care, rural water supply and rural road services across the States/LGs. Moreover, the pro-poor public expenditure policy

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121 One may question the designation of rural road as a pro-poor program believing rural road expenditures benefit more rich farmers to transport their products to urban centres. However, so far, class distinction in rural Ethiopia is not much visible and rural roads serve as blood vein for providing public services like primary education, primary health, water supply, transportation service etc to all rural population.

has contributed to reduce the share of population under the poverty line<sup>122</sup> from 41 percent in 1999/2000 to 29 percent in 2012 (MoFED, 2012).

A report on Household, Consumption and Expenditure Survey of 2004/5 indicated a 0.30 national level Gini coefficient in Ethiopia,<sup>123</sup> a low income inequality as compared to other poor African countries like Tanzania (0.35), Burkina Faso (0.40), and Zambia (0.42) (World Bank, 2007:1).

**(iii) Social welfare programs** -Productive Safety Net Program (PSNP)<sup>124</sup> is similar to the supplementary social transfer in the developed countries. It is a transfer to chronically food insecure rural people in the form of food aid and cash. The intention of this program is not to keep feeding the food insecure households for their lifetime, but to graduate them from the food insecurity vicious circle within a defined time<sup>125</sup> through supporting the poor to engage in various farming and off-farming income generating activities.

The eligible candidates who are able to work are supposed to be engaged in public works that builds community assets such as soil and water conservation, construction of feeder roads, irrigation structures and river diversions, health posts, water points, schools and health institutions. Poor people who are physically weak such as orphans,

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122 Poverty line is defined as a cut off of one United States Dollar income per day for an individual.

123 The late Prime Minister Meles Zenawi used to claim that his government has attained accelerated and equitable economic growth rate (11 percent for consecutive 8 years since 2003) with, 0.29 Gini coefficients, the highest equalization index in Sub African countries( Meles Zenawi lecture at Columbia University, New York, on September 22, 2010). Professor Desta Asayehgn (2010) is skeptical about the Prime Minister Meles Zenaw's claim for the equitable system. He argues that the Gini coefficient is far below the newly industrialized countries and conflicts with the Kuznet's inverted U curve hypothesis. He questions the methodological soundness and reliability of the data, and suggests the need to replicate the finding by other independent economists.

124 The program has been in place since 2005.

125 Payment in cash enables the beneficiaries to purchase agricultural inputs, (fertilizer, improved seeds, tools, ox, etc...) and to start up micro business activities such as livestock fattening, planting fruit trees for commercial purpose, small hold irrigation, beehives; debt repayment, etc.

pregnant and lactating mothers, and elderly are entitled to direct food and cash support.

PSNP is a shared task of the Federal, States (including the City Governments) and local governments. The Ministry of Agricultural and Rural Development at Federal level, the Agriculture and Rural Development Bureau, the Agriculture and Rural Development Office and the Kebele administration take part in the implementation of the PSNP. The Federal Government sets eligibility criteria for PSNP, provides technical support to the States, designs guideline of graduation from PSNP and partially finances the program from its treasury.<sup>126</sup> The tasks of selecting individual beneficiaries and implementation of the PSNP rest on sub-*kebele* (villages) believing that they have better information advantage by the fact that inhabitants of the Sub-*kebele* know each other quite well. After identifying beneficiary individuals with due care, Sub-*kebeles* submit list of eligible beneficiaries to *Kebele* Cabinet. *Kebele* officials organize public meetings to comment on the proposed eligible candidates and submit it to *Wereda* Government after approval of the *Kebele* Council. *Wereda* Councils approve *Kebele* safety net beneficiaries, plan and budget, and coordinate its implementation. Then, *Wereda* Governments submit the approved safety net plan to respective State. Finally, the States compile eligible beneficiaries and submit it to the Federal Government for final decision and approval. Such a decentralized welfare protection has made the redistribution function more human as it promotes face to face communication by avoiding long bureaucratic procedures. It also offers advantages in identifying the needy with high level of transparency and justice (World Bank, 2007b).

Beside the PSNP, the Federal government has recently introduced Health Insurance Scheme (HIS) (Federal, Proclamation No. 690/2010). The objective of the HIS is to provide quality and sustainable health care coverage to beneficiaries through pooling of risks and reducing financial barriers at the point of service delivery. The HIS is of two types: (a) for public and private employees and (b) for pensioners. In the case of (a), employers and employees contribute three percent of the employees'

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<sup>126</sup> Large part of the program is financed by mobilizing resource from development partners and loans from the World Bank.

gross monthly salary.<sup>127</sup> In the case of the latter the retired contribute only one percent from their income. (b), they contribute only one percent from their income. Those not included in (a) and (b) may benefit from the community-based health insurance system by voluntarily organizing themselves in groups (Federal, Proclamation No.690/2010).

The Federal Government subsidizes the HIS (Federal, Proclamation No.690/2010). The states also subsidize community-based health insurance system. Moreover, Wereda governments provide certificate for those who cannot afford to pay for their medical expenses that entitles to Fee Waiver scheme in health institutions under respective state Health Bureau. The Wereda (certificate issuing authority) pays the cost of the health services provided to the waived out residents (see for example Amhara Proclamation No.117/2005).

**(IV) Subsidization and waiving out user fees**-The States and LGs also exempt needy people from annual education and court fees as long as they present testimonials from respective *Kebele* office. Besides, ULGs provide subsidized water supply targeting the low income population by setting block rate pricing policy. Here, the States determine minimum daily household tap water demand and then set block rate pricing policy, a type of payment in which user charge rate progressively increases based on blocks of household tap water consumption.<sup>128</sup> Likewise, a block rate pricing policy is applied in household electricity consumption<sup>129</sup>

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<sup>127</sup> Health Insurance scheme covers outpatient care, inpatient care, delivery services, surgery services and diagnostic test only. The Federal Health Insurance Agency opens regional branch offices with responsibilities ranging from reporting the number of insured people, to promoting quality health service and paying the cost of the service to the providing institution according to the contractual agreements.

<sup>128</sup> For instance, in Addis Ababa the minimum tap water household monthly consumption block is set from 1 to 7m<sup>3</sup> @ Birr 1.75 / m<sup>3</sup>. The second block is 7m<sup>3</sup>-14m<sup>3</sup> @ Birr 3.75. The pricing rate increases as the block set increases. Note water use fee rate is Birr 5/ m<sup>3</sup> for the first block and increases with block in Hareri.

<sup>129</sup> The Ethiopian Electric Corporation belongs to the Federal Government. It generates and distributes power. The power supply subsidy is deductible from the dividend earnings of the Federal Government.

### 5.2.3 Residents' Preferences

One of the prime arguments for decentralization is that it brings government close to people and makes local officials to be more responsive to residents' preferences than a higher authority. The core issue, therefore, is: to examine whether the assignments of responsibilities of the States and LGs in Ethiopia promote bottom-up decisions on provision of public services and guarantee accountability of local officials.

The States and LGs are engaged in providing a range of local demand-driven public goods and services. The States have constitutional power "to formulate and execute economic, social and development policies, strategies and plans..." that fits to their specific circumstance (Federal Constitution, Art.52 (2c). Nevertheless, there is a criticism that the States and LGs are not responsive to local preferences as the Federal Government influences the States to gear their budget allocation in line to the national goals through its Five Year Development Plans (FYDP), Sector Development Programs (SDPs) and the centralized Party command (Paulos, 2007:263 and 268; Young, 1999).

It would be an unbalanced judgment to grossly consider that all components of the SDP undermine local preferences simply because they are initiated by the Federal Government. In a situation where access to basic public services were far below the average in Sub Sahara African countries <sup>130</sup>(EEA, 2000), and were concentrated in a few urban areas, the States are likely to have similar preferences for the basic public services (primary education, primary health care, clean water and rural road, etc). Under such a situation, what is wrong if the States take the federally initiated sector development programs (SDP) as their own and implement it with the objective to provide basic public services? If the States do not

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130 Primary school gross enrolment was only 19% in 1991. Thanks to the Education development program (ESDP), by 2011/12, it reached to 95.4 % (MoE, 2012), heading towards meeting the MDG in education before the 2015. Access to primary health service and water supply were not more than 10 percent and limited to a few urban centres when EPRDF assumed power in 1991. Currently, 64% of the total population have access to clean water (MoFED, 2012). Similar achievements have been registered in the remaining public service areas.

provide such basic services to their citizens what else would be the preferences of the States/LGs then?

Looking on the states' planning process helps us whether the Federal FYDP gives room to locally driven provisions of public services or not. A State's planning process starts at sub *Kebele* level. Local people identify their wish list of preferences and decide how much they would contribute in kind for the realization of capital investment projects through their General meetings. The Kebele Executive bodies prepare development plan taking into account the demands of the sub-kebeles and submit their plans to respective Wereda Administration Office. The latter, in turn, dispatches the Kebele plans to the Office of Finance and Economic Development (OFED) and to concerned Offices for assessment and analysis. The OFED together with respective sector Offices prepare a preliminary development plan and submit to the OFED. Then, the latter makes budget and priority analysis and prepare a Wereda level development plan. Finally it submits to the Wereda Head Administration and to Wereda Council budget standing Committee. The administration Head tables the plan to the Executive Committee (Wereda Cabinet) for discussion. After deliberations, it documents a preliminary wereda development plan and sends it to the BoFED. The latter prepares an indicative FYDP by making context analysis of the state, reviewing the wereda preliminary plans and taking into account the national FYDP. Then, the Executive body of the state approves after due deliberations and sends it back to the Weredas to adjust their development plan in line with the indicative plan. In the same fashion, *Weredas* prepare an indicative plan by taking into account the state's indicative plan and send it back to Kebeles. The Kebele Executive bodies discuss on the issues with representatives of sub-Kebele and come up with a modified list of priority public service. Kebele Council approves the plan and dispatches it to the Wereda Administration Office. Each Sector Office prepares its final draft development plan by considering the Kebele and the state's indicative plan and submits it to the OFED. Then the Office prepares a Wereda draft development plan. In the process of preparing wereda development plan, cancellation of some Kebeles' preferences from the list of priority preference is common mainly the Kebeles' preference menu is not



supported by adequate finance.<sup>131</sup> Under such a situation, some local preferences are compromised. *Wereda* Governments postpone Kebele demands. *Wereda* Councils are obliged to consider State's development goals partly because the states are major financiers of capital projects and partly because equity-oriented access to basic public service across LGs is a guiding principle.<sup>132</sup> Finally, the States prepare their FYDP by taking into account the revised *Wereda* plans and the Federal Government development plans, strategies and policies. Thus the planning process has element of bottom up and top-down.

The planning process does not always guarantee priority preferences of the States/LGs, however. There are practices of compromising local preferences for Federal /states objectives. Two common cases are in point. Despite the fact that there is notable agro ecological diversity across the States (even within a *Wereda*), it is not uncommon to observe uniform rural development approach (IFPRI, 2009:31). The Federal Government's agricultural development strategy is cereal production centred. It gives less focus to specific local circumstances like '*Enset*', a staple food in large parts of Southern Ethiopia, and animal husbandry, a major resource of the pastoral states and means of livelihood for the pastoral and semi-pastoral communities, who constitute about 15-20 percent of the total population of the country. Moreover, the Ministry of Agriculture and Rural Development (MoARD) imposes on the States the use of Urea and DAP fertilizers, regardless of the variations of soil type and agro-ecology features of the states.

The housing development program is another case. The Ministry of Works and Urban Development initiated the housing development program and facilitated borrowing scheme from the federally owned Commercial Bank and Construction and Saving Bank for the States to

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131 Local people contribute about 10 -20 percent to the total capital project cost in the form of labour, material and money. In such condition, local people cannot hold accountable local politicians.

132 *Wereda* Council allocates capital budgets to kebeles by taking equity into account (fair distribution of local public services across Kebeles). Even if all Kebele plans are incorporated in the *Wereda* development plan, in many occasions, all projects may not be implemented according to the plan partly due to lack of implementation capacity and partly donors do not disburse sufficient fund on time for the execution of projects for various reasons.

undertake massive housing development program.<sup>133</sup> It is believed that the program would be essential for ULGs which suffer from acute shortage of residential houses. The program was not a priority preference for many ULGs, however. To substantiate this point of argument, for residents of Mekele, Shire Endasilassie, (Tigray) and the City of Harari<sup>134</sup> to mention a few, lack of drinkable water supply has been the most chronic and critical problem that require priority instead of constructions of Condominiums. Many ULGs in Amhara, Oromia, and the SNNP face similar problems. The states would prefer to give priority to provide water supply or develop rural road service than engaging in the housing development program.

The critics of Paulos, (2007:263 and 268) and Young (1999) hold truth in relation to the Federal Government initiated housing development program and the forced application of Urea and DAP fertilizers at household level. The imposition of the Federal Government to implement the housing development program has undermined the States' spending choices. Others might argue that in a situation where urban unemployment and poverty rates are critical social issues, coordinating the Federal and the States' policies and creating employment opportunities for their residents would be among the core functions of the States/LGs.

At this junction, it is worth mentioning how the Federal FYDP influences the states' planning process. The ruling party, which is a coalition of TPLF, ANDM, OPDO, and SEPDM, sets general socio-economic policies, strategies and targets to be achieved in the next five years office-term. The Prime Minister, who is a chairperson of the ruling party, instructs all line Ministries and Agencies to cope up with a draft of FYDP in

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133 The prime objective of the Federal Government Housing development program of the 2006-2010 was to create job opportunity for the excessive unemployment, which had reached more than 30% in some urban centers by mid 2000s, and to address the deep rooted urban poverty. Realizing that the housing development program is not demand-driven in many ULG and contributed to the hyper inflation rate in 2005-2010, the Ministry of Works and Urban Development ordered the States to quit from construction of condominiumsexcept for Addis Ababa City Administration in June 2011.

134 As of 2009, the problem of drinking water shortage in the City of Harari and its satellite towns along the Dire-Dawa-Hareri highway has been solved. Oromia, Dire-Dawa and Harari have jointly constructed a water reservoir and installed pipes.

line with the Party's development targets. The top party leadership of the coalition members, who are also Executive Committee of the EPRDF, assesses, deliberates, and enriches the draft plan before it gets approved by the Council of Ministries as an official development plan document<sup>135</sup>. Since, by design, the top state leaders are also top decision makers of the ruling party, the states own the national FYDP with some adjustments. In some cases the states take the Federal development plan as it is.

Nevertheless, it would be wrong to generalize that all SDPs undermine local demands and preferences simply because they are federal initiatives. Given access to education, health service, water supplies, rural road, etc in Ethiopia were at the lowest ladder by any Sub Sahara African standards, it should be noted that the Federal Government initiated SDPs often coincide with the States'/LGs preferences. The SDPs are widely shared values. But this is by no mean to say that there is no conflict between maintaining States' spending autonomy and implementing the Federal SDPs.

#### **5.2.4 Cost of information and decision making**

Other variables remaining constant, a government closest to people enhances grass root participation in local decision making process. Enjoying participatory democracy is not priceless, however. It involves three types of costs:

*(i)Efforts to reach decision making for a function:* Exercising participatory democracy requires fast dissemination of information for decision making. It also requires negotiation and compromise until the decision makers reach consensus or a majority vote. Such efforts consume time and public funds.

*(ii)Administrative costs:* These refer to salaries of administrative personnel, operation costs and other related expenses for running many but small LG closest to people. Besides, there are costs of periodic local election processes and salaries of elected local officials.

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<sup>135</sup>It is not clear the role of the Partners' party and states (Afar, Benshangul-Gumuz, Gambela and Somali) in the process of drafting the national FYDP.

(iii) *Information costs for transparency*-. All States/LGs have enacted that resources and public spending should be written in a transparent accounting system, budget and account should be organized in a suitable form (that is current and capital account plus balance sheet, functional classification and economic classification of outlays and resources). It should be published and available for residents. This is a basic document for holding elected politician and for bureaucrats accountable to local voters and beneficiaries of public services.

However, the budgeting-accounting system has its own costs, and publication of the budget and accounts also consume public funds. All these costs crowd out the scarce resources of LGs that would have been allocated to capital investments. Therefore, policy makers have to make a choice between having many small LGs, which are closer to citizens and reaping from economies of scale by reducing levels of government as well as numbers of local governments. In this regard, In Ethiopia, policy makers have adopted two pragmatic policies.

(A) **Redrawing LG territories**- Heterogeneous States have redemarcated their administrative territories on ethnic-lines. Many self governments of minority ethnic groups have been established at Zone/Special *Wereda* levels of government regardless of their population size by breaking up a big multiethnic *Zone/Wereda*.<sup>136</sup> When a single ethnic group was found too small to establish its own Zone/Special *Wereda*, two or more small ethnic groups with similar cultures and languages were brought together to form a Zone/Special *Wereda* Government. As a result, in the SNNP, the numbers of ZA/ SWA and *Wereda* governments have increased substantially. The establishments of new Zonal /SW and *Wereda* Governments are associated with exercising self-government right.

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<sup>136</sup> For instance, average population size of a *Wereda* Government is about 100,000-120,000, but Irob, a minority ethnic group in Tigray, enjoys a *Wereda* status with 25,000 population. Regardless of their population size, minority ethnic groups of Awi, Oromo, Agew and Argoba in Amhara enjoy preferential Zone Government status. So do ethnic groups in SNNP, Gambela and Benshagul-Gumuz exercise their right to self-government and celerate cultural autonomy, although providing public function is more expensive.

In Oromia, Administrative Zones and *Weredas* were redrawn. As a result, the numbers of urban and rural weredas have increased from 180 to 305 for the same period. The fragmentation of LGs in Oromia is not associated with guaranteeing minority rights but was done to make local governments closer to people so that citizens would participate actively in local decision making process. It means that this territorial organization is more homogenous and this reduces efforts to take decision making for a function (cost I) above. A citizen, as a voter, can follow the local leader without too much effort of information: Citizens' tastes are closer to each other. But it increases administration costs (cost II) and more budgeting and accounting processes (cost III). And also it reduces possible economies of scale in the production and delivery of local public services.

(B) *Compulsory amalgamation policy*- Taking into account the impact on administrative costs of having small and many local governments on the very scarce public finance, States of Tigray and Amhara have opted for reducing the number of *Weredas*. Two entire or partial neighbouring *Weredas* were merged to establish a 'bigger' *Wereda* Government. Similarly, two or more *Kebeles (Tabias)* were amalgamated to form a bigger *Kebele* Administration. Such a compulsory merging policy reduced the number of rural *Weredas* almost by half in Tigray and Amhara. Here, *Weredas* decision making cost is less: less administrative cost(cost II), less costs in budgetary and accounting system (cost III), and access to economies of scale, but the risk is to have less homogeneous preferences, thus the cost of individuals' information and decision-making is higher(costly).

### 5.2.5 Economies of Scale

One has to distinguish between economies of scale on investment and on consumption of goods/services. Capital intensive public services may yield benefit from economies of scale, if the production function meets a minimal level of thresholds. In other words, unit fixed investment cost of public services is high in the first units of service and then the average fixed investment cost rapidly decreases with increase in the number of beneficiaries (of residents) until it reaches at the lowest point

of the U production curve. Economies of scale on consumption of goods/services vary by service. Some public services can be consumed at a lower cost with the lowest point of U curve number of consumers. For example, higher education level, hospital level health service, highway, demand more numbers of beneficiaries. In contrast, solid waste management service is efficient at inverse U curve, meaning it requires smaller number of consumers. This is the logic behind the assignment of solid waste management to municipalities. Postal, air, train and communication services are assigned to the Federal Government for reasons of economies of scale and inter-jurisdictional effects.

Pursuant to State's residual power, establishing and administering Nursing school, Teachers Training Colleges, Regional Agricultural Research Institutes, Regional Referral Hospital, to mention a few, are States' responsibilities. The States have not devolved these responsibilities to Zone/Special Wereda or *Wereda*; because these functions require large population size if they are to be provided at lower a cost. Devolving these responsibilities to the LGs will result in inefficiency or sub optimal provision of the public services; because LGs will produce these public services within the production frontier.

This is not to say that the responsibilities of establishing and administrating TVET, Zonal hospital service and Zonal Court services, to mention some, at Zonal level coincide with the definition of economies of scale, because these public services cannot have the same economies of scale across the Zones where the population sizes significantly vary by Zones. These services could be efficiently provided by establishing functional territories for each public service without losing Weredas' discretion power.

The States/LGs may maximize benefits from economies of scale on consumption of goods/services through coordinating their activities. For example the states coordinate bulky and high value procurement processes. The States have delegated to the Ethiopian Pharmaceutical Control Authority, which is responsible to carry procurements of bulky and large values of medical equipments and pharmaceuticals. The MoE also coordinates publishing of text books for secondary and technical schools. Coordination of purchasing processes at Federal level for large value procurements reduces costs of information and preparation of bid

documents. It also increases negotiation power of the buyers and enables them to get the goods at a lower price. Coordination of procurements processes between two or more states is also possible, although no state has taken any initiative to coordinate joint procurement. Similarly, publishing secondary and technical text books at national level would enable the states to reap benefits from economies of scale.

Literatures on fiscal federalism suggest that the problem of diseconomies of scale and spills over due to smallness of a jurisdiction could be addressed either by amalgamation of LGs or contracting out public services (Slack, 2006) or establishing functional territories (Oates, 1972). The City Proclamations of the States acknowledge the first two alternative mechanisms, although, so far, no urban local government has taken such an initiative. This is because LGs hardly internalize the cost of public services with benefits. They wait for the state to finance their expenditure needs. Had LGs been made accountable for their decision choice, they would have looked for the best alternatives either through amalgamation or contracting out the services or forming functional territories with neighbouring ULGs.

### **5.2.6 Inter-jurisdictional externality/ spill over effect**

The principle of inter-jurisdictional externality has well served in the assignment of responsibilities between the Federal Government and the States. The assignments of formulating and executing foreign investment policies and strategies, inter-state commerce, establishing and administering national defence and public security, as well as federal police, development and administration of air, rail, waterways, and sea transport and major roads linking two or more States as well as determining and administering the utilization of the river waters and lakes linking two or more States or crossing the boundaries of the national territorial jurisdictions, administering and establishing federally funded institutions (such as universities) that provide services to two or more States, to the Federal Government had been justified by the inter-jurisdictional externality argument. Had these responsibilities been assigned to the States, they would have generated inefficient resource

allocation or the services would have been sub-optimally provided or would have developed free riding behaviour.

Inter-jurisdictional externalities (spill over effect) have produced positive or negative effects.

### **Positive inter-jurisdictional externality effects**

**(I) Higher education service:** Tigrai established the Mekele Institute of Technology (MIT) that used to admit the best students from all preparatory schools of Tigrai,<sup>137</sup> with the objective to produce best future technocrats in the fields of computer science engineering, electrical engineering, Communication engineering, and biochemistry engineering by granting scholarships to the outstanding students. Tigrai's public expenditure policy on higher education has produced positive inter-jurisdictional externality to the other States. Because large part of the MIT graduates migrated to Addis Ababa for seeking jobs partly the economic base of Tigrai is not adequate to capture all the graduates and partly for better payment and career development opportunity. The Federal Agencies, Addis Ababa City Government and the private sector have benefited from the Tigrai's investment on the MIT.

**(II) Education and health services:** Harari's and Dire Dawa's expenditures on education primary, secondary and TVET) and health services have made beneficiaries to the neighbouring residents of Oromo and Somali.

**(III) Environmental protection** is another source of spill over effect. Highland jurisdictions' public expenditures on soil and water conservation activities produce positive spill over effect on the downstream jurisdictions. It not only prevents flooding and gully erosion, but also increases ground water sources at the bottom of hill jurisdictions.

### **Negative spill over effect**

There are federal and state laws that oblige the States and ULGs to keep the shipment of their solid wastes to other jurisdictions for final

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<sup>137</sup>By policy, admission to MIT was limited to Tigrians only.



disposal or to recycle or dispose wastes in an environmentally sound manner (Federal Proclamation No.513/2007). In violation of this environmental proclamation, the States/ULGs have kept polluting neighbouring states/LGs by discharging sewerage and dumping waste materials. Addis Ababa City Government is a typical example. The City discharges its waste water (including industrial chemical by products) without any treatment to the Akaki River, which flows to Oromia and pollutes those who reside along the river. The City also dumps its solid waste materials at *Repi* area, and pollutes the residents of Sebeta town, Oromia State.

Other ULGs also cause negative externalities to their neighbouring rural LGs by discharging sewerage and solid waste materials. For example, Jima town discharges its sewer to Gibe River and negatively affects the life of residents along the river. Mekele, Adama, Bahiya Dar metropolitans, to mention a few, also dispose their solid waste materials and sewerage at vicinity rural jurisdictions. The Hawasa City pollutes the Hawassa Lake.

Literatures on fiscal federalism teach that any spill over effect/inter-jurisdictional externality has to be internalized. Benefits or costs derived from policy measure(s) of a jurisdiction have to be compensated through financial indemnity.

Paradoxically enough, neither the negatively affected jurisdictions have asked compensation for the negative spill over effects they have born nor has the Federal Environment Authority enforced the implementation of the environmental protection policy.

### **5.2.7 Institutional (political) preference**

The choice of the ethnic-based political forces to have a strong State is a reaction to the unjust relationships the NNP had over the last century. As discussed earlier, during early 1900s to 1991, the country was characterized by centre-periphery relationship. The political, economic and cultural hegemony of a single ethnic group had instigated various ethnic-based political forces to wage armed struggle against national oppression for broad autonomy under a democratic union or for full independence. EPRDF, the architect of the multi-ethnic federal

arrangement, and other political elites believe that reshaping the political system that grants a wide range of political, administrative, and fiscal powers to the States would guarantee a union on free will of people, addresses the long standing national question in Ethiopia, and rectifies the “historically unjust relationship” between the NNP (Federal Constitution Preamble). Therefore, forging strong states from the then unitary and highly centralized political system and recognizing the right of NNP to self-determination, up to and including secession, has been taken as a compromise solution to holding together under unity-in-diversity principle. The multiethnic federal setting is also argued to benefit from the advantages of both greatness and littleness of a nation-state. For EPRDF and many ethnic-based political parties, following suit the Eritrean path in establishing small sovereign states would not maximize the wellbeing of the NNP, secure economic growth and regional peace and security. They also believe that pursuing “one country, one People” by concealing the existence of ethnic diversity for the sake of territorial integration is not a prudent state building strategy. Thus, the choice for the multiethnic federation is to benefit (large market size, security, resources, etc) from staying together and to accommodate the long standing nation/nationality issue by guaranteeing self-rule right of the NNP.

The federal arrangement has caused a paradigm shift from unitary and centralized political system to have strong Regions/States. As Brosio and Gupta, (1997:505) note, “The expenditure responsibilities assigned to the Federal and State Governments in the constitution is close to what is found in a highly decentralized system.” The States of Ethiopia have their own constitutions, flags, legislative, executive and judicial bodies. They determine their budgets and formulate their own development plans and strategies, working language and medium of instruction in schools. They establish their own government institutions; including police force. Above all, the Federal Constitution guarantees the right of Nations, Nationalities and People (NNP) to self determination up to and including secession (Federal Constitution, Art.39 (1). and, residual powers are reserved to the States (Federal Constitution, Art.52 (1).

As far as preferences to language and culture are concerned, the multiethnic federal arrangement has created more or less a perfect

correspondence between the States/LGs on the one hand, and ethnic groups who would like to use own language, to develop and promote their own culture, and to preserve own history on the other. In other words, Zones/Special Weredas have been carved out almost as many as the number of ethnic groups. And those ethnic groups who have homogeneous tastes and preferences for using own language in offices and in primary schools, and those who want to celebrate same culture have established own jurisdictions either at State or Zone or Special Wereda level of government.

### **5.2.8 Minimum national standard of public service delivery**

There is no document that explicitly defines the minimum national standard of public services packages in Ethiopia. The nearest proximity available legal framework is Article 90(1) of the Federal Constitution which notes, *“To the extent the country’s resources permit, policies shall aim to provide all Ethiopians access to public health and education, clean water, housing, food and social security”*. In addition, one may also include access to rural road service (universal access to road) to the above list of the basic public services.

The Federal Constitution has made delivery of minimum national standard public service as a criterion in the assignment of responsibilities between the Federal Government and the States. The assignments of primary health, primary education, drinkable water, rural road to the State ensure minorities’ right to have access to basic public services.

Ensuring minimum national standard public services delivery (MNPDS) is argued both for equity and efficiency reasons. Guaranteeing equal access to basic public services to all citizens regardless of their residence area rectifies the past asymmetric relationship and serves as an instrument to promote voluntarily union of the NNP. Achieving minimum standard provision of public service has also efficiency element as it checks mobility of fiscal induced mobility by providing better quality and quantity of public services. Here, the crucial questions are: which government level fixes the MNPSD? And who pays for those MNPSD?

The Federal Government determines the MNSPSD and each State may set its own MNSPSD in line with the Federal objectives. With regard to financing, the Federal Government transfers unconditional and conditional grants to the states for meeting the national standards, while the States allocate capital expenditures to respective LGs taking equal distribution of basic public services in mind across the LGs.

### **5.2.9 Principle of Subsidiarity**

The following articles of the Federal Constitution are adhering to the principle of subsidiarity.

*“All sovereign power resides in the Nations, Nationalities and People of Ethiopia” (Art. 8).*

*“States shall be established at State and other administrative levels that they find necessary. Adequate power shall be granted to the lowest units of government to enable the People to participate directly in the administration of such unit” (Art. 50.4).*

*“All powers not given expressly to the Federal Government alone, or concurrently to the Federal Government and the States are reserved to the States” (Art. 52(1)).*

*“Guided by Democratic principles, Government shall promote and support the People’s self rule at all levels” Art.88 (1).*

The subsidiarity principle puts people at the centre. The corner stone of the principle is that people are the sources and owners of all powers. A government level closer to people is more responsive to local preferences. It also promotes bottom-up and top-down accountabilities. The Ethiopian experience shows that inadequate institutional, human, administrative and fiscal capacities were/are not persuasive arguments not to devolve power from the centre to the states. Neither these problems are justifications to pass over powers and functions upward.

The constraints of managerial capacity have been addressed through integrated and multifaceted capacity building programs. The weak fiscal capacity of the States has been also addressed through fiscal transfers.

In Ethiopia, the assignment of responsibilities between the Centre and the States is a bottom-up, but a top-down assignment between the State and LGs. Any passing over of a State's competency requires a constitutional amendment. But in practice, there are recentralization tendencies. Neither the Federal Constitution nor the States' Constitution provides upward delegation clause for whatever reason, although the Federal Government may delegate its competence(s) to the States <sup>138</sup>(Federal Constitution, Art.50.9). The logic behind preventing upward delegation is to deter any possible desire of the Federal Government to concentrate power since upward delegation is likely to undermine the powers and functions of the States. However, upward delegation is not only common but has also been initiated by the federal Government. The upward power 'delegation' of the rural land administration to grant land for large agricultural investment and urban land administration to establish industrial zones are typical examples. The Ministry of Agriculture and natural Resource Development, a Federal Agency, has taken away the States' land administration competence above 5000 hectares of rural land suitable for agricultural investment. <sup>139</sup>

According to the discussion made with the Head of Agricultural Investment Office, the Federal Government has chosen to administer unoccupied agricultural lands exceeding five thousand hectares to (I) strengthen competitive capacity of the country in attracting FDI by preparing and delivering agricultural land for investment at nominal lease rate. The policy presupposes that the States lack managerial capacity to deliver sufficient land on time to investors because they do not have adequate and reliable land stock data, and (II) to curb corruption at lower level of government as land has become a major source of rent seeking at

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<sup>138</sup> Likewise the States may delegate their powers and functions to LGs.

<sup>139</sup> The Federal Investment Agency, established under the Ministry of Industry, has also taken the administration of urban lands in selected urban centres for industrial Zone since 2009. The Agency decides where to establish high level industrial zones for what manufacturing activities.

State and local levels of government. The first argument might have some grain of truth, although the problem of managerial capacity could have been addressed through capacity building programs and providing information to the states but there is no empirical evidence that supports the Federal officials are less corrupt than local ones.

The beneficiary states might consider the Federal Government intervention in the areas of developing industrial zones as blessing since all infrastructural investment costs (road, power, internet and communication facilities, etc) are covered by the Federal Government and makes them to maximize their share from concurrent revenue sources. Nevertheless, the up-ward ‘delegation’ poses constitutional issue. It also shifts public investment in favour of the selected states which definitely widens the existing fiscal disparity in the long-term<sup>140</sup>.

The benefit–received principle is less respected. The benefits of water supply service are limited to a small jurisdiction and, therefore, the assignment of providing water supply has to be a local task. However, the Federal Government used to construct and to co-finance water reservoirs for provision of water supply services in some towns<sup>141</sup>. The States have engaged in supply and production of water supply and leave the delivery and administration tasks to the LGs. Since the states do not bill the true costs of production to the LGs, the pricing determination for the service at the local level is incorrect. In other words, LGs do not internalize the cost of the benefit. In some cases, construction of intra state roads and dams for irrigation that serve a single state are also financed by the Federal Government.

### **5.3 Budget Autonomy of the States and Local Governments**

Budget autonomy refers to whether a State/LG has the capacity to “decide alone, fully independently, the categories, quantity and quality of

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<sup>140</sup> .Addis ababa, Oromia, Amhara(Kombolich) and Dire Dawa have been selected for the establishments of the Chinese style special economic zones

<sup>141</sup> For example, water supply projects of Mekele, Adama, and Bahir Dar, to mention a few, were carried out by the Federal Government. In addition, provision of water supply has been operated on subsidy by respective States, although a reform has undergone to gradually operate the state owned Water Supply and Sewerage Agencies on full cost recovery principle.

services that it intends to offer to its residents” (Dafflon and Madiès, 2009:67). Put differently, states’/LGs’ degree of budget autonomy can be explained through the power they have over controlling local policy and discretion on recurrent and capital budget; the extent of SNG’s power to formulate internal policies and spending discretion between recurrent and capital expenditures as well as budget allocation among sectors, setting standards and regulations in line with national values, and freedom to determine mix and modes of distribution of public services (own producing, or outsourcing or introducing build, operate and transfer system or privatizing public services)(Bell. et.al. 2006:27, and Shah, 2006).

Budget autonomy and expenditure decentralization are not the same. Expenditure decentralization is defined as a ratio of total sub national government expenditure to total national expenditure. It provides insight into the role of SNGs in public service delivery. However, it is inadequate to reveal SNGs’ budget autonomy for the following reasons. (i) Greater expenditure decentralization ratio does not necessarily imply high SNGs’ budget autonomy, because higher ratio can be achieved by meeting targets set by a higher level of government; (ii) higher expenditure decentralization ratio could be registered as a result of executing delegated functions of a higher authority and/or shared functions (including a higher authority), rather than devolved functions, (iii) two decentralized states with different degree of budget autonomy may have same expenditure decentralization ratio, and, (iv) even under a more decentralized system, the ratio does not indicate whether the expenditure decentralization is limited at state level or goes down to LG levels (Bahl and Linn, 1992:390-91).

The States enjoy full discretion over recurrent and capital budget allocation as well as across sectors. They determine the mix of public services and allocation of public budget among social development, economic development and General development. They allocate their budget where they think appropriate. As can be seen from Figure 5.1 below, over 1993/4 to 2011/12 fiscal years, Oromia and Tigray, exhibited to be more development orientation in their budget allocation by allocating 97 percent and 93 percent of their total capital budget for economic and social developments respectively. Addis Ababa, Dire Dawa and Gambela allocated about 90 percent of their capital budget on

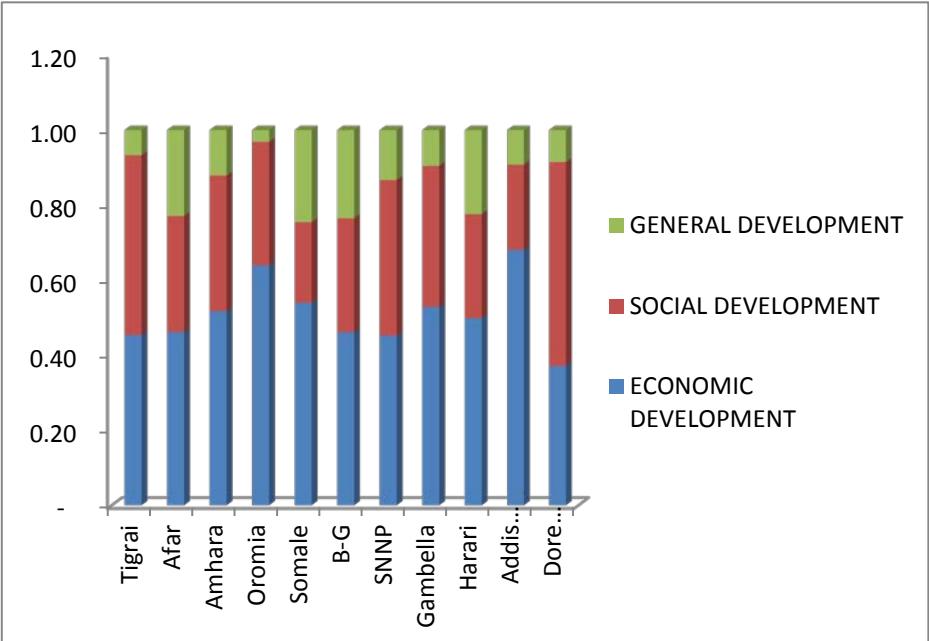
economic and social development. In contrast Afar, Benshangul-Gumuz, Harari, and Somali allocated, on average, only 76 percent of their total capital budget on economic and social development sectors, and had a great share on General development (24 percent), which includes public spending on public administration. As discussed above, the states can set their own minimum regional standard public service taking the Federal standard as a benchmark.

States'/LG's budget autonomy should be also assessed from the functions they carry out and whether the functions are devolved, delegated or deconcentrated (Dafflon and Madiès, 2009:68-69). Looking through the Federal Constitution, the States enjoy considerable powers (see Table 5.1).

In line with the Wereda level decentralization (WLD), the States have devolved some powers to respective Wereda governments. Weredas enjoy Administration autonomy. They have discretion to hire, promote, transfer, and take disciplinary measures on their public employees. Primary school, Primary health inter-wereda road service, land administration are also devolved to the Weredas. Secondary education, TEVT, and hospital level health service are delegated powers. Police service appeared to be a deconcentrated form of decentralization. Weredas prepare their budget and allocate recurrent and capital expenditures. Nevertheless, wereda capital budget needs are centralized at State level. The States decide what capital projects, and where they should be undertaken considering equal access to basic public service across the LGs in mind. This implies that *Weredas* apply States' policies and norms with little discretion to modify and provide public service menu set by the States.



**Figure 5.1. Capital expenditures by States, 1993/34- 2011/2**



Source: Computed from MoFED data base

Generally speaking, for technical, managerial institutional and political reasons, all Weredas do not enjoy the same level of budget autonomy. Weredas in the relatively advanced States enjoy better decision making power than their counterparts in the Emerging States. Weredas characterized by weak managerial, institutional and financial capacities, clan based social organizations have less functions and powers.

Weredas' power varies within the relatively advanced States too. The Functional Zone Administrations in Amhara and Oromia have stronger hands in the local affairs than the Zonal Administrations (ZAs) in Tigray. In the latter, authorities of the ZAs are limited to coordinate the responsibilities and functions of Bureaus of Trade & Industry, Urban Development & Construction, and Water resource development & mining, while in Amhara and Oromia, ZAs are active in all sectors (see Amhara, Proclamation No.33/2005, and Megaleta Oromia, Proclamation No.16/2006). Moreover, in Oromia, ZAs are stronger than in Amhara as

they decide on issues of the Wereda Administration. Mayors are appointed by a President of the State (Oromia, Proclamation No.16/2006), while in the other States Mayor are elected among the City/Municipal Councillors. The concentration of functions and powers at the state level and the interferences of functional ZAs over the Weredas' affairs have installed delegation and deconcentration forms of decentralization and a paternal State-LGs relationship.

Establishments of functional ZAs were necessary in the 1990s, when administrative, institutional, and technical capacities of *Weredas* were very weak and professionals were almost second to none in the labour market. One may question the rationale for perpetuating the FZA after two decades where lack of skilled manpower is no more a problem.<sup>142</sup>

## 5.4 Conclusion

The Federal Constitution came out of revolution led by predominantly ethnic-based political forces, which had been waging armed struggle demanding either for wide political power, administrative discretion, and fiscal and social autonomy under democratic Ethiopia or for full independence. The Federal Constitution grants a wide range of responsibilities to the states including the residual power to the States to respond the political preferences of the dominant political force.

Theories of fiscal federalism do not provide golden rule of assignment of responsibilities, but only general guidelines. Different countries apply different mix of economic and non-economic factors in the process of designing the responsibilities to different level of government. The choice of non-economic variable and the weights given to each variable are main sources of variation for assignment of responsibilities in a federal setting. The principles of assignment of responsibilities between the Federal Government and the States as well as between the States and *wereda* applied in Ethiopia are summarized below.

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142 LGs have registered remarkable improvements in building their managerial capacities. Public and private universities have been producing thousands of young graduates every year, although experienced manpower is still unresolved problem.

**Table 5.3. Summary Principles of Assignment of responsibilities**

Economic variables	Non-economic variables
Macroeconomic management	political preferences
Interpersonal redistribution	Minimum national standard delivery of public service
Residences' preferences	Principle of subsidiarity
Cost of information and decision making	
Economies of scale	
Inter-jurisdictional externality	

Managerial capacity (administration, institution) and fiscal capacity were not taken into account in the assignment of responsibilities between the Federal Government and the States, but they are criteria for the Wereda level decentralization.

In spite of the fact that the States' fiscal capacity is very weak to play a role in short term stabilization policy through fiscal policy, it is by no means to say that the long term macroeconomic growth is a sole responsibility of the Federal Government. The Federal Government is too weak to use unilaterally PIT and business profit tax as fiscal policy instruments, because the former is predominantly in the hands of the States and a lion's share of the latter is a concurrent taxation power of the Federal and the States. Therefore, the Federal government cannot use fiscal policy alone without cooperation and negotiation with the States.

The States control PIT and rental income tax, the most important instruments of interpersonal redistribution variable. Large portion of progressive taxes such as PIT and rental income tax are derived from the States /LGs, which are not in the hands of the Federal Government tax power. The PSNP and HIS are also shared functions. These exhibit that the Federal Government alone cannot pursue effective redistribution policies without the involvement of the States. Therefore, inter-personal redistributive function is shared among the federal, States and local governments that need cooperation and coordination of policies.

The intention of reserving residual power to the States is to guarantee wider legislative, political and cultural powers to the States. However, *de facto* the States are not as strong as the Federal Constitution stipulates. Moreover, *weredas* do not have a say in the law making process at States level. They do not participate in the law making process. Neither their consent is mandatory before legislation is ratified.

The Party channel is an effective instrument in influencing lower levels of government to accept the goals of a higher level of government. In doing so, State/local politicians are the core actors. State Heads and almost all members of the executive bodies at the States level are top party officials.<sup>143</sup> Similarly, members of the executive bodies at LG levels are, by and large, members of the ruling party. The States prepare their Five Year Development Plans in line with the Party policy, strategy, and social and economic plan in mind, because State/LG decision makers believe that EPRDF's social and economic policies, strategies and plans as well as the developmental statism philosophy are indispensable.

The separation of powers and functions between the Federal Government and the States can be characterized by devolution form of decentralization, while few tasks of *weredas* are devolved and many functions are either delegated or deconcentrated forms of decentralization.

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<sup>143</sup> State ruling parties in the relatively less developed States and in Harari are not formal coalition of the EPRDF, but they are close partners of the ruling party and have similar political programs with the EPRDF.



on the premises of the trio branches of public sector that assign macroeconomic stabilization and redistribution to the central government only and the function of resources allocation to both central and sub national governments (Bird, 2008:7; McLure, 1999; Ambrosanio and Bordignon, 2006:312 and 319; King, 1984). According to the FGTFF prescription: (i) tax bases with cyclical nature should be assigned to the centre, (ii) mobile tax bases having highly progressive rate for redistributive purpose should be assigned only to the central government to avoid labour mobility and capital flight for tax reasons, wasteful competition among states/LGs and to reduce compliance costs (Musgrave, 1983; Oates, 1972; Ter-Minassian 1997; Tanzi, 1995), and, (ii) Sub national governments' taxation power should be limited to immobile taxes, user charge fees and excise taxes. Such assignments of tax leave sub national governments with the smaller and the less buoyant tax bases. As a consequence, it creates a wide vertical fiscal gap.

The SGTFF gives due respect to the FGTFF's well-founded economic tax assignment principles. But in addition to the economic arguments for (de) centralizing tax bases, the SGTFF considers non-economic variables like tax autonomy, accountability, tax flexibility, etc. It argues that if states and LGs are to enjoy tax autonomy, in addition to user charges and immobile real property taxes, they must have access to various revenue sources including mobile tax bases, at least marginally. Indeed, the SGTFF has enriched the Musgravian tax assignment principles.

**Table 6.1. General Principles of Tax Assignment**

Criteria	Content
Macro-economic stability	<p>Tax bases like CIT and PIT having cyclical nature, and fluctuating with economic down turn and boom should be assigned to a central government. CIT and PIT are also critical instruments of macroeconomic stabilization policy (Oates, 1972; Musgrave, 1983; Tanzi, 1995 and Ter-Minassian, 1997 and McLure, 1999). Central government can induce economic activities by reducing CIT or granting tax relief that would attract investors. It may also increase CIT and/or PIT rates to supplement the financing of huge public work programs, when it plans to awake the economy from recession or to maintain a reasonable economic growth rate. As CIT and PIT fluctuates with economic environment, disaggregating a large tax base through decentralization to SNGs would increase SNGs fiscal stress when the economy heads for a downturn. The taxation assignment to the State should be stable tax bases in order to perform smoothly the responsibilities they assume.</p>
Inter-personal equity	<p>Progressive PIT must be assigned to the centre for redistribution purpose. If a jurisdiction unilaterally imposes high progressive tax rate on PIT, for redistribution purpose, low income people would flow to a relatively generous welfare state/LG. On the contrary, high income people would leave the jurisdiction and migrate to a less welfare one. Thus, decentralizing a highly progressively PIT for the purpose of interpersonal equity will end up with bankruptcy where the better welfare jurisdiction would no longer have the financial means for its redistributive policy (Oates, 1972; Musgrave, 1983; Tanzi, 1995 and Ter-Minassian, 1997).</p>

Mobility	<p>Mobile tax bases should be assigned to a central government, because uncoordinated decentralized tax decisions of SNGs on mobile tax bases would lead to wasteful tax competition to attract investment into their jurisdiction. Other variables remain the same; capital flow will concentrate in a jurisdiction where tax rates are lower and deductions and exemptions on mobile tax bases are higher. Decentralizing mobile tax bases distorts allocation of productive forces, as it causes fiscally induced migration of capital and labour to a lower tax jurisdiction with better or some public services (Oates, 1972; Musgrave, 1983; Tanzi, 1995 and Ter-Minassian, 1997).</p> <p>However, the effects of decentralized PIT and CIT might be less in producing fiscally induced mobility for reasons of psychological and social values (cultural language, and local affection). This is more pronounced in multiethnic societies. Decentralized PIT and CIT may not lead to inefficient allocation of productive resources, if the cost of mobility is perceived higher than the net fiscal benefit (Boadway and Shah, 2009). Thus, a rational person makes calculus not only on tax rate and cost of public services that are disposable in a destination jurisdiction, but also the cost of social values of migration before he /she decides to migrate.</p>
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<p>Unevenly distributed Natural resources</p>	<p>Musgrave (1983) argues for a centralized assignment of natural resources, because decentralized unevenly distributed tax bases would:</p> <p>(i) Result in a wide disparity in net fiscal benefit which, in turn, gives rise to fiscally induced mobility of resources. It makes natural resources endowed sub national governments to provide more quality and quantity public services and/or provide public services at lower tax rate, while poor ones will be forced to raise their tax rate in order to provide comparable basic public services. In turn, this is likely to cause fiscally induced mobility of labour and capital;</p> <p>(ii) Creates wide horizontal disparity between rich and poor jurisdictions. Wide inequality in public service delivery across states likely triggers conflicts. There are two sorts of revenue that are generated from natural resource: revenue from natural resources directly (permission to exploit, license) and mobilizing revenue (tax) from mining natural resources. Revenues from taxation are inherently volatile and are highly vulnerable to global economic situations. A global price cut adversely affects the macroeconomic environment. The effect of a decentralized assignment of natural resource taxation makes the macroeconomic stabilization more complicated. It may result in unsustainable public expenditures (extravagant expenditure during boom periods and fiscal stress when economy downturns), if sub national governments fail to save adequate money in good periods for bad days to smooth their expenditure needs during economic crises. These arguments justify for a centralized natural resource tax.</p> <p>McLure (1994 and 1999), however, argues that assignment of unevenly natural resources and/or economic bases to states may serve as a glue to keep</p>
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<p>Unevenly distributed Natural resources</p>	<p>resource endowed states within the federation or to join to a federation.</p> <p>Neither a complete decentralization nor a fully centralization of unevenly distributed natural resources revenue are immune from problems. Both policies may lead to develop secession mentality, particularly in a heterogeneous society. On the other hand, a completely decentralized unevenly distributed natural resources revenue and economic bases likely to cause wide horizontal economic disparities and economic hegemony that may develop a mentality of “Why we are subsidizing others, while we can be better-off separately”. On the other, full centralization of unevenly natural resources revenues may deny the resource endowed States to benefit from our resources. As a compromise deal Politicians may assign revenues generated from unevenly distributed natural resource revenues and economic bases to be shared between a central government and sub national governments. In addition, guaranteeing SNGs compensation scheme for environmental damages caused by mining operations and for using local public services would be necessary to avoid secessionist tendency as well as to address economic disparity among States.</p>
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Benefit-received principle	User charges and fees must be assigned to a level of government that provides a particular public service. LGs have to have access to the user charges for providing municipality services like water supply, intercity road service, collection of solid waste materials, entertainment and parking (Oates, 1972; Bird, 2008;
Visibility and accountability	Accountability of local officials to their constituencies is stronger if local public services are financed predominantly from local taxes and user charges, because residents would have power to control the utilization of budget allocation. Thus, the assignment of taxes to LGs must be visible to tax payers, if accountability is to prevail. This needs a properly organized budget, account and annual publication. (McLure, 1999;
Tax exportation	Tax exportation occurs when a jurisdiction imposes any form of tax on non-residents. Tax exportation causes tax burden on non-beneficiaries. A tax base that creates tax exportation has to be centralized (McLure, 1999; Bird, 2008
Tax externality	When states and LGs impose tax on a federal tax base, unilateral decision of a federal government on tax base or deduction on a certain shared tax (say, PIT), will negatively affect the revenue size of the shared tax, which likely lead the states and LGs to fiscal stress (Wilson, 1999:289 and Afonso, et.al,

	230:417). Vertical tax Coordination may resolve the problem.
Tax flexibility	Tax flexibility is very similar to a piggyback. It allows states /LGs to impose certain percent of tax on shared taxes. It empowers SNGs to mobilize revenues required to balance their budget and to provide public service according to local preference. The centre has to determine the tax flexibility rate. A tax flexibility defined by individual jurisdiction would lead to tax competition which in turn results in inefficient resource allocation and horizontal disparity.
Tax autonomy or financial independence	Tax assignments must be designed in a way to ensure SNG to have access to various revenue sources so that they will be able to substantially finance the devolved responsibilities from own-resources, determine their fiscal destiny and to promote accountability (Martinez-Vazquez, McLure and Vaillancourt, 2006:21; Bird, 2008; Boadway and Shah, 2009:158). In a decentralized budget, own local taxation should at least be concomitant with devolution of responsibilities. Delegated functions should be financed by transfer, or even better by additional taxing power.
Political acceptance	Tax assignments need to take into account political, historical, and institutional realities of a country. Countries which pursue a decentralized system to end civil war are often associated with higher level of tax power to satisfy political demands for a higher level of tax autonomy. For instance, if assignment of natural resources taxation fails to receive acceptance among those who claim to possess fully or partially the resources, it may trigger political instability (McLure, 1999).

Administrative feasibility	<p>Tax assignment should be made where tax information advantage, lowest cost compliance to tax payers and to tax collection agencies, and tax administration convenience are gained. But it must be appreciated some technical constraints. If taxation on immovable properties is assigned to LGs, then they also must have technical facilities in order to elaborate the cadastral register and appreciate the value of taxable items. This is not always easy to organize. A solution could be to have cadastral register at the State or even the national level (e-cadastral system), with access for LGs in order to tax.</p> <p>Assessments of VAT, CIT, PIT, import duties, natural resource taxes are less administratively convenient to LGs, while excise taxes and some user charges are of low administrative costs to LGs (Bird, 2011:21-22; Shah, 2007a:28; Boadway and Shah, 2009). Nevertheless, administration cost of PIT and CIT could be very limited at SNG level, if the tax base, deductions and tax rate are defined at the centre, but ensuring SNGs the right of surtax (piggy-back).</p>
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The above list of twelve tax assignment principles is not exhaustive. Here, focus is made on the most common ones. In addition to these criteria, other variables can be added on case-by-case basis to the specificity of a country. It should be noted that these principles neither lead to 'optimal' nor to uniform tax assignments across countries.

Macroeconomic stability, interpersonal equity, mobility of tax base, tax exportation, and tax externality are centralization forces. Tax assignment criteria such as fiscal independence/tax autonomy, visibility to tax payer and accountability, and tax flexibility, to mention a few, justify the decentralization of taxation powers. Administrative feasibility and benefit-received principles, political acceptance and unevenly distributed natural resources/tax bases are conditional. The administrative feasibility criterion prescribes that tax should be administered by a government which has cost

advantage and simplicity. User charges and fees should be paid to the level of government that provides a specific public service.

Since centripetal and centrifugal forces are present at the same time in the decision process, the weight and importance given to each of the above criterion may well differ when they are viewed through federal or local eyes. Thus one cannot apriority decide which tax should be assigned to which level based on the fundamental theoretical arguments. At this stage, the formal proposition is to construct a decision matrix which gathers these arguments for discussion with stakeholders, central and SNGs. This is discussed in the next subsection.

## **6.2 Tax Assignment Decision Matrix**

Bird (2011) and Dafflon (2011) have developed a tax assignment decision matrix in line with the SGTF perspective. The process of tax assignment decision matrix presupposes the establishment of an *ad hoc* Task Force drawn from legitimate stakeholders, and professional experts like economists and constitutional lawyers. The composition of the Task force might vary depending on the mission of the Task Force. If the mission is to ascribe taxation powers between a Central government and states, the composition of the Task Force should include representatives of legislative and executive bodies from the Centre and States as well as representative of concerned Ministries/Bureaus. Likewise, if the mission is to assign taxation revenue between State and LGs, representatives of state and LGs Councils, Mayors, relevant Departments have to participate in the process of decision making. Professional advices of economists and constitutional lawyers are critical on economic arguments and legal issues respectively as well as to ensure the coherence of the choice and weights, leaving political choice to the decision makers. The process of tax assignment among different levels of government can make more participatory by including concerned civil societies. But the problem of involving as many relevant actors as possible in the Task Force may make difficult the negotiation process to easily reach consensus. Therefore, limiting the size of the Team would minimize the problem. As an alternative, civil societies can be consulted to express their views. External experts from IMF and World Bank may be included but they should not be part of the round table discussion.

**Table 6.2. Decision Matrix for tax assignment for 'X' tax base**

Selection criteria	weight	Levels of government				
		central	.....	State	.....	LG
Macroeconomic stability						
Interpersonal equity						
Mobility						
Unevenly distributed natural resources						
Benefit-received principle						
Visibility to tax payer and accountability						
Tax exportation						
Tax externality						
Tax flexibility						
tax autonomy)						
Political acceptance						
Administrative feasibility						
Reduce horizontal fiscal disparities						
Compliance cost						
Attitude towards corruption						
Others ...						
Total score	100					

Source: Adopted from Bird, (2011) and Dafflon (2011)

The decision matrix has five elements.<sup>144</sup>

[1] Identify *what tax base is under examination*: The decision matrix supposes “one tax one matrix”. Thus, a matrix decision must be constructed for each tax under review. All existing tax bases should be investigated against the corresponding tax assignment criteria with the help of experts’ technical advices on the advantages and disadvantages of (de) centralizing tax bases under study.

The usual situation would be to start with the existing taxes. New tax bases can be suggested by the *ad-hoc* Task Force, the federation or States or LGs. In theory at least, the list of tax base for examination is left open-ended.

[2]*List of economic and non-economic tax assignment criteria*: The first left-hand vertical column presents the list of economic and non-economic tax assignment criteria. The list is not exhaustive. Members of the Task Force may delete irrelevant criteria or add more criteria when deemed necessary during the process. The political economy of tax assignment gives several analytical criteria that have been shown as relevant in practice. Members of a Task Force are supposed to propose a list of criteria for discussion to political decision makers. The latter can add more criteria that they think important or modify or omit the proposed criteria. But a comprehensive list of criteria and explicit vocabulary understanding are essential.

All criteria proposals should be thoroughly examined. The interpretation of each criterion applies the same for each tax base under consideration. If it is decided that one or more additional criteria should be added during the analysis, the process has to be re-started. That is, previously discussed criteria must be reviewed in line with the new one in order to check coherence. This is to avoid that the *ad-hoc* criteria should be added in the course of negotiation not to influence the outcomes (Bird, 2011; and Dafflon, 2011). Reaching consensus among the members of the Task Force on the list of criteria as well as on definitions and concepts of each criterion is necessary. To avoid any misunderstanding of communications among the members, setting some rules of conduct that governs the dialogue process and procedures as well as clearly defining the

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<sup>144</sup> The decision matrix is heavily drawn from Bird(2011) and Dafflon(2011)



meaning of each concept are paramount. These have to be put in place before the actual discussions of the various taxes are starts.

[3] *Assignment of weights*: Weights have to be given to each tax assignment criterion (second column). The issue of weighing poses a question: who is entitled to rank each criterion? The Task Force should make the proposal which would be explicit and duly informed. Then, elected politicians in a Parliament or Members of the State Council have to have the final word either to endorse or reject or to make some changes on the proposal. Leaving the discretion to determine the weight to members of the Task Force may develop biasness as the members might assign weights to the criteria that would maximize the benefits of their institutional interests (Bird, 2011:23). For instance, decision makers at Federal level may like to have control over PIT, business profit, and VAT for efficiency reasons, while representatives of States and LGs may wish to have access to these tax bases for enjoying more tax autonomy. In principle the assignment of weights to the criteria should depend on the role they play to achieve the intended objective of a (de) centralized tax system. That is, if decision makers at Federal level think that macroeconomic stability or interpersonal redistribution is most important function of the central government, then they would give more weight to the criterion. If they feel that a certain criterion is relatively important in decentralized governance, they are expected to give more weight to that criterion.

Criteria that appear to be irrelevant for the particular tax under examination should be given zero weight, but for transparency and accountability reason, they should remain in the list. Taking a criterion off the list might imply the Task Force has not considered it at all. Giving a zero weight to a certain variable means that the criterion has been examined, but the Task Force's opinion is that this particular criterion is not relevant. The grand weight should be equal to 100 points or percent.

[4] *Levels of government*: The vertical columns 3 to 7 represent various levels of government. In addition to the commonly known three levels of government (centre, state and LGs), other existing intermediate like the Special Districts of the USA or Zone/Special Weredas of Ethiopia, or supra-nation of the EU, or any new government layers intended to be introduced can be considered. Normally one would start with the existing

layers of a specified country and possible horizontal cooperative level (for example LG units, but also special service precincts of LG units).

[5] *Filling out the corresponding cell in the matrix*: Depending on the weight assigned to each tax criterion, the suitability of tax base under examination should be assessed by the Task Force and then the arguments for and against (de)centralization should be explicitly written in the corresponding cell of the matrix (Bird, 2011; and Dafflon, 2011).

The process of the decision matrix enables the *ad hoc* Task Force to formulate a proposal for the separation of taxation powers among different levels of government, but subject to the considerations of a legislative body. Members of the Task Force are expected to determine the assignment of taxation to different levels of government through consultation and negotiation.

In principle, all tax bases have to be examined and the entries in the matrix cells should be filled out based on the general principles for and against a (de)centralized taxation system *vis-à-vis* all the listed tax assignment criteria presented on Table 6.2.above. But, for the interest of space, only PIT is considered as an example below to illustrate how the decision matrix of tax assignment works.

**Macroeconomic stability**- Progressive PIT expands and remains a major long run revenue source in developed economies, albeit it fluctuates with economic performance of a government. Revenue yields from PIT increases faster than national income growth when a national economy performs well and diminishes when the economy declines. PIT is a fiscal policy tool for macroeconomic stabilization. Governments may reduce PIT rate to stimulate private consumption when economic recession occurs. This, in return, contributes to increase output and employment. Governments may also raise PIT to finance budget deficit or to improve quantity and quality of public service instead of injecting new money to the economy which likely causes inflation. Therefore, progressive PIT serves as an automatic anti-cyclical stabilization policy instrument.

**Inter-personal equity**-In many countries, a progressive PIT is applied on the basis of ability-to-pay principle to ensure interpersonal equity. However, in a decentralized system PIT might not treat equals equally,

because tax burden of equals in different states or in LGs within a state can differ depending on their tax base and/or expenditure choices.

**Mobility-** The conventional theory of fiscal federalism asserts that if States/LGs unilaterally impose higher progressive tax on personal income for redistribution purpose, rich people would choose their residence jurisdiction where PIT is low, whereas poor people tend to move to a more welfare jurisdiction. Therefore, according to the theory, such a decentralized income redistribution policy will cause two effects. First, it would distort geographical distribution of population and thereby adversely affect labour market. Secondly, the influx of poor people to a more generous welfare jurisdiction would increase the demand for public services in this jurisdiction, whereas the migration of rich people would make the jurisdiction to lose some tax yield. Ultimately, the higher public expenditures need in favour of lower income people and lower tax yield on the other would lead the welfare jurisdiction to bankruptcy and poor public services.

The argument against a decentralized PIT may not hold true everywhere. In an ethnically diverse country, the association between a decentralized PIT and mobility of people could be weak. That is, a decentralized PIT might not induce out-migration of well to do to other lowest PIT state or in-migration of poor people from other state for language, cultural and local social affection reasons. Moreover, the problem of rich out-goers would not be serious if they believe that they receive adequate public services for the tax they pay. To avoid the problem of mobility, in many advanced decentralized countries, PIT is assigned to the centre but SNGs are allowed to impose certain percent of tax rate on PIT.

**Unevenly distributed natural resources-** One may argue for a decentralized PIT generated from economic activities on unevenly distributed natural resources to benefit states from its resource. Others may argue for centralization of PIT for a couple of reasons:

(i) Depending upon the PIT size, it may aggravate horizontal fiscal disparities, and

(ii) Natural resource revenues are vulnerable to global prices and fluctuate frequently. This may result in significant employees lay-offs,

which negatively affects the total revenue of a state, which in turn may cause to reduce quality and quantity of public service delivery, and

(iii) Centralization of PIT on unevenly distributed natural resources may enable the Central government to mobilize more public fund for national development goals and/or to transfer substantial money to achieve minimum national standard public service delivery on the fiscally weak SNGs. Still others may argue for shared tax between the centre and the state on origin basis.

***Benefit-received principle***-This is irrelevant to use as a criterion for the assignment of PIT among different levels of government.

***Visibility to tax payers and accountability***- PIT is visible to tax payers. More than one collector increases visibility.

***Tax exportation***-refers to tax imposition by a jurisdiction on non-residents. If employment and residence are in the same place, then there is no exportation problem of PIT. But if the place of residence and the place of employment are different, a problem of tax exportation arises. The traditional politically correct way is to pay PIT in the place of domicile though it does not mean that it is optimal. The extreme reasoning would be: if all people work in LG <sup>A</sup> but live in LG <sup>B</sup>, the latter will be well-off. Normally these differences are solved through some form of equalization.

***Tax flexibility***-Applying tax flexibility on PIT means allowing States/LGs to impose a certain percent of tax on personal income, while the tax base of the centre. It enables the SNGs to generate more revenue so that they will finance large part of their expenditure needs and to provide public service according to local preferences. But completely leaving tax flexibility to each level of government increases tax competition and vertical coordination is needed to address the problem.

***Tax externality***-Any uncoordinated decentralized PIT causes the problem of tax externality. If one level of government taps on the shared tax base of PIT, the capacity of other levels of government to tap the same base diminishes. And therefore, some form of vertical tax coordination is necessary to apportion the tax between the concerned levels of governments.

***Financial independence/tax autonomy***-PIT would be an important revenue source to states/LGs if they have powers to set tax on PIT or

they are allowed to impose independently tax on the central government PIT base. SNG's enjoy more tax autonomy when they have access to more elastic revenue sources like PIT rather than limiting them to property tax, user charges and excise tax.

**Political acceptance**-Progressive PIT is an effective redistribution tool. But heavily progressive PIT or heavy rate on PIT may not only discourage economic entrepreneurship, but may not be politically feasible too. A high tax burden on PIT deters economic dynamism and induces shadow economic activities.

**Administration feasibility**-PIT is imposed on taxable total income of an individual tax payer. Administering decentralized PIT is complex at local level when an individual tax payer has other sources of personal income outside a residence jurisdiction. Under this scenario, centralized assignment of PIT might be recommended. Because, LGs lack access to information about tax payers' income receipts outside their jurisdiction; unless higher government levels provide them income information of individuals to lower levels of government.

Administration of PIT is easier in the place of residence than on place of employment, provided that the tax payers do not frequently change their residence jurisdiction. If PIT rate is set centrally, its administration at local level is relatively easy. A decentralized PIT but central administration of PIT would also avoid administrative inconvenience for tax payers.

**Reduce horizontal fiscal disparities**-If industrial agglomeration and business activities are concentrated in a few states/LGs, centralization of PIT may contribute to reduce horizontal fiscal disparity. Others may argue centralizing PIT to address horizontal disparity may not help as the problem can be tackled through revenue equalization.

**Compliance cost**-Assessment of PIT is complicated if PIT is derived from more than one jurisdiction that have different exemptions, tax schedules and/or tax rates. Such scenario provides strong argument against decentralized PIT. However, establishing a single centralized tax administration would reduce tax payers' compliance cost.

**Attitude towards corruption**- Transparency and corruption are inversely related. If local institutions are more open to the public (more transparent), residents will be aware about what is going on with the

governance system. Thus, as an effect, low degree of corruption is expected. If decision makers think that attitude towards corruption is a grave concern at a higher level of government than lower ones, and they think there are anti-corruption social values or citizens act as a watch dog for public finance and properties at lower level of government, then a decentralized PIT might be recommended. If the reverse is true a centralized PIT may reduce tax evasion.

### **6.3 Tax externality, tax competition and tax harmonization**

Uncoordinated decentralized tax decision causes tax externality and can lead to tax competition. Tax competition may take place vertically and horizontally. Vertical tax competition occurs when different levels of government in a country impose taxes on the same tax base. Horizontal tax competition refers to independently setting tax or taking fiscal actions of a state /LG without considering the reaction of the same level of government (Wilson, 1999). To avoid the negative tax externality and tax competition, vertical and horizontal tax harmonisations are important.

#### **6.3.1 Tax externality and vertical tax competition**

There are two categories of vertical tax externalities, one is institutional, and the other is its application known as vertical tax competition. Consider the following simplified formula which admits that three levels of government have access to the same tax base:

$T = t \times [B - D_i] \times [K_{\text{federal}} + K_{\text{states}} + K_{\text{LG}}]$ , where  $T$  is the tax yield,  $t$  is the tax rate schedule,  $B$  is the tax base,  $D$  is tax expenses and deductions (i of them), and  $K$  is the piggyback or tax coefficient (limited or not) of each government level (Dafflon, 2007).

Assume, (i) a federal government is in charge of defining  $t$ ,  $B$  and  $D$ , and (ii) it changes the tax law without considering the position of the States or LGs, then its decision creates vertical externalities for the states and LGs. The federal decision will affect the  $t \times [B - D_i]$  components of the tax system and modify the result for the state and local levels when they apply  $K$ . These are “tax externalities” because states and LGs have not participated in the decision but they suffer (or benefit) from the change

(Dafflon, 2007). States and LGs can react to the federal decision: if the change produces a reduction of the tax potential (for example more generous  $D$ ), then they can recover the same tax yield by increasing their own  $K$  under the condition that local voters accept the new higher piggyback coefficient.

Vertical tax competition is introduced with changes intervening in the coefficient  $K$ . With a given acceptable taxable potential ( $t \times [B-D_i]$ ), or the maximum acceptable tax burden (for the taxpayers and the economy), independent decision to raise the tax coefficient  $K$  by a single level of government negatively affects the size of shared tax base available to the other level of government (Wilson, 1999:289; Afonso, et.al 2003:417; Boadway, 2006).

Vertical tax coordination refers to coordination of the component of the tax, and apportionment on coefficient ( $K$ ) among the federal, state and local governments. Therefore, to avoid a vertical tax externality, introducing some form of vertical tax coordination is prudent.<sup>145</sup>

### 6.3.2 Horizontal tax competition

Horizontal tax competition implies cutting one's own tax rate to attract investment into one's own jurisdiction. There is no consensus among public finance economists on the desirability and outcome of a horizontal tax competition. Horizontal tax competition is always bad in the logic of normative fiscal federalism. It argues that horizontal tax competition leads to inefficient allocation of productive resources, because when a state/LG cuts its tax rate to attract investment into own jurisdiction, others can adopt the "beggar-thy-neighbour" policy. The

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<sup>145</sup> In Switzerland, for example, the federal constitution and the law fix the tax potential and  $K_{\text{federal}}$  at value 1. That is, the federal government has no way to adjust annually  $K$  to balance its budget. Balance must be obtained exclusively through expenditure adjustments. And most Cantons have put a ceiling on LGs'  $K$ . For example in Canton Fribourg, the "normal" ceiling for  $K_{\text{local}}$  is  $\leq 1.00$  or 100% of the tax potential defined in the law ( $t \times [B-D_i]$ ). A Commune can exceptionally increase  $K$  up to 1.25 but it has to present the Canton with a justified request (normally a five-year plan attesting that a 100% coefficient and expenditure cuts will not result in a balanced current budget (Dafflon, 2007).

policy mainly plays on tax rate and 'k' in the formula.<sup>146</sup> Oates (1972:143) argues that keeping tax rate low in order to attract investment cause to loss of government's tax revenue, which in turn negatively affects the quality and quantity of public service delivery.

Aggressive horizontal tax competition is criticised for various reasons. (i) Left wing economists and politicians argue that tax competition is associated with welfare-decreasing (Wilson, 1987:855),

(ii) When states/LGs are required to meet a balanced budget by law, they would be compelled to impose higher tax rate on less mobile tax bases to compensate the tax loss caused due to tax cut on mobile tax base to attract investment to their jurisdiction (Dafflon 2007:149), and this leads to economic inefficiency. The reasoning is the following: if LG<sup>A</sup> reduces its own tax coefficient  $K_A$ , the idea is that it would attract more base in its jurisdiction thus compensating the short-term loss of revenue. The argument is  $(t \text{ minus } \Delta \downarrow t) \times (B \text{ plus } \Delta \uparrow B)$  would give higher tax yield  $T_A + \Delta \uparrow T_A$ . But this supposes no retaliation from other jurisdictions which see their own bases reduced with the departure of tax payers to LG<sup>A</sup>. Other LGs will also reduce their tax coefficient in order to retain economic activities. Thus, in a repetitive game, total tax revenue of LGs diminishes. Thus, tax race-to the-bottom makes all competing jurisdictions worse-off. This, in turn, leads to low level of public service delivery and poor interpersonal redistribution function (Sinn 1990:502; Zodrow, 2003: 665).

(iii) Tax race-to-the-bottom leads to concentration of business firms in a few relatively well developed states<sup>147</sup> (Aroney, 2003:493). It also "further widening the horizontal fiscal gap across jurisdictions"<sup>148</sup> (Dafflon, 2007:161).

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146 Adjustment in B and D are less frequent. It is politically delicate and it is generally aimed either at re-orienting redistributive tax policies or logrolling and patronage for votes of specific support groups.

147 Tax war on VAT across the Brazilian States has caused concentration of manufacturing and business firms in the few States.

148 Dafflon (2007) argues the tax-race-to the-bottom among the Swiss cantons has resulted in horizontal fiscal asymmetry. However, Kirchgasser and Pommerehne (1996:361), argues that the fierce inter-cantonal/ inter-communal tax competitions do not cause undersupply of public services in Switzerland.



Others believe the opposite. For example, McLure, (1999) argues, “as competition in market place protects consumers from the rapaciousness of business, so tax competition protects citizens from the rapaciousness of politicians and bureaucrats. It helps to assure that tax payers are getting what they pay for”. Putting in different words, the argument for tax competition revolve around: (a) tax competition enables tax payers to vote with their feet, to choose a state/LG that efficiently delivery public service, (b) it reduces government waste and inefficient public spending, and (c) it makes politicians disciplined and accountable to their voters (Janeba,Guttorm,2002; Boss,1999).

Tax competition presupposes the same quantities and qualities of public services are provided between two LGs. It also assumes that LGs need to maintain balanced budget rule or fiscal discipline, at least, implicitly.

Public finance economists propose various alternative policy options of avoiding harmful tax computation: setting tax floor, or tax harmonization or fiscal/budget competition. The first two prescriptions are not immune from criticism, however. For example, Baldwin and Krugman (2000:1, cited in Stults.2004) criticises the proposal for setting a minimum tax rate floor for EU believing it “leads to a weak Pareto improvement” , while (Kanbur and Keen,1993) argue the imposition of a minimum tax rate benefits both lower and higher rate member countries and prevents a racing to bottom.

Tax harmonization may serve as an effective instrument to avoid the “beggar-thy neighbor” approach. The forms of harmonization, as well as their merits and demerits are discussed below.

### **6.3.3 Tax Harmonization**

Tax harmonization implies making tax bases, deductions and tax rates similar or identical vertically and/or horizontally. Vertical tax harmonization avoids vertical tax externalities. Likewise, horizontal tax harmonization avoids a tax-race-to the-bottom in a federal system (Musgrave, 1977:65-72). Horizontal tax harmonization makes tax administration more efficient when a single tax payer operates in two or

more states/LGs, or when the legal fiscal domicile of the tax payer is different from the place of work/ production.

Dafflon (2007) distinguishes three forms of tax harmonization: (a) formal, material (real) and uniform. In  $T = t \times [B - D_i] \times [F_{\text{federal}} + K_{\text{states}} + K_{\text{local}}]$ , formal harmonization refers to same definition and computation of B, and same list and definitions of  $D_i$ . Under formal tax harmonization, competition takes place on tax rate (t) and on coefficient (K) without jeopardizing sub national governments' tax autonomy. Formal tax harmonization brings about multiple benefits. It reduces information and transaction costs for tax payers and administrative costs for Revenue Agencies. It also avoids sources of tax disputes between different vertical levels of government (Dafflon, 2007:144).

(b) Material harmonization includes formal harmonization plus same tax rate schedule (t). That is, sub national governments apply same B,  $D_i$  and t. Under this form of harmonization, only 'K', the piggy back coefficient, is left to federal, states and local governments to ensure tax flexibility. Sub national governments may vary  $K_{\text{state}}$  and  $K_{\text{local}}$ .<sup>149</sup> This opens the possibilities of fiscal/budget competition. But, it poses the problem of vertical coordination (as to percentage of K that should be appropriated by the federal, states and LGs). To avoid this problem, one has to fix the ratios of K to the federal, states and LGs. Therefore, with flexibility in 'K' there are advantages and inconveniences. Material harmonization also simplifies tax administration.

While horizontal tax competition leads to a tax race-to-the-bottom and causes distortions of productive factors, material tax harmonization corrects distortions of mobile resources. Material tax harmonization avoids the harmful effects of tax competition without jeopardizing the

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149 It may be interesting to mention that "in Switzerland, from 2001 onwards there is a formal tax harmonization on the personal income and wealth and on business profit and capital at the federal level with the cantons (vertical) and between the cantons (horizontal harmonization). But there are still 27 tax rate schedules (one federal + 26 canton). Yet, in all the cantons at the local level there is material harmonization, that is communes have to take t, B and D from the cantonal law without any room of manoeuvre; they only decide  $K_{\text{local}}$  usually with three constraints: (i) the current budget must be balanced; (ii) it must include interest payment for loan and amortization (effective reimbursement of external debt at a rate which corresponds to the real util life of the investment thus finances—25 years or 4% for a school building, for example) and (iii) no bail out from the canton"(Dafflon,2007).

efficiency and equity objectives (Boadway and Shah, 2009:192). It obtains a certain degree of allocative neutrality and avoids inefficient distortion. Since the list of deductions and the rates are also identical, the same redistributive ability-to-pay scheme is respected. In fact material harmonization leaves out only K, the piggyback coefficient. Yet it has to be matched with a balanced current budget and no bailout so that, in this way tax competition becomes *de-facto* fiscal or budget competition. Thus mobile bases have to consider at the same time local services and tax coefficient in the fiscal part of their choice to move or not.

(c) Uniform tax system or total tax harmonization refers to same  $B$ ,  $D_i$ ,  $t$  and  $K$  between states/LGs (Dafflon, 2007:144). A uniform tax harmonization means there is no horizontal tax competition since tax rates, tax bases,  $D_i$  and  $K$  are defined centrally. 'T' can be federal with a constitutional formula for apportionment through revenue sharing. Thus, states' and LGs' tax power is limited to tax administration and to receive certain portion from tax collections on derivative base or on a formula. Uniform tax harmonization enables the Federal government to pursue national equity and efficiency goals at minimal administrative cost.

Applying material tax harmonization to correct the negative sides of tax competition destroys the positive side of tax harmonization. Therefore, there is no "best" outcome as the negative side will be transformed in the positive side and the reverse is also true. The gray area between tax competition and strict tax harmonization should be a balanced choice, depending on the specific reality of a country.

It should be noted that exercising tax harmonization among many jurisdictions is not an easy task. Bring all jurisdictions to consensus on common goals is cumbersome because, (I) some states may not be willing to pass over their full tax discretion power for partial tax control; and (II) material tax harmonization, does not equally benefit all constituent members of a federation. The outcome of tax harmonization may make worse-off rich jurisdictions and better-off the fiscally weak. So, those jurisdictions which think they will gain more from a unilateral action (non-cooperation) might not be willing to cooperate for a material harmonization or for a uniform tax harmonization.

Fiscal/budget competition and yardstick competition are alternative forms of horizontal tax competition.

**Fiscal/budget competition** across SNGs gives the right incentive for the efficient provision of public services. Tiebout (1956) views fiscal competition among SNGs as efficiency-enhancing tool for mobile households. Oates (2003:42) also argues that fiscal competition gives policy makers the freedom to make sensible fiscal decisions, but “whether or not such competition is likely to be efficiency-enhancing depends on the institutional setting in which governments compete with one another and on their objectives” (Oates, 2002:183). For Edwards and Keen (1996), fiscal competition among SNGs checks the predatory behaviours of officials and reduces the size of government.

**Yardstick competition** refers to when local voters assess the performance of their own local government in terms of quality and quantity of public services delivery, tax level, and overall socio-economic development by taking the performance of neighbouring jurisdiction as a benchmark (Besely and Case, 1995). Yardstick competition promotes local innovation in the provision of public services, and induces healthy competition for better public service delivery among SNGs. It also serves as an efficient instrument to make local officials responsive to local preferences. In short, fiscal and yardstick competitions are good mechanisms for efficient government.

## **6.4 Financial autonomy and Tax autonomy**

Autonomy refers to making independent decisions and freedom to act without being influenced by a higher level of government. As far as fiscal federalism is concerned, autonomy has financial and tax dimensions.

### **6.4.1 Financial autonomy of Sub national governments**

Financial autonomy of a LG refers to the ability “...to obtain through its own means the financial resources it needs without recourse to or depending on other local governments situated at a higher level or the same level of government” (

minimum constraint to mobilize own-revenue and it enables LGs to adequately provide public services both in quality and quantity.

Different experts of fiscal federalism use different methodologies for measuring financial autonomy of sub-national governments. Revenue decentralization, defined as a ratio of SNG total revenue (excluding grants) to total national revenue (Bell. et.al. 2006:27), was used as a proxy to measure financial autonomy. Convinced that revenue decentralization ratio is inadequate to measure financial autonomy of sub national governments; fiscal federalists have developed different alternative methodologies of measuring financial autonomy of sub national governments. The approaches of Ebel and Yilmaz (2002) and Meloche, et.al (2004) for measuring financial autonomy are discussed below.

[1] Ebel and Yilmaz (2002:10) measure fiscal autonomy of sub national governments as a ratio of own revenue to total revenue.

treated as own revenues.” The rationale behind this assertion is that SNGs enjoy expenditure autonomy over unconditional specific grant (Ebel and Yilmaz, 2002:10). The higher the ratio is the greater the financial autonomy.

The Ebel Yilmaz methodology is not immune from critique. The Ebel Yilmaz approach is a good example of the confusion between budget autonomy and financial autonomy: they include block grants because of their characteristic of expenditure autonomy, which is in the other column of the account. And they use “fiscal” which in semantic designate the total budget. If one uses budget autonomy for expenditures and financial autonomy for revenues, this confusion is avoided. Grants in this case, whether block or conditional should not be included in OR.

[2] Meloche et.al. (2004:12-13) have developed three measures of fiscal autonomy. The first is same to Financial Autonomy except naming RA (for revenue autonomy).



revenue by setting tax rate, determine tax base, and tax administration. The latter is defined as a ratio of SNG total revenue (excluding grants) to total national revenue (Bell. et.al. 2006:27). It is about the size of SNGs' own revenue source. It indicates the role of SNGs in collecting revenue. Higher revenue decentralization is not always associated with higher tax autonomy, because a higher revenue decentralization ratio might be overwhelmed by tax sharing (grant) which SNGs have less or no role in determining the distribution formula. Revenue decentralization ratio conceals the real picture of tax autonomy of SNGs<sup>151</sup> (OECD, 1999), because two SNGs with same revenue decentralization ratio may experience quite different tax autonomy.

Literatures on fiscal federalism identify two approaches of measuring tax autonomy: the OECD and the Swiss perspectives.

### ***The OECD Perspective***

Noting the revenue decentralization ratio does not reveal the real tax autonomy of SNGs, the OECD developed a new methodology of measuring SNGs' taxation power<sup>152</sup> (Blöchliger and King, 2006:159). The taxonomy of taxation power comprises six tax categories (a) to (f). It examines to what extent SNGs have discretion in determining tax bases, setting tax rates, and in influencing tax sharing distribution formula. SNGs' tax discretion diminishes as their sources of revenue reliance shifts from category (a) to (f). That is, "a" shows independent decision power over tax rate and tax base. Categories (b) and (c) represent SNGs' power over tax rate only or tax base only respectively. The more SNGs have power to determine their tax base and to set tax rate, the higher is their

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151 For instance, among the OECD countries German Länders' and Belgium states had almost same revenue decentralization ratios (21.8 % and 22.8% in 2002 respectively) but the former rely heavily on tax sharing arrangement and grants (89.2%) from the federal government, while the latter have relatively higher discretion on tax rates and relief, which constituted (57.1%) of its total revenue. In contrast, Canada and Switzerland demonstrate among the highest revenue decentralization ratios as well as tax autonomy (Blochliger and King, 2006:180-181).

152 OECD Committee on Fiscal Affairs developed taxonomy of taxing power in 1991, which classified SNGs' taxation power into five from 'a' to 'e' (OECD, 1999:11) and Blochliger and King (2006:159) modified the taxonomy and added one category.



tax autonomy. Having considerable power over tax base and tax rate enables SNGs to determine the volume of own revenue sources that they need to carry out their responsibilities. In contrast, higher SNGs' reliance on tax-sharing (d) means they enjoy less tax autonomy. SNGs' influence on the tax sharing arrangement diminishes as it goes from (d.1) to (d. 4).

#### Box 6.1. The OECD Taxonomy of taxation power

<p>"a1 The recipient SCG sets the tax rate and any tax relief without needing to consult a higher level of government.</p> <p>a.2 The recipient SCG sets the rate and any relief after consulting a higher level of government</p>
<p>B.1 The recipient SCG sets the tax rate and a higher level government does not set upper or lower limits on the rate chosen.</p> <p>B.2 The recipient SCG sets the tax rate and a higher level government does set upper and/or lower limits on the rate chosen.</p>
<p>c.1 The recipient SCG sets tax relief – but it sets tax allowances only</p> <p>c.2 The recipient SCG sets tax relief – but it sets tax credits only</p> <p>C.3 The recipient SCG sets tax relief – and it sets both tax allowances and tax credits.</p>
<p>d.1 There is a tax-sharing arrangement in which the SCGs determine the revenue split</p> <p>d.2 There is a tax-sharing arrangement in which the revenue split can be changed only with the consent of SCGs.</p> <p>d.3 There is a tax-sharing arrangement in which the revenue split is determined in legislation, and where it may be changed unilaterally by a higher level government, but less frequently than once a year</p> <p>d.4 There is a tax-sharing arrangement in which the revenue split is determined annually by a higher level government</p>
<p>e. Other cases in which the central government sets the rate and base of the SCG tax</p>
<p>f. None of the above categories a, b, c, d, or e applies"</p>

Sources: Blöchliger and King, 2006

As far as tax autonomy is concerned, the OECD categorizes SNGs revenue sources into the following three:

(i) *Own revenue sources* are tax and non-tax revenue sources in which SNGs have discretion over tax rate, or tax base or both as well as have control over tax administration. The more the SNGs rely on own revenue, the higher is the tax autonomy. Higher own revenue is also strongly associated with responsiveness to local priority public service delivery and deepening political accountability.

(ii) *Shared tax* is a tax arrangement where states/LGs can unilaterally set tax rate or 'K' (piggy back) on central government tax base. Shared tax is a common source of SNGs in many developed countries. There are three issues that need decision when a government intends to introduce a shared tax arrangement: Which tax bases are good for shared tax? Who chooses the tax bases to be shared among vertical levels of government? And how should shared taxes be administered and disbursed? (Blöchliger and King, 2006). With regard to the first issue, there is no 'same size shoe-fits- all' prescription. Different countries determine their shared tax differently. For example, in Canada, PIT, CIT and General Service Tax (GST) are shared taxes (Rangarajan and Srivastava, 2004:1899), whereas in the USA, CIT in all states and PIT in many states are shared taxes (Rao, 2007a:325). In Switzerland, PIT and CIT are shared taxes (Dafflon and Tóth, 2005). In many developed countries, the central government defines the shared tax base. There is no uniform rule as to administration of shared taxes. They can be administered centrally or decentralized. For instance, Canadian Provinces have right to administer shared tax but for efficiency reason the Federal Government collects the shared taxes and proceeds are transferred to the Provinces and LGs on derivative basis except in Quebec (Rangarajan and Srivastava (2004:1899). The Swiss experience is quite different. The Cantons collect the shared taxes and transfer upward to the Confederation, whereas the Communes collect shared taxes for themselves (Dafflon and Tóth; 2005).

A single tax administration of a shared tax avoids duplication of tax administrations and compliance costs to tax payers. Tax administration of shared tax can be defined by law or contract agreement. But, in a situation where shared tax bases are concentrated in a few States/LGs, Shared tax arrangement gives rise to horizontal fiscal disparity. Because

those SNGs endowed with more business firms would be able to get a larger share.

(III) *Tax sharing (Revenue sharing)* is a different form of transfer. Under this arrangement, a single level of government collects and shares certain percentage of the revenue to different levels of government. Global experiences on which tax base to designate as a tax sharing, which level of a government determines the distribution formula and administers the tax vary from country to country. Often, central governments define what tax bases should be designated as tax sharing, and determines the tax rate. Regarding the administration of tax sharing, it is centralized and proceeds would be transferred to lower levels of government. Decentralized tax administration and up-ward transfers are also possible.

States'/LGs' discretion over the distribution of tax sharing ranges from very limited to none, depending on the legal procedures of tax sharing formula. They might have a role in determining how much of the distributive pool has to be shared among SNG (d1), or tax sharing arrangement might be changed only with the consent or majority vote of states (d2) or distribution of tax sharing would be determined jointly by the upper and lower chambers as it is the case in Germany on regular base (d3), or SNGs might have no say in the determination of tax sharing allocation (d4) <sup>153</sup> (Blöchliger and King, 2006:167).

### ***The Swiss perspective***

Dafflon (2007:146) examines the extent of tax sovereignty of Swiss Cantons and Communes by formulating (i) a general taxation of :

$$T = t_{f,c} \times [B - (D_1, \dots, D_n)] \times (K_{\text{federal}} + K_{\text{canton}} + K_{\text{commune}}) \quad \text{Equation. 6.5}$$

Where,

- T      revenue from a tax
- t      tax rate schedule of federal and Cantons

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153 Tax sharing arrangement serves as horizontal fiscal equalization mechanism in Austria, and Germany, , but not in Spain (Blochliger and King, 2006:167).

- B gross tax base
- D tax expenses and possible deductions from the tax base
- K annual coefficient aiming at a balanced budget, and

(ii) by developing the following criteria:

Criteria	Explanation
“[a]	The use of the ability-to-pay principle (taxes) versus benefit principle (user charges);
[b]	The object of taxation, implicit in [B-D] in the formula above;
[c]	The circle of taxpayers (including the definition of the taxpaying unit);
[d]	The computation of the tax bases (for example, for the taxation of income: the definition of gross income [B], and the adjustments to taxable income, specific deductions and exemptions) [D <sub>i</sub> ];
[e]	The tax rate schedules [t] , including the amount of deductions and exemptions in the previous letter [D <sub>i</sub> ];
[f]	The annual coefficient of taxation [K <sub>ij</sub> ];
[g]	Collecting the taxes
[h]	The procedure in case of tax disputes. »

Based on the above criteria, Dafflon has ranked the tax sovereignty of sub national governments into four categories:

(i) Sub national governments would be designated as having full tax sovereignty when they may enjoy all tax powers listed (a) through (h) above,

(ii) Sub national governments enjoy partial tax sovereignty if they have power to decide on the use of taxes and user charges (a) and some but not all items listed between (b) and (e).

(iii) Tax flexibility exists when sub national governments, at least, enjoy liberty to decide on the coefficient of taxation, k, (f) but do not have power to determine tax base, and

(iv) Compulsory taxation is a case in which sub national government has no power over (a) to (f) above listed, but collects taxes and/ or user-charges according to the regulations set by a higher level of government (Dafflon, 2007:144).

Swiss Cantons have access to various tax sources. PIT and CIT are harmonized. Any change in tax rate should be approved by referendum which needs double majority of the Cantons to pass. Tax administrations are retained at Cantonal and Commune levels (Dafflon and Tóth, 2005:8-9).

Each Canton and the Confederation decide their own tax schedule. 'K' is set at 1.00 for the Confederation, and decided elsewhere by cantonal parliaments and Communal assemblies. Thus there are actually: one countrywide definition of B and D, 27 tax rate schedules (a Confederation and 26 cantons) and 26 cantonal K (K federal is one, no room of manoeuvre) and almost 2550 K for LGs. All these give Swiss cantons partial tax sovereignty. Swiss communes have the liberty to set user charge and tax rates which fall in their domain, but they pursue respective Canton's tax base and  $D_i$ . The upper limit of 'K' is fixed by respective Cantonal law, but they have power to manoeuvre the 'K' within the limit. Therefore, Swiss Communes qualify for tax flexibility (Dafflon, 2007:145-146). Nevertheless, Swiss cantons and communes have broad tax autonomy. There are some legal conditions that limit the tax autonomy of the Cantons and Communes. They cannot decide 'B' or change the list of 'D'. In addition, Cantons have neither access to levy on VAT nor to special consumption taxes, which are exclusively Federal tax power.

## **6.5 Conclusion**

There is no golden rule of tax assignment. It varies by country. The FGTF's tax assignment takes in mind the Musgravian centralized macroeconomic stabilization and interpersonal equity functions. The prescription is that mobile tax bases which have impact on macroeconomic stability and personal equity should be assigned to the centre, whereas property tax and user charges should be left to local

governments. Excise taxes are considered suitable to States (Oates, 1972; Musgrave, 1983; Tanzi, 1995; Ter-Minassian, 1997).

In practice, tax assignment does not fully respect the conventional theories of fiscal federalism (Bahl and Cyan, 2010). This is because, unlike the conventional theories of fiscal federalism, tax assignment among different levels of government is not guided by economic efficiency, national equity, benefit received principle and administrative arguments. In addition to these criteria, other factors such as visibility and accountability to tax payers, political acceptance, tax autonomy, tax exportation, tax flexibility etc do play role in the tax assignment between different levels of government. Dafflon (2011) and Bird (2011) have developed a general framework of tax assignment decision matrix that takes into account various criteria and involvement of stakeholders.

The desirability of and outcome of horizontal tax competition is debatable among scholars and experts of fiscal federalism. Some argue for while others stand against horizontal tax competition. Still others consider it neither white nor black but a gray one having advantages and disadvantages. Therefore, it is up to the discretion of decision makers to make trade-off between the merits and demerits of tax competition.

Literatures on tax autonomy provide us the OECD and the Swiss thoughts of measuring tax autonomy. The former analyzes SNG's tax autonomy whether they have power to determine tax base or decide tax rate, or both and their influence on the distribution of tax sharing. The Swiss perspective measures tax autonomy the extent to which SNGs have the liberty to choose between tax and user charges, circle of tax payers, to determine tax base and deductions on tax base, to set tax rate, to administer taxes, the liberty to tax flexibility, power to administer tax and how they set if conflict interest arises among vertical levels of government.

In practice, no state/LG absolutely depends on transfer, nor maintains full autonomy. It ranges in between. When states/LGs enjoy power to tax base and set tax rate over rang of revenue sources, they can mobilize sufficient resources to carry out their responsibilities and to promote accountability.



taxation power, and the concurrent taxation power between the Federal and the State Governments. Devolution of taxation power is left to the States. So far, no state has devolved taxation power to local governments, except Tigray.

Taxation powers of Addis Ababa and Dire Dawa Administration Council are stipulated in Federal Proclamations. The City Government of Addis Ababa enjoys almost equal taxation powers like the States except the concurrent revenue sources. The political economy rationale for not granting concurrent revenue sources to the City is not to exacerbate the existing wide horizontal fiscal disparity between the states and the City as the lion's share of private companies have made their legal registration in the City. The Federal Government takes all revenues derived from private companies registered in Addis. Instead, it has given rental income revenue on housing to the City (Federal Proclamation No.361/2003). The Dire Dawa Administration enjoys almost identical taxation powers what the Federal Constitution grants to the states, but with the exception of levying taxes on federal public enterprises, and VAT on individual tradesmen (Federal Proclamation No.416, 2004, Art.43).

One may observe that the list of taxation powers stipulated in the Federal Constitution of 1995 are less than from the list enumerated in Table 7-1 below, because the Table includes tax assignments amended by the Joint session of the HoF and the HoRP as well as by Federal Proclamations.



**Table 7.1 Ethiopia's Fiscal Construction**

Revenue sources	Federal Power of Taxation(Art.96)	State Power of Taxation (Art. 97)	Concurrent power of taxation (Art. 98)	The State of Tigray		
				ULG Proclamation No. 107/1998)	RLG Proclamation No.99/1998)	Concurrent taxation power between the State of Tigray and RLG Proclamation.No.99/1998)
1	2	3	4	5	6	7
Personal Income Tax (PIT)	"shall levy and collect income tax on employees of the Federal Government "(96.2)	"shall levy and collect income taxes on employees of the State" (97.1)		"shall determine and collect PIT on all employees within the urban jurisdiction except on employees of Federal and State enterprises(42.1)	"shall collect PIT on employees who are paid from the <i>Wereda</i> budget civil servants within the <i>Wereda</i> " (39.1a)	
	"shall levy and collect income tax on employees of international organizations" (96.2)	"shall levy and collect income tax on employees of domestic non government organizations"Note1a				
		"shall levy and collect taxes [PIT] on employees of private enterprises" (97.1)Note2a		"shall determine and collect PIT on employees of private business entity"(Art. 42.1)	"shall collect PIT on employees of private[enterprise] within the <i>Wereda</i> " (39.1c);	

Revenue sources	Federal Power of Taxation(Art.96)	State Power of Taxation (Art. 97)	Concurrent power of taxation (Art. 98)	The State of Tigray		
				ULG Proclamation No. 107/1998)	<u>RLG</u> Proclamation No.99/1998)	Concurrent taxation power between the State of Tigray and RLG Proclamation.No.99/1998)
		"shall levy and collect taxes on the incomes [PIT] of private farmers and farmers incorporated in cooperative associations" (97.3) Note 2b				
	"shall levy and collect [personal] income on enterprises owned by the federal government" (96.3);	"shall levy and collect PIT on [employees] of enterprises owned by the state"(97.7);	" shall Jointly levy and collect PIT on enterprises they jointly establish" (98/1);	"shall determine and collect PIT on employees of development enterprises owned by the LG" (42.8);	"shall collect PIT on employees of enterprises owned by the <i>Wereda</i> " (39.1b);	
			"shall Jointly levy and collect profits on dividends due to shareholders"(98.2);			
	"shall tax the income and winnings of national lotteries and					

Revenue sources	Federal Power of Taxation(Art.96)	State Power of Taxation (Art. 97)	Concurrent power of taxation (Art. 98)	The State of Tigray		
				ULG Proclamation No. 107/1998)	RLG Proclamation No.99/1998)	Concurrent taxation power between the State of Tigray and RLG Proclamation.No.99/1998)
	other games of chance" (96/4);					
		"Shall levy and collect Income derived by entertainer, musician or sportsman/ woman from his/ her personal activities" Proclamation No 86/2003 <i>Note1b</i>		"Shall levy and collect Income obtained by entertainer, musician or sportsman from his/her personal activities "Proclamation No. 86/2003		
		"shall levy and collect gain on transfer of certain investment properties(capital transfer gain tax)"Note 1c		"shall determine and collect income derived from gain on transfer of certain investment properties" (42.14)	"shall collect turn over tax(TOT) on gain transfer of investment properties"(40.3b);	
			"shall levy and collect PIT on interest tax from bank deposits" (HoF and HoPR) Note 3a			

Revenue sources	Federal Power of Taxation(Art.96)	State Power of Taxation (Art. 97)	Concurrent power of taxation (Art. 98)	The State of Tigray		
				ULG Proclamation No. 107/1998)	RLG Proclamation No.99/1998)	Concurrent taxation power between the State of Tigray and RLG Proclamation.No.99/1998)
			“shall Jointly levy and collect taxes on incomes[PIT] derived from large scale mining petroleum and gas operations”(98.3			
Rental Income tax	“shall levy and collect taxes on income of houses owned by the Federal” (96.6) Note 4	“shall levy and collect taxes on income derived from private houses”(97.6)		“shall determine and collect rental income tax on housing and other assets within the LG” (42.6);	“shall collect taxes on incomes derived from rental housing [within the LG]” (39.1e)	
	“shall levy and collect taxes on incomes of properties owned by the Federal Government; fixes rents” (96.6)	“shall levy and collect taxes on incomes of other properties within the state” (97.6);		“shall determine and collect rental fees on houses and properties owned by the LG” (42.10);	“shall collect taxes on incomes of properties (39.1e); Collect revenues from sales of mobile and fixed assets ,sands along rivers’ stones, soil of the <i>Wereda</i> 41.1 and ; 41.2);	

Revenue sources	Federal Power of Taxation(Art.96)	State Power of Taxation (Art. 97)	Concurrent power of taxation (Art. 98)	The State of Tigray		
				ULG Proclamation No. 107/1998)	RLG Proclamation No.99/1998)	Concurrent taxation power between the State of Tigray and RLG Proclamation.No.99/1998)
Agricultural income tax		"shall levy and collect taxes on income of private farmers and farmers incorporated in cooperative associations" (97.3);		"shall levy and collect PIT on urban agricultural activity" (42.3);	"shall collect income tax on agricultural activity" (39.1d);	"Agricultural income tax on leased lands for investment purpose" (43.1)
Business profit tax	"shall levy and collect profit tax on enterprises owned by the Federal Government"(96.3)	"shall levy and collect profit tax on income of enterprises owned by the States "(97.7)	"shall Jointly levy and collect profit tax on enterprises they jointly establish" (98.1);	"shall determine and collect business profit tax on development enterprises owned by the LG" (42.8)	"shall collect business profit on envelopment enterprises owned by the LG" (39.2c)	
			"shall Jointly levy and collect profits [CIT] of companies"(98.2) Note 5			
		"shall levy and collect profit tax on individual traders carried out a business within their territory" (97.4);		"shall determine and collect business profit tax on incomes of individual traders within a LG" (42.4)	"shall collect business profit tax on category C" (39.2a)	

Revenue sources	Federal Power of Taxation(Art.96)	State Power of Taxation (Art. 97)	Concurrent power of taxation (Art. 98)	The State of Tigray		
				ULG Proclamation No. 107/1998)	RLG Proclamation No.99/1998)	Concurrent taxation power between the State of Tigray and RLG Proclamation.No.99/1998)
			“shall Jointly levy and collect taxes on incomes derived from large scale mining petroleum and gas operations” (98.3)Note 6			
	“Shall levy and collect taxes on the income of air, rail and sea transport services “(96/5). <b>Note 7 a</b>	“shall levy and collect taxes on incomes from transport services rendered on waters within their territories” (97/5) Note 7b				
		“Consistent with the provisions sub-Article 3of Article 98, shall levy and collect taxes on income derived from mining operations “(98.8)		“shall determine and collect business profit tax on income derived from small scale mining activities undertaken within the LG” (42.11)	“shall collect income derived from small scale mining activities” (39.2b);	

Revenue sources	Federal Power of Taxation(Art.96)	State Power of Taxation (Art. 97)	Concurrent power of taxation (Art. 98)	The State of Tigray		
				ULG Proclamation No. 107/1998)	RLG Proclamation No.99/1998)	Concurrent taxation power between the State of Tigray and RLG Proclamation.No.99/1998)
		"shall levy and collect income tax [profit] on gains from renting of patent rights within the State (Joint session of HoF and HoPR)" Note 3b	"shall levy and collect income tax [profit] on gains from renting of patent rights of a private company (Joint session of HoF and HoPR)" Note 3c			
Sales tax [VAT] and excise tax Note 8	"shall levy and collect sales [VAT] and excise tax on enterprises owned by the Federal Government"(Art.96.3)	"shall levy and collect sales tax [VAT] and excise tax on income of enterprises owned by the States(98.7)"				
		"shall levy and collect sales tax [VAT and TOT], excise tax on individual traders carried out business within [the States]" (97.4);		"shall collect excise tax and TOT on individual traders within the LG "(42.4);	"shall collect excise tax and TOT on individual traders" (40.3a);	

Revenue sources	Federal Power of Taxation(Art.96)	State Power of Taxation (Art. 97)	Concurrent power of taxation (Art. 98)	The State of Tigray		
				ULG Proclamation No. 107/1998)	RLG Proclamation No.99/1998)	Concurrent taxation power between the State of Tigray and RLG Proclamation.No.99/1998)
Urban/Rural land use fee		"Shall determine and collect fees for land usufructuary rights" (97.2).		"shall determine and collect urban land use fees(42.2);Urban land rent and house tax" (42.5);	"shall collect land use fee, except land use fee allotted for investment: (39.3)	
Fees and charges	"Shall determine and collect fees and charges relating to licenses issued and services rendered by organs of the Federal Government" (96.7).	"shall determines and collects fees and charges relating to licenses issued and services rendered by State organs "(97.9);		"shall determine and collect fees on: permission, and renewal services provided by urban Administration(42.12); Intra-urban road use (42.9); shall levy and collect municipal taxes, duties as well as fix and collect user charges hereof" (42.13).	"shall collect use charges on: marriage, divorce, death and contract agreement registration(40.2c); on permission, renewal services (40.2d); toll roads, Halls, hostels, bridges, well irrigations, Health Centres, and other similar local services rendered by Wereda"(40.1and 40.2a)	"Tourist entrance fee derived within the Wereda" (43.2)



Revenue sources	Federal Power of Taxation(Art.96)	State Power of Taxation (Art. 97)	Concurrent power of taxation (Art. 98)	The State of Tigray		
				ULG Proclamation No. 107/1998)	RLG Proclamation No.99/1998)	Concurrent taxation power between the State of Tigray and RLG Proclamation.No.99/1998)
Import and export duties <b>(Note 9)</b>	"shall levy and collect custom duties, taxes and other charges on imports and exports" (96.1)					
Monopoly taxes	"shall levy and collect taxes on monopolies" (96.8);					
Stamp duties	"shall levy and collect Federal stamp duties" (96.9);	"shall levy and collect state stamp duties on contracts and agreements, as well as title duties registration executed in the State (Joint session of HoF and HoPR) <b>"Note 3d</b>		"shall determine and collect stamp duties on contracts, agreements, title duties, and registration executed in the State" (42.7)		
Royalty and rent on natural resources			"shall Jointly levy and collect royalties on large scale mining and all			

Revenue sources	Federal Power of Taxation(Art.96)	State Power of Taxation (Art. 97)	Concurrent power of taxation (Art. 98)	The State of Tigray		
				ULG Proclamation No. 107/1998)	RLG Proclamation No.99/1998)	Concurrent taxation power between the State of Tigray and RLG Proclamation.No.99/1998)
			petroleum and gas operations" (98.3);			
		"Consistent with the provisions of concurrent power of taxation [98.3] levy and collect royalties and land rentals on such operations (97.8)"; <b>Note 10</b>		"shall determine and collect royalties, land rental fees and revenue tax on small scale mining operations " (42.11);		"Royalties on mining. operations other than Small mining petroleum products (43.2) <b>Note11a,</b>
		Shall fix and collect royalty for use of forest resources <sup>154</sup> (97/10);				"incense and gums, water and other natural resources" (43.2) <b>Note 11b</b>

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154 Fixing royalty fee by the State is not limited to use for forest resources .It also includes royalty on artisans and small scale mining operations(FDRE, Mining Operations Proclamation No.678/2010)

Table 7.1 above, depicts the political economy perspective of the tax assignment matrix in Ethiopia. The matrix comprises three components.

Component one refers to the first column which lists various tax bases identified in the Federal Constitution. The taxation powers are enumerated in a standard list of tax bases, not in the sequence mentioned in the Federal Constitution. Sources of personal incomes are grouped under PIT<sup>155</sup> category, followed by Rental income tax, agricultural income tax and so forth.

Component two refers to the categories of taxation powers at the top row: Federal level (column2), the States (column 3) and concurrent taxation (column 4). Columns 5 to 7 depict the *de jure* tax separation between the State of Tigray and respective Weredas (ULGs and RLGs).

The third component is the matrix cells. Each corresponding cell of the matrix exhibits the revenue sources that belong to a certain level of government. The text in the cell also gives the legal reference. If a matrix cell is filled out under a single level of government, and the other cells on the same row remain blank, then that tax base is exclusively assigned to the Government indicated at the top of the column. When more than one cell is filled out in the same row, then the corresponding tax base is shared between different levels of government.

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155 Theory of taxation makes distinction between regular and irregular tax bases. The former is a permanent source of revenue, while the latter is a windfall income where it may or may not happen once in time according to circumstances. Thus interest income tax and dividends would be considered as “regular” and are normally included in taxable income defined on a “large basis”, whereas capital gains, lottery and similar receipts may be considered as “windfall” earnings and are taxed separately on a flat rate basis. Sometimes gifts and inheritance are also included in “windfall” earnings. However, in Ethiopia, interest income tax on bank deposit, dividends, capital gains, and incomes from winnings of National Lottery and other games are not aggregated to wages and salaries in determining taxable PIT. They are separately taxed on flat rate basis.

### Box 7.1. Some Notes on the Ethiopian Revenue Assignment Matrix

Notes	Explanations
1a,b, and c	<p>The Federal Constitution is silent on 1a, 1b and 1c revenue sources, but they have been listed as taxable in the Federal Income Tax Proclamation No.286/2002. Notes 1a and 1b are progressive PIT up to gross income of Birr 5,000 bracket. Capital gain on transfer is a flat tax payable on gains from the transfers (sale or gift) of properties (a) building held for business, factory, and office 15% and, (b) shares of companies 30%. The State of Tigray has ceded these tax sources to Weredas.</p>
2a and 2b	<p>Levy and collect on employees of private enterprises and on the incomes of private farmers imply income on employees of any business organization established for profit that does not belong to public sector. (I.e. PIT on employees of individual traders and private companies as well as on incomes of private farmers)</p>
3a,b,c and d	<p>They are undesignated in the Federal Constitution. Nevertheless, pursuant to Article 99 of the Constitution, the HoF and HoPR jointly designated.</p>
4	<p>The Federal Government passed over its tax power to levy and collect on income of houses to Addis Ababa City Government. (Federal Proclamation No.361/2003).</p>
5	<p>The Amharic and the English versions of Article 98(2) do not have same text. The English version states, "They [the Federal Government and the States] shall jointly levy and collect taxes on the profits of companies..." while the Amharic version, in addition to profit tax, includes sales tax. Since "the Amharic version of the Constitution shall have final legal authority" (Article 106), private companies are subject to sales tax, which was replaced by VAT in 2003. Article 98(2) is silent on excise tax, although in practice private companies are subject to excise tax.</p>
6	<p>The 'tax on income' in Articles 98(3) of the Federal Constitution is general. The wording of 'income' is vague whether it implies income on employees or income on business. But the Memorandum of HoF on the distribution of concurrent tax between the Federal Government and the State, issued in 1996,</p>

Box 7.1. Some Notes on the Ethiopian Revenue Assignment Matrix	
Notes	Explanations
	refers to business profit tax.
7	The “tax on income” in Article 96(5) and 97(5) is general. In practice, ‘tax on income’ refers to PIT, and business profit tax (BPT).
8	The Federal Constitution states sales tax. This tax base was replaced by Value Added tax (VAT) and by turn over tax (TOT) in 2003.
9	The term “taxes” in this sub-article (96/1) is general. In practice, the term “taxes” includes VAT, withholding tax and excise tax. A word of caution is important here. Currently, the Federal Government imposes 3 percent withholding tax on imported good. Withholding taxes which are deducted from the States’ sources of revenue are transferred to the States on origin basis.
10	The States fix royalty payment, rental and license fees on small scale mining operations. Large, small and artisanal scale mining activities are defined in laws (Proclamations No.53/1993 and 678/2010).
11a,b	What sources of revenue (business profit tax, VAT, excise tax, royalty) are to be shared between the State of Tigray and <i>Weredas</i> is not explicitly defined.

## 7.2 Some Distinctive Features of the Tax Assignment

As discussed earlier, there is no best model of tax assignment that can fit to all countries. Rather it is country specific dictated by economic and non-economic variables. This section discusses some unique features of the Ethiopian tax assignment.

### **7.2.1 No tax immunity on profit making enterprises**

Art.100 (3) of the Federal Constitution notes, *“Neither the State nor the Federal Government shall levy and collect taxes on each other’s property unless it is a profit making enterprise.”* Unlike the shared tax arrangement, which grants authority to impose certain percent of tax rate on the federal tax base, article 100 (3) refers to two ways of taxation power (top-down and bottom-up) on profit making enterprises. Reading the Article, one may poses couple of practical questions. What type of taxes (PIT, CIT, VAT ...) shall the Federal Government or the States impose over the other? What tax rate shall they impose? And how can be the possible vertical fiscal externality tackled?

The Federal Government levies custom duties and 10 percent surtax on states’ enterprises. The states, so far, have neither imposed tax nor fees on the Federal Government-owned enterprises, although Federal enterprises like Ethio-tele, Ethiopian Power Corporation, Ethiopian Sugar Corporation, Hotel enterprises, mining enterprises, Ethiopian Aviation Enterprise etc make wealth by using the land-based resources of the states and some of them produce environmental pollution.

### **7.2.2 Undesignated power of taxation**

Tax powers which are assigned neither to the Federal Government nor to the States nor concurrent taxation powers of the Federal and the States are regarded as undesignated tax power. Allocation of undesignated tax powers is determined by joint session of the HoF and HoPR (Federal Constitution, 1995:Art.99).

In Ethiopia, separation of tax assignment are not exhaustive, partly because of the distinctive tax assignment nature between the Federal Government and the States (the tax assignments in Ethiopia are not made on tax base as it is the case in other countries) and partly because the Federal Constitution has granted residual taxation power neither to the Federal nor to the States.

Pursuant to Article 99 of the Federal Constitution, the HoF and HoPR, in their Joint Session, <sup>156</sup>have designated the following revenue sources.

(1) Income on interest tax from earnings on bank deposits and income derived from company intellectual property right (renting patent and coping) are concurrent taxation powers;

(2) income derived from renting patent right of individual revenues, from stamp duties imposed on functions executed by the States are State taxation powers (HoF and HoPR minute, 1996);

(3) Capital gain transfers on investment properties, and income derived by an entertainer, musician or sportsman/woman from his/her personal activities are subject to tax (Federal Income Tax Proclamation No.286/2002). In accord with this Proclamation, the States have legitimized their taxation powers over these sources of revenue through respective Income Tax Proclamations.<sup>157</sup>

In practice the States can invent new tax sources without waiting for the designation of undesignated taxes by the joint decision of the Houses, provided that the tax base does not refer to any of the Federal Government tax base. For example, all the States impose agricultural income tax. The pastoral States of Afar and Somali, Oromia (in the Borena Zone) and the SNNP (in Omotic pastoral zones) have also introduced livestock tax. Given that livestock are main asset for the pastoralists, and providing veterinary and other services remain the responsibilities of the LGs, the introduction of livestock tax is an important measure to raise the revenue capacity of the States.

### **7.2.3 Concurrent powers of taxation**

Article 98 of the Federal Constitution grants concurrent powers of taxation between the Federal Government and the States. Concurrent

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156 Article 99 of the Federal Constitution stipulates that any undesignated taxation power has to be designated by a Joint Session of the HoF and HoPR with two-third majority votes. In reality, as discussed on Chapter 3, the former does not have deterrence power in the decision making process of designation tax, because the latter can meet the two-third votes to pass a resolution in the joint session without the need of a single support vote of the HoF.

157 Tax bases such as gift tax, real property tax (on buildings residential and commercial and vehcles), environmental tax, hotel occupancy tax (tourist tax), highway tax, to mention few, are still undesignated taxes.

taxation powers should be jointly levied and collected by the Federal and the States (Federal Constitution, Art.98). But the Constitution is not clear whether the phrase “jointly levy and collect...”implies : (1) the Federal Government deals with individual State or (2) the Federal Government and the States sit together in a round table and collectively determine the tax rate, deductions and exemptions on tax-by-tax-base on consensus base (Solomon, 2006:136). If the first scenario takes place, each State may come up with a lower tax rate and deductions that would enable it to attract investment to its jurisdiction. This is undesirable. So the Constitution seems to presuppose Federal Government and the States together decide the tax base, tax rate and the tax administration of the concurrent revenues on consensus base.

Realizing the jointly tax administration of concurrent revenue sources has created inconvenience, in accord with the Article 105(2) of the Federal Constitution, the HoF and the HoPR jointly delegated the tax administration to the Federal Government (HoPR and HoF 1996a EC).

Constitutionally speaking, the concurrent taxation powers are superior to the conventional shared tax arrangement which is common in the developed nations. Because in the latter sub national governments are only allowed to impose tax rate on federal government tax bases, while the Ethiopian states have legislative power to jointly decide the tax base, tax rate ,deductions as well as tax administration, which do not exist in shared revenue arrangement.

Looking about the practice of the concurrent taxation powers, one may find that they are reduced to a revenue sharing arrangement,<sup>158</sup> partly because the States have abandoned their taxation powers to set tax rate and partly because the federal government has instructed the states to harmonize and standardize their tax base with the Federal tax base (Federal Proclamation No. 57/1996).

Article 62 (7) of the Federal Constitution notes that the HoF determines the distribution of proceeds generated from the concurrent revenue sources between the Federal Government and the State. The House

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<sup>158</sup> Here the author takes the definition of revenue sharing arrangement given by Blöchliger and King, 2006 (see Section .6.4.2 of this dissertation).



distributes concurrent revenue proceeds on a derivation basis on the following percentage ratio.<sup>159</sup>

**Table 7.1. Distribution of Concurrent taxation proceeds between the Federal Government and States<sup>160</sup>**

Revenue Sources	Share of Federal Government	Share of State Government
1. From enterprises jointly established <ul style="list-style-type: none"> <li>• Business Profit tax.</li> <li>• Personal Income tax.</li> <li>• Sales** and excise tax.</li> </ul>	<p>*</p> <p>50%</p> <p>70%</p>	<p>*</p> <p>50%</p> <p>30%</p>
2. From private companies <ul style="list-style-type: none"> <li>• Business profit tax</li> <li>• Sales** and excise tax</li> <li>• taxes on dividends</li> </ul>	<p>50%</p> <p>70%</p> <p>50%</p>	<p>50%</p> <p>30%</p> <p>50%</p>
3. From large scale mining; all petroleum and gas operations. <ul style="list-style-type: none"> <li>• Business Profit tax</li> <li>• Royalties</li> </ul>	<p>50%</p> <p>60%</p>	<p>50%</p> <p>40%</p>

Source: HoF, 1989 E.C 2<sup>nd</sup> Regular Meeting minute, page76-80.

\* As per capita share contribution.

\*\*Sales taxes are replaced by VAT

The setting of the HoF opens a loophole for manipulation. The three populous states may easily change the rule of game through establishing a simple majority rule, by forming coalition, to take lion's share from the

<sup>159</sup> Here derivation basis mean a state obtains part of the tax yield if the economic activity (or production) takes place within a state and/or the legal registration of the business is within the state.

<sup>160</sup>The HoF set the distribution formula in 1988E.C (1995), but it came into effect in 1995E.C (2002), because the HoF did not communicate officially the resolution to the Ministry,MoFED (HoF,3rd year, 1st Regular Meeting Minute, 1995E.C.)

concurrent revenue sources<sup>161</sup>. If the wide asymmetric representation of the States in the HoF is accompanied by deficit of genuine horizontal solidarity spirit, the power of the House to determine allocation of concurrent revenue sources between the Federal Government and the States can be a source of conflicts. Think, for example, what will happen if the decision of the House does not satisfy the claim and aspiration of the State which generates the concurrent revenue(s)? What will be the reaction of the mineral resources rich states but remain minority, if the House sets the distribution of concurrent revenue heavily skewed in favour of the Federal Government? Given the setting of the HoF, solidarity spirit among the states seems to be an effective saviour disposable to the states. If the House's appropriation favours the generating states, it will create wide horizontal fiscal and socio-economic development disparities between the resource rich state and the 'have-not' States. Those states which have legal power to change the rule of game to their interest by forming coalition and the minority states but endowed with natural resources need to refrain from taking any action that could dilute the solidarity spirit that serves as a glue to remain united.

The concurrent taxation powers are designed to ensure States' access to a wide range of elastic revenue sources, so that they would be able to effectively carry out their responsibilities. So far the experience does not support the intended objective because in some elastic revenue sources, the Federal Government takes the lion's share of the concurrent revenue sources.

#### **7.2.4 Tax Assignment on tax bases is seldom applied**

Global experiences show that tax assignments to different levels of government are done on tax bases. A certain tax base, say PIT or VAT, is either assigned exclusively to a certain level of government or is a shared

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161 The SNNP constitutes almost 45% of the total 134 seats. This enables the State to win a simple majority vote (50+1) by forming coalition with either Oromia or Amhara or Tigray or combinations of any two states from the emerging states, except Afar and Harari. In principle, the simple majority rule enables the SNNP to pass decisions on the distributions of revenues generated from concurrent tax powers in its favour or to reject, if it likes, any states' claims for higher share from concurrent revenue that generates within their jurisdiction in the name of 'democratic majority vote.'

tax between different levels of government. Such tax assignment principle is seldom practiced in Ethiopia however. Rather, a single tax base is divided between the Federal Government and the States based on various principles. They independently levy taxes and administer the revenue sources assigned to them. As can be seen from Table 7-1, the Federal Government and the States have exclusive taxation powers on PIT, BPT, VAT revenue sources etc. This unique feature of the Ethiopian tax assignment leads to pose a question: what tax assignment criteria have been applied in determining the taxation powers of the Federal, or State or concurrent?

Looking about the tax separation among the Federal, State and concurrent taxation powers, we may identify the considerations of various principles such as ownership principle, type of business form establishment, principle of origin, benefit-received principle, domiciliation principle, inter-State and international trade, and administrative feasibility.

***Ownership of revenue sources principle*** refers to the level of government that owns the source of revenue. According to this principle, the owner of a certain public sector or a business activity has taxation power on the resulting tax yield. That is, if the Federal Government owns a public sector that generates revenue, then taxation power of that revenue sources is assigned to the Federal Government. Similarly, if a State possesses a business entity, then that revenue source belongs to the State. When a revenue source is jointly owned by both the Federal Government and the States, the taxation power is automatically a concurrent power.

The ownership principle ensures the right of the States to have access to a wide range of revenue sources generated from public sector activities they own and from natural resources located within their jurisdictions. Out of the existing 44 total revenue sources, seventeen (35 percent) are assigned to the Federal, or to the States or to both on ownership principle.

A shift of ownership of a business entity results in a change in taxation power over the revenue source. The privatization of Federal Government enterprises automatically shifts the taxation power to a concurrent or a state taxation power.

***Type of business organization***-refers to the legal registration of business organization form. All revenue sources that derive from private companies established in the form of Private Limited Companies (PLC) and Share Companies (Sh.co) are concurrent taxation powers, whereas revenues generated from firms registered as sole proprietorship business (individual traders) are State taxation powers. The separation of taxation powers between the Federal Government, the states and Concurrent are not made on tax base. Both the Federal Government and the States exclusively tax on the same tax base. Using type of business organization as a criterion for tax assignment between vertical levels of government is unique to Ethiopia. A change of business organization form causes a shift in taxation power. If an existing individual trader registers his/her business as PLC, the taxation power applicable will shift automatically from a State to a concurrent taxation power. Likewise, if a PLC business organization is reduced to a sole proprietorship, then the taxation power will shift from a concurrent taxation power to a State.

The states' taxation power on PIT, BPT, VAT, and TOT on individual traders (business organization criterion) might be argued for two grounds. First, given the economic base of the country is at low level, business activities organized on sole proprietorship are not only characterized by small scale manufacturing and trading activities but also their market (consumption area) are confined to local boundaries or assumed less mobile. That is, business entities like restaurants and cafes, pastries and bakeries, photo studios and beauty salons, wood workshops and garages, small dairy farms and trading etc... are less mobile and are established to exploit a niche market. Second, the States have responsibilities to discharge vast public functions that require commensurable public funds. Thus the assignment of such elastic revenue sources to the States, presumably, intends to ensure tax autonomy of the States.

In practice, however, using the type of business organization as a criterion for assignment of revenue sources between the Federal Government and the States raises some critics: (i) The criterion does not give a dependable source of revenue to the states for a couple of reasons:

(a).The revenue sources easily get shrink down. They shift from a state taxation power to concurrent power when entrepreneurs opt to register as Private Limited Company or Share Company any time.<sup>162</sup> Such a shift brings in adverse effect on the State's fiscal capacity, because the revenues generated from BIT, and VAT on sole proprietorship that should have been entirely gone to the States' treasury would become concurrent revenues and they will be shared according to the HoF distribution ratio.

(b) Sole proprietorship is not a revenue source of the future. The shift from sole proprietorship business organizations to PLC and Sh.Co is a natural growth process. With the success of economic transformation of the country, revenues generated from sole proprietorship business organizations will eventually wither away or small business entities will be swallowed by big firms. Therefore, states' revenue sources from sole proprietorship will sharply diminish in the long run.

(ii) Treating revenue sources generated from local-oriented small business entities as concurrent revenue seems to be bizarre because they are simply established in PLC to mobilize financial and/or entrepreneurial skill.

**Origin principle** refers to the production/ business area where a particular revenue source generates from. Revenue sources like rental income tax derived from private houses and capital transfer taxes on properties, tax on incomes from transport services rendered on waters within State territory, and PIT on income of private farmers and farmers incorporated in cooperative associations are assigned to the States, because the production areas are defined within the States' territory.

Here, a caution is in order. Location of production/business area does not automatically guarantee taxation power of a state. If a private company<sup>x</sup> established in either PLC or Sh.Co form of business makes its HQ state<sup>A</sup> but it operates its production or makes business area in States of <sup>B, C</sup> and <sup>D</sup>, then the taxation power will be concurrent revenue and the revenue is distributed between the Federal Government and State<sup>A</sup> only. States of <sup>B, C</sup> and <sup>D</sup> get nothing even if they contribute in the creation of

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<sup>162</sup> There is a trend to register sole proprietorship business firms as PLC without real investment increment, to escape from the presumptive tax assessment method, highly subjective and heavy tax burden, of the State Revenue Agencies.

wealth. If an enterprise organized as a sole proprietorship making its HQ<sup>163</sup> in State<sup>A</sup>, but operates in state<sup>B</sup> in addition to State<sup>A</sup>, then the taxation power falls in the domain of state<sup>A</sup>. The seat of the enterprise (HQ) has denied the hosting states from sharing revenues which have generated within the states, except PIT.

The distribution of concurrent revenues on legal entity registration basis would lead to a wide horizontal fiscal disparity as the legal seats of private companies are mainly concentrated in Addis Ababa City Government. Interestingly, the Federal Government has attempted to minimize the adverse effect through introducing asymmetric taxation power. Unlike the States, the Addis Ababa City Government does not have concurrent taxation powers. The Federal Government takes away all concurrent revenue sources. Instead, it has given its taxation power stipulated on Art.96 (6) of the Federal Constitution (to levy and collect taxes on income of houses owned by the Federal Government) to the City. Therefore, in reality all concurrent revenues which would have been distributed to Addis are apportioned to the Federal Government which partly is transferred to the states in the form of unconditional and conditional grants and partly used to carry out Federal functions. Such an asymmetric taxation power to Addis is an innovative way of addressing horizontal fiscal disparity.

***Benefit-received principle*** links the real costs of public services with beneficiaries. It is a mechanism of financing cost of public services through setting user charges and fees. Thus user charges and fees are assigned to the jurisdiction that provides a certain public service.

***International trade tax bases***-custom duties and other charges on imports and exports are exclusive taxation powers of the Federal Government. The reasoning is that a decentralized international trade tax base leads to inefficient capital resources allocation and distorts inter-state trade.

***Domiciliation principle*** refers to the assignment of taxation power to different levels of government permanent residence of the tax payer. Regardless of the form of business organization, PIT on employees of

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<sup>163</sup> When the states get started varying tax rate, corporations will have incentive to transfer pricing and switching costs on paper from lower tax rate state to a higher tax rate one in order to reduce their tax burden.

private companies is assigned to the States on domiciliation principle. Tax payers may earn incomes by performing their activities in various jurisdictions, even outside the country, or by renting their patent right across the country, but finally they should declare their taxable income to a revenue agency where they reside. This principle calls for horizontal tax coordination. Exchange of tax related information between the states may check tax evasion.

**Administrative convenience-** Time and resources devoted to assess, collect, and audit for revenues, as much as possible, should be the lowest for both the Revenue Agency as well as for tax payers. PIT on employees of international organizations, taxes on incomes of air, rail, and sea transport services; taxes on monopolies and road funds are assigned to the Federal Government on consideration of administrative convenience.

It is worth mentioning that the above principles (criteria) applied in the separation of taxation powers between the Federal Government and the States are not exclusive each other. For instance, BPT, VAT, etc generated from private companies (PLC and Sh.Co.) are concurrent taxation power, but PIT on private companies is a state taxation power on domiciliation principle. A revenue sources that should have been assigned to the States on origin basis can be concurrent revenue if the business is registered as PLC or Sh.co. The Federal Government may completely control revenue sources which operate production in State<sup>A</sup> on ownership principle.

**Table 7.2. Tax Assignment Principles in Ethiopia**

Tax Assignment criteria	Federal power of taxation	State power of taxation	Concurrent power of taxation (Federal-State)	State of Tigray	
				RLG /ULG taxation powers	State-LG concurrent power of taxation
Ownership principle	PIT on employees of the Federal Government	PIT on employees of the State		PIT on employees of the LG and on employees of enterprises owned by the LG;	
	PIT on employees of enterprises owned by the Federal Government;	PIT on employees of enterprises owned by the States;	PIT on employees of enterprises jointly established by the Federal and State		
	Rental income tax on income of houses owned by the Federal Government;	Royalties and land rentals on small scale mining operations		Royalties and land rentals on small scale mining operations undertaken within the LG;	Royalties on small scale mining operations, and petroleum products;
	Income from other properties owned by the Federal Government;	Business profit tax, on enterprises owned by the States	Business profit tax on enterprises jointly established by the Federal and the States;	Business profit tax, VAT, excise tax on enterprises owned by LGs	
	Business profit taxes on enterprises owned by the Federal Government;	VAT, TOT, excise tax on enterprises owned by the States	VAT and excise tax on enterprises jointly established;		



Tax Assignment criteria	Federal power of taxation	State power of taxation	Concurrent power of taxation (Federal-State)	State of Tigray	
				RLG /ULG taxation powers	State-LG concurrent power of taxation
	VAT, and excise tax on enterprises owned by the Federal Government;	royalties for use of forest resources;			Income tax from incense and gums, water and other resources;
	income tax on winnings of national lotteries and other games of chance;	Fees for land usufructuary rights;		Services rendered Fees for rural and urban land fees;	
	Tax on monopolies				
Type of business organization		VAT or TOT, and excise tax on individual traders;	Profit tax , VAT, and excise tax on companies;	VAT or TOT, and excise tax on individual traders;	
			Royalty on large scale mining and Petroleum and gas operations		
		Profit tax on income derived from small scale mining operation;	Dividends due to Share;	BPT on income derived from micro and artisan mining;	
			income[PIT] derived from large scale mining petroleum and gas operation		

Tax Assignment criteria	Federal power of taxation	State power of taxation	Concurrent power of taxation (Federal-State)	State of Tigray	
				RLG /ULG taxation powers	State-LG concurrent power of taxation
		income tax [profit] on gains from renting of patent rights within the State;	income tax[profit ]on gains from renting of patent rights on private companies;		
Origin principle	Stamp duties;	Stamp duties;		Stamp duties	
		Gains on transfer of certain investment properties;(capital transfer tax)		Gains on transfer of certain investment properties (capital transfer tax);	
		Rental income tax derived from private houses,		Rental income tax derived from private houses within the LG;	
		Rental income tax on other properties within the States;		Rental income tax on other properties within the LG	
		PIT on income of private farmers and farmers incorporated in cooperative associations		PIT on income of private farmers and farmers incorporated in cooperative associations;	
		tax on incomes from transport services rendered on waters within State territory;			

Tax Assignment criteria	Federal power of taxation	State power of taxation	Concurrent power of taxation (Federal-State)	State of Tigray	
				RLG /ULG taxation powers	State-LG concurrent power of taxation
		Profit tax on individual traders carried out business within their territory			
Benefit-received principle	Fees and charges related to licenses issued and services rendered by the Federal Government;	Fees and charges related to licenses issued and services rendered by the States;		Fees and charges related to licenses issued and services rendered by the States;	
		fees for land usufructuary rights		fees for land usufructuary rights	
International trade tax bases	Custom duties, taxes and other charges on imports and exports;				
		PIT on employees of private companies;		PIT on employees of private Companies;	
Domiciliation Principle		Incomes [PIT]of private farmers and farmers incorporated in cooperative associations			
		PIT on employees of domestic NGO;			

Tax Assignment criteria	Federal power of taxation	State power of taxation	Concurrent power of taxation (Federal-State)	State of Tigray	
				RLG /ULG taxation powers	State-LG concurrent power of taxation
		PIT on income derived by an entertainer, musician or sportsman/woman from his/her personal activities		PIT on income derived by an entertainer, musician or sportsman from his personal activities	
Administrative convenience	PIT on employees of international organizations;				
	Taxes on incomes of air, rail, and sea transport services;				

Source: author, constructed based on the Federal Constitution taxation power and Tigray Proclamations No.99/19998 and 107/1

### 7.3 Wereda Government taxation powers

As noted earlier, the Federal Constitution defines the fiscal relations between the Federal Government and the States only. Wereda Government taxation powers are not only derived from the State's tax assignment but also left to the discretion of the States because Weredas are creatures of the States. Despite the States have devolved considerable assignment of responsibilities to respective Weredas, no State, so far, has legally defined taxation powers of Weredas, except the State of Tigrai.

As can be seen from Table 7.1, above, the State of Tigrai has devolved most of the revenue sources granted to it. Royalty on small local minerals and petroleum products, natural resources (incense and gums, water) and tourist entrance fees are also concurrent taxation powers between the State and Wereda. Very few revenue sources are retained at state level such as PIT on States' employees, BPT, VAT, and excise tax on enterprises owned by the States, and fixing royalty on small scale mining. The taxation power gives access to various revenue sources to the Weredas. In addition to own revenue, (i) wereda block grant, (ii) budget subsidy to be granted by the state for the implementation of special purpose, (iii) loan, (iv) assistance from governmental and non-governmental in cash or in kind, and (v) other sources are defined as revenue sources of ULGs.

The highly decentralized taxation power will make the state of Tigrai fiscally starved and to rely mainly on the federal unconditional grants, concurrent sources of revenue EFFORT<sup>164</sup> and borrowing to finance its expenditure needs. The devolution of taxation powers envisages strong weredas. In practice, however, the tax devolution has remained on paper as the Council of the State has not yet determined the minimum and maximum tax rate in accord to the Proclamation No 107/1998.

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164 Legally speaking the Endowment Fund for the Rehabilitation of Tigrai (EFFORT), a second biggest domestic business corporation in terms of investment and employment in the country, belongs to the People of Tigrai. It is supposed to finance the State's capital investment needs. The State receives considerable revenues being generated from EFFORT in the form of concurrent taxation.

Therefore, taxation powers of the Weredas in Tigray are limited to municipal revenues.

The Amhara State has identified the following revenue sources to the ULGs: (i) City/Municipal revenue sources, (tariffs, land rental fee and lease revenues; (ii) dividend of development enterprises administered under city/municipal); (iii) revenue sharing between the Regional states and ULGs; (iv) subsidy granted by the Regional state(Wereda block grant); (v) special budget subsidy or assistance by the Regional state for the implementation of special purpose, (vi) short-term and long-term loan; (vii) aid from governmental and non-governmental organization in cash or in kind, and (viii) other sources(Amhara Regulation No. 37/2005). The Amhara state has preferred a revenue sharing arrangement, although, again, the State Council has not determined what revenue sources should be shared between the state and the ULGs. The Amhara revenue sharing system gives less taxation power to the LGs as compared to the Tigray.

#### **7.4 Vertical Tax Co-ordinations**

As discussed earlier, revenue sources are either exclusively assigned to the Federal Government or to the States or are concurrent (shared) between the Federal and the States. Table 7.3 shows 44 revenue sources of which 13 and 22 are exclusively assigned to the Federal Government and to the States respectively, while the remaining 9 sources of revenue are concurrent revenue sources.

Article 96 and Article 97 of the Federal Constitution note that the Federal Government and the States “shall levy and collect...” which imply each government has legislative taxation authority to determine the  $B$ ,  $t$ ,  $D_i$  over their tax domains. Besides, the Federal Government and the States jointly determine  $t$ ,  $B$ ,  $D_i$ , and make tax assessment and collection on concurrent revenue sources. The joint taxation powers presuppose consensus based decision to avoid any fiscal externalities.

Sub-sections 7.4.1 to 7.4.4 examine how the vertical tax coordination works in the Ethiopian taxation system. Emphasis is given to PIT, CIT, VAT and unevenly distributed natural resources. These tax bases are purposely selected on their existing and potential contributions to the

total revenue pool as well as the degree of cooperation and harmonization they entail.

#### **7.4.1 Personal income tax (PIT)**

PIT is imposed on taxable income of payees. PIT is a highly decentralized revenue source in Ethiopia. It is assigned to the Federal Government, the States and jointly to the Federal and the States. Constitutionally speaking, in the general taxation formula stated above, the Federal Government determines the B, D<sub>i</sub> and t, on PIT generated from its employees, on enterprises it owns, and on employees of international organizations. Similarly, the States levy PIT on employees of (i) the States, (ii) the enterprises owned by the States, (iii) the private companies, (iv) local non-government organizations, and (v) on incomes of entertainers, musicians, and sportsmen/women. Constitutional speaking, the States have authority to determine the tax base, set tax rate, and administer and collect PIT assigned to them.

In Tigrai. PIT on employees of civil servants of Weredas on employees of development enterprises owned by Weredas, and on employees of private business entities are assigned to Weredas (Tigrai Proclamation No 99/1998 and Proclamation No.107/1998). According to these Proclamations, the urban Weredas have authority to set tax rate within the minimum and maximum tax rate to which shall be set by the State Council. LGs have to apply the state's 'B' and 'D<sub>i</sub>'.

The FGTF argument for centralization of PIT to impede fiscally induced labour migration is less persuasive in Ethiopia. In the Ethiopian reality, unilateral measures on PIT for interpersonal equity purpose would hardly cause out migration of rich people to a lower PIT States. Neither will it result in influx of poor people to a more welfare State, at least, in the foreseeable future unless unemployment and poverty levels become serious problem. Language and cultural diversity, and strong social affection towards locality area, strong ethnic identity tension, and widely spread indigenous versus non-indigenous mentality in the states are believed to make inter-state mobility of people very expensive. The existing rural land tenure policy that obliges land users to stay

permanently in their local areas and housing problems in big urban centres also contribute to the existing low level of inter-state mobility of people in Ethiopia.

But it should be noted that other variables remaining same, significant difference on PIT rate for interpersonal redistribution purpose within the relatively homogeneous States is likely to result in labour mobility to lower PIT rate jurisdiction. For example, in Tigray, where PIT is decentralized to LG, other things remain same, people may be reluctant to apply for a job in a higher PIT weredas and thus it may cause misallocation of labour force in the State unless (a) the difference between minimum and maximum tax rate, to be determined by the State Council, (Tigray, Proclamation No.107/1998) will remain insignificant, or (b) residents believe that the higher tax rate brings in better public service in their locality. Given Tigrians are relatively mobile people,<sup>165</sup> social affection to birth place is believed to be less to hinder movement of people from one LG to another LG within the state.

The principle of PIT on work place restricts the States/LGs access to PIT from their residents who work for establishments in other jurisdictions. The case of Addis Ababa Surrounding Special Zone of Oromia State is a typical illustration.<sup>166</sup> The satellite towns in the Zone supply considerable labour force to the Addis Ababa City Government. In accord with the principle of ownership or origin principle, commuters pay PIT to the Addis Ababa City Government, while the satellite towns, which provide public services to the commuters and their families, get nothing. This issue is, therefore, an agenda that calls for some sort of horizontal coordination and negotiation between the hosting States and employer state.

The decentralized assignment of PIT has made impossible to determine the taxable income by aggregating all sources of personal

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<sup>165</sup>For instance, people from the Eastern part of the State have been migrating to the western and southern parts of the state since 1950s.

<sup>166</sup> The emerging trends of cluster industrial zones in continuum jurisdictions (for example Kombolich and Dessie in Amhara, Adwa and Axum in Tigray, Shashemene and Hawassa) and, the Federal Government public investment on selected 'strategic industries' in the economic zones may exacerbate the problem unless some sort of compensation mechanisms are designed for the costs of public services provided by LG or PIT on place of residence principle is applied.



income derived from more than one justification because each level of government is entrusted with the power to determine the taxable income generated only within its jurisdiction.

#### **7.4.2 Corporate income tax (CIT) or Business profit tax (BPT)<sup>167</sup>**

The tax bases of CIT or BPT are public and private profit making enterprises. The Federal Government tax bases of CIT are enterprises owned by the Federal Government and incomes generated from air, rail and sea transport services, whereas individual traders (private business), enterprises owned by the States and income from transport service rendered on water within states' territories (private or public) are BPT sources of the States. The States can determine  $B$ , set ' $t$ ',  $D_i$ , independently assess and collect BPT. But in practice, the states apply the Federal Government's,  $B$ ,  $t$ , and  $D_i$ .

CIT on companies jointly established by the Federal Government and a State, as well as on large scale mining on all petroleum and natural gas operations are concurrent taxation powers of the Federal Government and the States.  $B$ ,  $t$ ,  $D_i$  and tax administration are jointly determined (Federal Constitution, Art.98). Such a joint taxation power gives access to elastic revenue sources to both governments.

Literatures on fiscal federalism plausibly argue that a decentralized CIT/BPT spurs tax competition among jurisdictions to attract capital to their own territory and would cause fiscally induced capital migration. This is less practical in the Ethiopia federal arrangement as business people perceive that local politicians make favour to the 'son-of-the soil'.

In order to avoid tax race-to-the bottom among the States, the Federal Constitution designates the relatively mobile nature business entities as concurrent taxation power. Business entities characterized by immobile tax base are given to the States. Psychological cost of mobility

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167 To avoid any confusion, in this study CIT and BPT are used interchangeably. Note that CIT/BPT on business entities organized in PLC and Sh.co are subject to 30 percent tax, while sole proprietorship businesses are imposed 35 percent.

to other state for small business entities organized as sole proprietorship is believed to be high.

Other factors remaining the same, effects of the decentralized BPT in Tigray on the choice of investment location will depend upon the tax rate to be set in the LGs. The higher the difference between the minimum and the maximum tax rate, the greater will be the distortion of capital allocation among the LGs. Entrepreneurs may migrate to a lower BPT LG.

### **7.4.3 Value Added Tax (VAT)**

VAT was introduced in 2002 to replace the sales tax. The tax base for VAT includes all taxable goods (consumer and capital) and services of legal business entities whose annual sale turnover exceeds Birr 500,000 (equivalent to USD 26,500) except exempted transactions identified in the VAT Proclamation. All imported goods and services are subject to VAT registration (Federal VAT Proclamation No.285/2002).

The assignment of VAT implicitly respects the assignment of sales tax which has stipulated in the Federal Constitution. The Federal Government determines the VAT base, and  $D_i$ , tax rate, assesses and administers VAT bases which fall in its domain. The same is true for state VAT. The Federal Government and the States jointly determine the VAT base,  $D_i$ , and  $t$  on the concurrent revenue sources. However, in practice, the Federal Government defines the tax bases, deductions, exemptions, the rate and administration of states' and concurrent revenue sources of VAT without making amendment on the taxation power<sup>168</sup> (Federal VAT Proclamation No.285/2005). Thus, VAT is uniform across the states. VAT on individual traders is assessed, audited and collected by the Federal Custom and Revenue Authority (FCaRA) and the Authority transfers the VAT proceeds to the States every two months based on the legal entity (seat) of an enterprise(Federal Custom and Revenue Authority Directive, No.22/2001)

True, harmonizing the VAT base, deductions, and exemptions avoids inefficient allocation of resources. A single VAT administration might be

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<sup>168</sup> VAT is imposed at 15 percent. Any business organization may also voluntarily register for VAT, if it regularly supplies or renders at least 75 percent of its goods and services to VAT registered business entities (Federal, VAT Proclamation No.285/2002).

also desirable to reduce tax administration inconvenience and compliance costs to both the Revenue Authority and tax payers. The criticism is however, even if there is good justification for uniformity of tax base,  $D_i$  and tax administration on VAT; it should have been done in line with the spirit of the Federal Constitution, rather than by a unilateral Federal decision.

#### **7.4.4 Natural resources revenues**

Article 40(3) of the Federal Constitution reads, “The right to ownership of rural and urban land, as well as of all natural resources, is exclusively vested in the State and in the Peoples of Ethiopia....”

In the spirit of this article, natural resource revenues are assigned either exclusively to the States or, jointly to the Federal and the States. The States have power to levy and collect taxes on incomes derived from small scale mining activities (Federal Constitution, Art 97(8)) and royalty on use of forest (Federal Constitution, Art.97(10)). Royalties on production, rent on resources, business profit tax, VAT and excise taxes on large scale mining and all petroleum and natural gas operations are concurrent revenue sources. Like any the other concurrent taxation power, tax rates, deductions, exemptions and tax administration on natural resources revenues are jointly determined by the Federal Government and the States (Federal Constitution, art.98 (3)).

The States have right to determine tax bases, deductions, exemptions, set tax rate and charge fees on natural resources that fall on their jurisdiction. The Federal Government has no exclusive taxation power on natural resources revenues, but on fees for the services it provides (issuing licenses). In practice, however, the Federal Government determines  $B$ ,  $t$ , and  $D_i$  on natural revenue sources.

The assignment of natural resource taxes to the States and to concurrent jurisdictions has both political and economic rationale. In terms of politics, guaranteeing the States right to benefit from their natural resources endowment is believed to promote holding together of the constituent members of the federation. It gives incentive to states rich in natural resource to stay within the federation and to undermine secession sentiment that might be evoked by ethnic entrepreneurs, on

the pretext of ‘We are not benefiting from our natural resources as the centre takes all’. It may also serve as an instrument to join the federation including neighbouring countries in the future.

**Table 7.3. A Summary of taxation power on natural resources**

Revenue sources	federal	state	Federal and state Concurrent revenue sources)
Royalty on large scale <sup>169</sup> exploitation			✓
Royalty on small scale exploitation		✓	
Large mining License and registration fees	✓	✓	
Tax on earning and profits of large scale operating business			✓
Tax on earning and profits of small scale operating business		✓	
VAT on large scale exploitation			✓
VAT on small scale mining exploitation		✓	

Source: Federal Constitution, Art.98

In terms of economics, assignment of unevenly distributed natural resources revenue to the States only would cause a wide economic horizontal disparity between the resource endowed states and the less endowed one. This, in turn, enables them to provide better quantity and quality of public services at a lower tax burden than poorly endowed states. Hence, the latter would be forced to impose higher tax rate to provide comparable basic public services. In addition, resource-rich States would have better opportunity to invest on modern infrastructures. As a result, business organizations may have an incentive to choose the rich states as their investment location. Labour will likely to migrate there, although it is not as mobile as capital, seeking for better

<sup>169</sup> Large scale mining and small scale minigs are defined in the Federal Government Mining Proclamation No 678/2011.

job opportunities and higher wages. All these would lead to misallocation of productive resources among the States.

Therefore, natural resource revenues are assigned as a concurrent revenue sources as well as State revenue power to achieve couple of conflicting objectives: (i). to benefit the states from their natural resources. Sharing out the concurrent revenue in favour of the state would appease the resource endowed States and may curb secession mentality and (ii) to address the problem of politically unacceptable horizontal disparity.

The assignments of natural resources seem to have implicit objective to compensate both for environmental damage that would occur in the process of extracting the resources and for the public services provided by the States/local governments.<sup>170</sup> To this end, the states have right to claim up to 5 percent equity of the total mining investment without paying for it (Federal Proclamation, No. 678/2010 and Federal Proclamation No. 816/2013). Surprisingly, so far the states do not receive royalty revenue from large-scale mining activities nor they make use of the 5 percent equity right on the total capital investment of private companies.

In summing up, the separation of taxation power between the Federal Government and the states intends to ensure a high level of tax autonomy. It is designed in a way to have access to a range of revenue sources, except custom duties related taxes. The Federal Constitution empowers the States to determine tax base, set tax rate and tax administer. They have also equal legislative taxation powers over concurrent taxes. But in practice, tax base, tax rate and deductions are uniformly applied across the States, except agricultural income tax, and deductions on rental income.

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170 The Federal Government enforces the need for the establishment of "Environment Impact Assessment and Rehabilitation Fund" in mining operations with the objective to cover the costs of rehabilitation of environmental impact in the hosting jurisdiction(Federal Proclamation No 678/2010).

## 7.5 Horizontal Tax Competition and Tax Harmonization

### 7.5.1 Tax harmonization

As discussed earlier, the phrases “shall levy and collect...” in Art.97 of the Federal Constitution imply, the States’ taxation power to determine  $B$ ,  $t$ , and  $D_i$  over a range of revenue sources. Theoretically, such variations of the states’ taxation powers would likely lead to tax competition and would make the tax administration complicated, particularly for business firms which operate in more than one state. In order to avoid the possible consequences of tax competition, the Federal Government has compelled the States “to ensure harmonization and standardization of the States’ new or changed tax bases with the Federal Government” (Federal Proclamation No.57/1996 and Council of Ministries Regulation No.17/1997).<sup>171</sup> That is, in  $T = t_{f,c} \times [B - (D_i)] \times (K_{\text{federal}} + K_{\text{state}} + K_{\text{LG}})$ , the States have to harmonize and standardize  $B$  with the Federal Government tax base. Applying uniform definitions of tax bases, deductions, and exemptions on mobile tax bases across the states, make sense, as long as constitutional amendments are done in line to the constitutional causes, for well founded economic arguments,, to minimize if not to avoid wasteful tax competition, to reduce fiscally induced mobility of resources, to minimize costs of tax assessment and administration, and to reduce compliance cost when tax payers operate in different states.<sup>172</sup>

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<sup>171</sup> The constitutional ground of the Federal Financial Administration Proclamation that obliges the states to harmonize and standardize their tax base with the Federal Government may raise a legitimacy question as the Constitution is supreme law over any proclamation and rule.

<sup>172</sup> According to the Proclamation, tax base harmonization is limited to tax bases common to the Federal and the States. The tax harmonization does not apply on tax bases limited to the States. For instance, Addis Ababa sets 50 percent deductions as depreciation cost on total rental income, while the states apply only 20 percent deduction (see Tigray Income tax Proclamation No. 86/2003). This has obvious impact on diverting investment in construction sector in Addis.

### 7.5.2 Tax competition

The States have legislative power to set tax rates, however, they are *de-facto* uniform across the States, except agricultural income tax, rural land use fee and urban land lease fee. One may ask why the States do not exercise their constitutional right to set tax rate. We may postulate some possible political economy explanations for the existing uniform tax rate in Ethiopia:

(i) The States have either ‘voluntarily abandoned’ their right and have preferred to pursue the Federal tax rates or they are ‘advised’ by the ‘invisible hand’ [ruling party] not to dare playing with tax rate intending: (a) to avoid the possible consequences of inter-state tax competition; and (b) to provide minimum standard public services at nation-wide at comparable tax burden.

(ii) It could be “gentlemen’s agreement” in the sense of Nash cooperative equilibrium in the prisoner’s dilemma. Cooperative equilibrium avoids moral hazard in that each State is acting the same: State<sup>A</sup> does not use its own tax rate schedule but the Federal one, knowing that the other States will do the same. So, State<sup>A</sup> takes no risk having to respond to tax competition from the other States. This may make each State to benefit equally or denies benefits equally.

(iii) It could be simple tax mimicking in the sense that politicians in State<sup>A</sup> adopt exactly the same tax behaviour in the other States. State politicians may prefer to stick to the Federal tax rate schedule. Adopting the same tax behaviour makes politicians in State<sup>A</sup> not to be judged by their constituents on their “tax performance” in comparison with what has been happening in other States (benchmarking). So, politician may opt to compete not with very sensitive tax variable, but playing with public expenditures.

(iv) The States may not have incentive to raise tax rate as the Federal Government is generous enough to transfer large sum of unconditional grant and specific grants to them, although these sources of revenue do not meet all their expenditure needs. The Federal transfer has developed dependency feelings on the States. They expect the Federal Government to finance all their expenditure needs as much as possible.

(v) The States may believe that the existing tax burden is heavy enough<sup>173</sup> and raising tax rate may not be politically feasible. Rather they may opt for broadening their tax base than raising the tax rates.

(vi) The States may feel that reforming the archaic tax administration is of a priority issue. This assumes that once the States feel that they modernize their tax administration system, and make necessary capacity building measures, they may start tax games.

The *de-facto* uniform harmonization (same B, Di and t across states/LGs) has made the states to lose setting tax rate power, the basic instrument of tax autonomy. It has precluded the States from designing their tax policies to maximize their revenues, which contradicts with the intention of the Federal Constitution that perceives strong states.

The States attempt to attract investment into their jurisdiction not in the conventional way of cutting tax rate on mobile taxes such as PIT, CIT, VAT, but by differentiating urban land lease rates, agricultural income tax and by public expenditure competition and providing single window shopping service to investors.

### ***Land leasing and Agricultural income tax as instruments of inter-state competition***

The States have used land lease rate<sup>174</sup> variation as an instrument of inter-state competition to attract investment into own jurisdiction. Until 2012, the states used to offer urban and rural lands: (i) at nominal rate or for free by assessing the impact of the investment on the states social and economic developments, or (ii) on negotiation bases (between the government who supplies the land and investors), or (iii) on bid auction for

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173 Note that VAT for all sorts of transactions is 15%, BPT on Corporation is 30% while BPT on sole proprietorships is 35% of the taxable income.

174 Ethiopia had different forms of land ownership policy. During the Imperial regime, land property rights included communal lands, private, state, church and open land (no-man lands). During the Dergue regime, in line with the socialist economic principle, land became under the ownership of the entire people. The current regime has perpetuated similar land policy with the Dergue regime with minor modifications. Land administration is entirely State's function.



land lease.<sup>175</sup> Urban land lease rates widely vary not only across the States but also within a LG depending on infrastructure development (availability of utilities, transport net work, etc), grade category of an urban centre, and distance from economic centres. The States/ LGs use land lease as an effective means of inter-state competitions to attract investment by adopting differential land lease rate per square meter, lease duration by sector, grace period of land lease payment, and payment modality (say, small portion advance payment with pieces of instalment).

The inter-state competitions on urban and rural land lease rates have influenced, to some extent, the choice of investment location of both domestic and FDI. The land lease policy of Oromia could be an illustrative case. Land lease rate per M<sup>2</sup> is the highest in Addis Ababa City Government than in any other State for the comparative advantages it has (market size, relatively well developed infrastructure and availability of inputs to start a business, etc). One may not expect a wide difference in urban land lease rate between the suburb of Addis Ababa and its adjacent towns of the Special Zone of Addis Ababa Surrounding Oromia as they have similar infrastructural development, access to market and proximity factors. However, in the mid 2000s, minimum land lease rate at grade five of Addis Ababa (continuum to the Special Zone of Oromia), was 191.00 Birr per M<sup>2</sup>, while it was between Birr 5.85 to Birr 6.50 per M<sup>2</sup> at a short distance in the Oromia towns, showing 31 times lower than that of its adjacent Addis Ababa areas (Ethiopian Investment Agency, 2008). The Oromia state had also designed an attractive lease payment modality to attract investment. The significant cutting off land lease rate to the bottom has attracted Addis Arabian investors to choose Oromia (continuum to Addis) for manufacturing location rather than Addis.<sup>176</sup> Language difference is not found to be a constraint as Amharic, the working language of the Federal

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175 The highly decentralized land lease system has become one sources of rent-seeking, and has resulted in land garbing. Understanding the severity of the problem, the Federal Government issued a land leasing modality Regulation recently (2012) that prohibits offering land for free or on negotiation basis, but on bid only. Note that the regulation gives discretion to a Mayor , upon the consent of respective Council, to provide land on negotiation basis for huge private investments that are believed to bring significant impact on social and/or economic development to a ULG.

176 However, the highly decentralized land lease management was found among the main sources of rent seeking, and the first two alternatives have been ruled out since mid 2012.

Government, is well spoken in the Zone. The political choice of the Oromia state to offer land at low lease rate and the locational advantage have made the Surrounding of Addis a leading industrial zone. It also contributed to rank the Oromia State a second (next to Addis Ababa) investment destination in the country (MoFED, Macro Development Reports of 2007/8 to 2008/9).

The remaining States have also pursued the “beggar-thy-neighbour” strategy. They set low urban land lease rates, or negotiable fee and/or offering lands for free for investors who would like to invest on the states’ priority areas. The States of Amhara, SNNP and Tigray have managed to attract substantial ‘son-of-the-soil’ investors. However, the strategy has lured little domestic investors in the Emerging States. Many factors have contributed to this. First, the Emerging States have not yet built-up indigenous entrepreneurs, partly due to the marginalized economic policies they experienced in the previous regimes, and partly due to the clan-based social structure they have. The market size is very small and transportation cost is costly. Besides the economic variables, investors take into account various non-economic factors like rule of law and internal political stability in selecting investment location. These states have relatively low record in respecting rule of law and stability.

It should be stressed that the States’ cutting down land lease rates have less influence in swing capital from one State to another, except from Addis to Oromia. It has not pulled out an Amhara investor who resides in the State of Amhara to Tigray, or to SNNP or to Oromia, etc. The reverse is also true. My discussions with the top officials of States’ Investment Agencies revealed that almost 100 percent investments in Tigray have been made by Tigrians, and more than 90 percent investments in Amhara have been made by Amharas. The remaining balance has been made by non-Amharas who have lived for long periods of time in the urban centres of Amhara.

The roles of non-indigenous domestic investors and FDI are more pronounced in Oromia, SNNP, Gambela, Gambela and Benshangul-Gumuz for a couple of reasons: (i) for historical reason ‘non-indigenous’ or ‘settlers’ are dominant in number and have economic power in the relatively big urban centres, and (ii) the states have comparative

advantage on land and water resources, very critical components, to attract mechanized agriculture investment

The tax base of agricultural income tax is land size in hectare, not the income generated from the agricultural land. Agricultural income tax rate varies across the States, although it is not significant. In Oromia, Benshangule-Gumuz and Gambela, agricultural income taxes are progressively levied, while it is a fixed rate per hectare of land in Tigray and Harari. In Amhara agricultural income tax rate varies depending on the food secure status of a *Wereda*. That is, agricultural income tax per hectare of land in food in secured weredas ranges from Birr 5 to Birr 20, while in the food secured weredas range from Birr 10 to Birr 25. In the SNNP, agricultural income tax varies depending on whether the purpose of agricultural production is for market or for personal consumption. It is higher on cash crops such as '*chat*' and coffee production than crop productions for personal consumption, which range from Birr 5 to Birr 300 per hectare (HoF, 2007:20-21).

So far, the variations in agricultural income taxes across the states have insignificant influence to attract investment. Because availability of vast agricultural land, infrastructure, water supply, labour and rule of law are more critical to engage on mechanized agricultural investment.

### **7.5.3 Fiscal/budget competition**

Fiscal/Budget competition refers to mimicking of public expenditure spending policies and strategies on economic sectors of a jurisdiction in line to spending policy of neighbouring jurisdictions. The states use public expenditure competition as a strategy to attract investment into their jurisdiction. It takes in two ways: (i) by allocating large public fund on infrastructural development. Understanding investors are more interested in the availability of basic infrastructure stock, market size and trained labour to engage into a business, the States spend large public fund in physical and social infrastructural developments<sup>177</sup>; and,

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177 For example, when the State Council of Oromia decided to move its seat from Addis Ababa to Adama City in early 2000s, the Council allocated one billion Birr on intercity road, sewerage and pavement works with the objective to make the city a centre of conference tourism and business. The Council of SNNP, astonished by

(ii) By spending public fund on human development and institutional capacity building programs. The States invest on their civil servants and institutions through introducing new management systems to make the bureaucracy more efficient and customer-oriented. The states also attempt to attract investors providing a “single-window-shopping” service for investors.

These non-tax competitions are necessary and healthy; however, the nature of competitions crowds out public spending on education, health, rural roads, etc in favour of the private business service. For example, public spending on establishments of industrial Zones have taken the capital budget that would have been allocated to education, water supply, and road services and on other pro-poor public investments.

## **7.6 Financial Autonomy and Tax Sovereignty**

Financial resources play a make or a break role for fiscal federalism to work. Lack of resources was one of the causes for the failure of federal systems in many developing countries (Elazar; 1987:242). If States and LGs lack access to adequate revenue sources, they cannot adequately carry out the responsibilities they assumed. In a situation where competitive election for political power is weak, reliance on transfer undermines accountability.

The Federal Constitution allows the States to levy tax, set tax rates and tax administration on a range of revenue sources. But, what degree of financial autonomy and tax sovereignty do the States and LGs enjoy? To what extent is really in practice the Ethiopian tax assignment decentralized? In order to examine the extent of financial autonomy of the States and LGs, Ebel and Yilmaz (2002) and Meloche, et.al (2004) methods are used, while the Blochliger and King taxonomy of taxation power and the Dafflon tax sovereignty criteria are applied to investigate the degree of tax sovereignty of the States and LGs in Ethiopia.

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the success story of Adama, allocated Birr 750 million to improve intercity roads of Hawassa in mid 2000s. The Amhara state made similar investment in Bahir Dar. The States of Amhara, Oromia and the SNNP have also allocated public fund to build modern stadiums, and international standard conference Halls following suit the State of Tigray.

Before we examine the extent of financial autonomy of the States, it seems worth noting briefly how the tax revenue structure of Ethiopia looks like. The ratio of tax revenue to GDP in Ethiopia used to be among the lowest in developing countries, but it grew, from 7 percent in 1992/3 and 16 percent in 2012(MoFED data base). Since 1993/4, the indirect tax revenue (foreign trade related taxes and VAT) has dominated the national tax structure. In the 2009/10 budget, it constituted about 80 percent of the total national revenue (MoFED, data base).

The States have direct access to various revenue sources, except on import and export duties. Nevertheless, the States and weredas mobilized only 15.41 percent of the total national revenue in 2009/10 budget year. 64 percent of their revenue was generated from direct tax of which PIT and BPT constituted 32 percent and 9 percent respectively for the same year. Urban land lease contributed 6 percent while the share of agricultural income tax was only 4 percent of the SNGs' total revenue. The share of domestic indirect tax was 20 percent and the remaining balance was generated from non-revenue tax and municipality revenues<sup>178</sup>

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178 The share of municipal revenue to the States has to be interpreted with caution. While municipality revenue is completely decentralized to LGs, it is centralized at state level in Harari and Dire Dawa (because they are of two tiers of government-the statel and Kebele).

**Table 7.4. Revenue Structure 2009/10, in Million Birr**

SN	Revenue sources	Federal level		State level		State and Wired	
		% to total Federal revenue	In Birr	% to total state revenue	In Birr	% to total wereda revenue	In Birr
1	Direct Taxes	16.8	8801	62	1184	64	6105
1.1	Personal income tax	2.3	1220	20	393	32	3171
1.2	Rental income tax	0	0	1.6	31	1.5	142
1.3	Business income tax	0	0	10.3	198	8.8	844
1.4	Corporate income tax	12.2	6388	1.5	29	0.4	37
1.5	Capital Gains Tax	0	0	0.16	3	0.4	37
1.6	Agri. Income Tax	0	0	1.2	22	4.0	389
1.7	Royalty Payment	0	0	1.2	24	0.4	39
1.8	Withholding on imports	1.5	796	21.6	416 <sup>1</sup>	4.4	416
1.9	Tax on dividends and Chance winning	0.6	314		0.49		0.49
1.10	Interest income tax	0.2	83	0.16	3		3
1.11	Chat Tax	0	0	1.8	35	1.3	122
1.12	Rural Land use Fee	0	0	0.5	9	2.8	270
1.13	Urban Land Lease	0	0	1.2	23	6.3	606
2.	Indirect taxes	67	34862	23	440	20	1905
2.1	Indirect taxes(domestic)	17	8825	23	440	19	1903

2.1.1	VAT on goods	0.12	5166.1 *	0.18	388.86#	0.11	0.12
2.1.2	Excise Tax on Local Goods <sup>4</sup>					0.05	0.003
2.1.3	Turn over tax on goods			0.6	12	2.7	254
2.1.4	Service VAT/ TOT	7	3503	1.2	25	2.4	226
2.1.5	Stamp sales	0.3	156	0.7	14	1.6	157
2.2	Indirect taxes on Import	50	26037				
2.2.1	Custom duties	11	5852				
2.2.2	VTA/excise taxes	16	8352				
2.2.3	Other imports	23	11833				
	Total tax revenue	83.8	43663	85	1624	84	8010
3	Non-Tax Revenues	17	8719	0.024	47	7.0	663
3.1	Charges & Fee	0.1	311	0.024	47	1.8	178
3.2	Other non-tax reve <sup>5</sup>	16	8408	0	0	5.1	485
3.3	Municipality Revenue			0.13	250 <sup>6</sup>	9.0	872
	Total Revenue	100	52382	100	1921	100	9545

Source: MoFED, 2010 FY data base Ethiopia Federal and Regional Governments Revenue performance. [www.mofed.gov.et](http://www.mofed.gov.et)

<sup>1</sup>Weredas do not have taxation power but they collect taxes on delegation base. <sup>2</sup> did not include withholding tax and VAT which were transferred to the States from the FC&RA. 2% withholding tax is imposed on goods when purchasing takes place but 3% is imposed on imported goods. <sup>3</sup> Includes VAT and excise tax. <sup>4</sup> Includes excise tax on petroleum, alcohol & tobacco <sup>5</sup> Includes sales of goods, residual surplus, reimbursement and property, miscellaneous revenues; <sup>6</sup> Municipality revenues are mobilized at state level in Harari and in Dire Dawa as they are two tiers government.

### 7.6.1 Financial autonomy of the States and LGs

This section investigates the financial autonomy of sub national governments in Ethiopia using the Ebel and Yilmaz (2002) and Meloche, et.al (2004) methods.

**Table 7.5. Financial autonomy of States and LG, 2009/10, in million Birr**

	Tax and non-tax revenue	States	LGS	Total SGN	Share to total revenue of	
					State	LGs
1	2	3	4	5	6	7
1.0	Own-revenue	8,380	1238	9,618	23.7	25.9
1.1	tax revenue+	8,010	-	8,008	22.7	-
1.2	Non-tax revenue++	297	1,238	1,535	0.8	25.9
1.3	Concurrent taxation <sup>+++</sup>	73		73	0.2	
2.0	Federal Unconditional Grant <sup>1</sup>	20,934		2094	59.1	
3.0	Wereda block grant <sup>2</sup>		3,424	3,424		71.6
4.0	Tax sharing <sup>3</sup>	306	121	427	0.9	2.5
5.0	Specific purpose grant <sup>4</sup>	5,774		5,774	16.3	
6.0	Total revenue	35,394	4,783	4017	100.	100
7.0	Total Federal Government revenue(FR)				44, 029	
8.0	Financial Autonomy					
	Ebel and Yimaz method	Financial autonomy (FA)= $OR_{SNG}/TR_{SNG}= 30,552/40,177$				76
	Meloche,et.al method	Revenue autonomy(RA)= $OR_{SNG}/TR_{SNG}= 30,552/40,177$				76
		Own revenue Ratio= $OR_{SNG}/TR_{SNG+FR}=30,553/(40,177+44,029)=$				36.3
		Dependent Revenue ratio (DRR)= $IGT/TR_{SNG}+TR_{FR}=27,135/(40,177+44,029)=$				32.2

**Sources:** + and ++ are derived from Table 7.6 above. Note ++ includes municipality revenues.



+++ Federal Revenue and Custom Agency;

<sup>1</sup> Federal Government, 2010 budget proclamation

<sup>2</sup> MoFED data base. Note that *Wereda* block grant is State transfer to LGs. The States allocated Birr 11,048.9 million as *Wereda* block grant, however, since it was off-set from total LG revenue collections, in effect, the size of *Wereda* block grant was 11,048.9 million minus 7,623.9 = 3,424 million Birr. Note also the grant did not include *Wereda* capital expenditures.

<sup>3</sup> Office of Road Fund, MoARD,

<sup>4</sup> The figure is not complete. It includes only Agricultural Marketing Improvement program (2009/10), Birr 13.9 million, Productive safety net Program Birr 5 billion; Sustainable land management, Birr 102 million (2009/10), MoH, UNICEF, (2008/09) Birr 2.6 million; Rural Capacity Building Project, (2009/10) Birr 293.2 million and Public service capacity building program (2009/10) Birr 64.3 million, Italian cooperation to ESDP Birr 14 million, (2002 EFY), Italian Cooperation to HSDP Birr 113 million (2002 EFY), Pastoral Community development program (PCDP) Birr 153 million. In order to avoid double accounting, the grant is treated under state column.

Notes: 1. The Federal Government transfers specific purpose grants to the States through its Line Ministries. The States again transfer it to the eligible LGs after they take about 10 percent of the total project cost for themselves as project administration cost.

2. Amounts of Specific purpose Federal grants are deflated for lack of data. Thus all Federal Government transfers to the States through Line Ministries are not included.

Column 2 on Table 7.6 above identifies various revenue sources of sub national governments ranked in descending order according to the policy control they enjoy. Columns 3 to 7 show States' and LGs' revenue size both in absolute figures and in percent. The revenue share of States and LGs are disaggregated in column 6 and 7 depicting the share of each revenue sources to the total state/LG revenue. Row 8 depicts the extent of financial autonomy of the States and LGs.

According to the Ebel and Yilmaz financial autonomy (FA) and Meloche, et.al, revenue autonomy (RA) methods, in 2009/10, the States and LGs in Ethiopia had policy control over 76 cents on every Birr collected in setting budget allocation between recurrent and capital

budget as well as among various sectors<sup>179</sup>. True, the considerations of unconditional grant as own revenue source of the States/ LG raised the degree of financial autonomy of the States/LGs. Had we considered only row [1.0] of Table 7.6above, the degree of financial autonomy would have been reduced to 23.7 percent. This undermines the States' spending discretion on the Federal unconditional grant which constituted 59.1 percent of the total revenue of the States.

Concurrent taxation power is designed to empower the States with various elastic tax bases, however, so far, its contribution to the States' total revenue is very small (2 percent) partly because secondary and tertiary economic sectors (manufacturing and services) are not well developed and partly the existing medium and large scale manufacturing and national corporations (power supply, Air Lines, Shipping Lines, Ethio-telecom, Banking and Insurance, sugar plantations, and Hotels, National Metal Corporation, etc) are still owned by the Federal Government.<sup>180</sup> In addition, the allocation of the concurrent revenues between the Federal Government and the States favours the former (see Table 7.2). Tax evasion is another serious problem not to tap the potential of concurrent revenue. This is highly associated with weak tax administration and corruption.<sup>181</sup>

FA/ RA and DRR are inversely related. Higher FA /RA rate means lower DRR. The reverse is also true. The rates of FA/RA and DDR for 2009/10 in the above Table should be interpreted with caution, however. The DRR (32.2 percent) is understated and did not reflect the reality, because all specific conditional grants channelled through the Line Ministries were not considered due to lack of aggregated data.

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<sup>179</sup> Note that SNG's financial control included unconditional federal transfer.

<sup>180</sup> The share of concurrent taxation receipt to the States revenue will raise up with the expansion of private sector and the ongoing privatization program

<sup>181</sup> According to the Addis Fortune (2011), total Birr 397.9 million (equivalent to USD22 million) tax evasion was reported from OILIBYA over Birr210 million on dividend tax and capital gain tax, Total Ethiopia Birr 23.3 million on VAT, withholding tax, and profit tax; National oil Company Birr2.6 million on profit tax and VAT; BGI-Ethiopia Birr 109 million, and Bambis Super Market 53 million on VAT and BBPT.

## **7.6.2 Tax Autonomy of the Ethiopian States/LGs**

This sub section assesses the degree of tax autonomy of the States and LGs from OECD and Dafflon's perspectives with the objective to draw public policy lessons that might parallel the realities of the Ethiopian fiscal federalism from the comparative analysis of the OECD and the Swiss experience.

### **Tax Autonomy from OECD Perspective**

As discussed in the previous chapter, the OECD tax autonomy categorizes SNG's revenue sources into three:(i) own-revenue (tax revenues and non-taxes) where SNGs have full control over tax rate and/or tax base and tax administration;(ii) shared tax, where the central government determines the tax base, but SNGs impose tax rate only, and (iii) tax sharing, where the SNGs may have influence on the revenue split of the central grant.

Table 7.7 below measures the degree of tax autonomy of the Ethiopian SNGs from OECD's perspective. The first row depicts the taxonomy categories as defined by Blöchliger and King (2006). The cells were filled out taking in to account Article 98 of the Federal Constitution, the Federal Financial Administration Proclamation No.57/1996 and related States' tax proclamations. The States have constitutional power to levy tax which includes defining tax base, setting tax rate and collect taxes on all revenue sources that fall in their domain. But through the Federal Financial Administration Proclamation No.57/1996, the states are compelled to harmonize and standardize their tax base including  $D_i$  with the Federal tax bases. Thus, own-revenue of the states would fall under (a2).In spite of the fact that the States have access to wide range of revenue sources, own-revenue constituted only 23.5 percent of the States' total revenue.

**Table 7.6. Tax autonomy of States and LGs from OECD perspective, 2009/10 in million Birr**

	a1	a2	b1	b2	C1	C2	C3	D				e	f	Total SNGs revenue
								d1	d2	d3	d4			
stat		8307 (23.5%)							306 (0.9%)				26,781 <sup>1</sup> (75.6%)	35,394
LGs				622 <sup>2</sup> (13 %)					121 (2.5%)			616 <sup>3</sup> (12.8%)	3,428 <sup>4</sup> (71.7%)	4,787

Source: own computation from MoFED consolidated revenue performance data base, 2009/10

<sup>1</sup>includes Unconditional federal subsidy to the States (Birr 20,934 million), concurrent revenue (Birr73 million) and total specific purpose grants (Birr 5774 million)

<sup>2</sup>Municipality revenues (Birr 622 million)

<sup>3</sup> Non-tax revenue of LG minus municipality revenue (Birr 1238-622= 616million)

<sup>4</sup> Sum of *Wired* block grant (Birr3.428billion).

Note figures are rounded to the nearest whole number

The States have not devolved taxation power to respective LGs but municipality revenues by setting the minimum and maximum user charge fee (b2) which contributed 13 percent of the total ULGs revenue for 2009/10 budget year.

The Road Fund is the only revenue sources of the States and the LGs that meets the tax sharing definition of Blöchliger and King (2006). The Road fund is generated from fuel tax, annual vehicle license renewal, fee based on axle weight and configuration, over-loading fine, and municipality tax on fuel oils and lubricants, Federal Government budget and any other road traffic levied, as may be necessary, (Federal Proclamation No.66/1997). It is the Federal Government that sets the tax rate/ fees of the sources of Road Fund. Tax administration of the fund is centralized but the States collect some proceeds on delegation basis. The Ethiopian Petroleum enterprise, a Federal agency, collects fuel levies on oil and lubricants). Annual vehicle license renewal fees are collected by Federal and State agencies. Bureaus of Transport (state organs) collect fees from respective State plated motorized vehicles, whereas the Ministry of Transport collects fees from Federal plated vehicles and on overloading fine.

All the States and eligible LGs receive a certain percentage of revenue from the Road Fund proceeds on formula basis. The transfers are earmarked for road maintenance and road safety only. Currently the Road Fund has been distributed on 70:20:10 ratios among the Federal Road Authority, State Road Authority and ULGs respectively. Decisions about how much to allocate for distributive pool each year and how the pool should be distributed among the Federal, the States and LGs are decided by the Road Fund Board, where the States have five representatives out of fifteen<sup>182</sup>. Therefore, the States do influence the split of the Road Fund among the eligible Agencies. The Road Fund contributed only 0.9 percent and 2.5 percent to the total revenue of the States and LGs respectively in the 2009/10 fiscal year (d2).

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182 Management of the Road Fund is structured in a way to promote a Public–Private partnership, as the Board is composed of six Federal appointees, five State representatives on rotation base and four Private transport sector representatives.

The OECD tax autonomy approach fits less to assess the tax autonomy of the Ethiopian states, because it does not recognize the concurrent taxation power, which is an emerging revenue source of the States and the unconditional transfers and the specific purpose conditional grants, which are major revenue sources of the States. According to the OECD taxonomy, all these three revenue sources have to be treated under (f) category. Putting the concurrent revenue sources and the unconditional grants under (f) does not reflect the reality of tax powers of the states and LGs, because (i) treating the concurrent revenue under (f) category underestimates the States' tax autonomy. The States have as equal tax legislative power to determine tax base, set tax rate over the concurrent revenue sources as the Federal Government. This makes the concurrent taxation power superior to the shared tax arrangement as the latter limits SNGs to impose tax rate only, (ii) putting the unconditional Federal transfers under category (f) also conceals the States' role in designing the federal subsidy (unconditional grant) through the HoF. It also undermines their discretion over the spending of the unconditional transfers.

Article 100(3) of the Federal Constitution also grants the states to levy on Federal Government profit making enterprises, which is related to the shared tax assignment.

Despite the fact that the States have access to various revenue sources, as indicated above, the States' own revenue constituted only 23.5 percent of their total revenue in the 2009/10 budget year, a far lower than the 35 percent states' own-revenue of Indian, (Bhattacharya, 2001:269), presumed a centralized federation, or even slightly less than the 25.9 percent of the Spanish Autonomous Regions' own-revenue collection of the total revenue (Castella, 2001:91), which is a unitary decentralized system. This may pose a question: Do the shares of own-revenue to the total Indian States or the Spanish Autonomous Regions alone testify higher tax autonomy than the Ethiopian states? Judging the states' tax autonomy from their share of own-revenue to total revenue source without examining their constitutional taxation power may mislead the reality. It is true that low level of own-revenue implies high level of States' dependency on Federal Government transfers but does not necessarily mean low degree of tax autonomy. Constitutionally

speaking, the Ethiopian states have more taxation power than the Indian counterpart states and the Spanish Autonomous Regions.

### **Tax autonomy of Weredas**

The States have retained all taxation powers except municipality revenues. ULGs may manoeuvre municipal revenues within the lower and upper limit rates determined by the State (b2). Legally speaking, the State of Tigray is the only State that has defined taxation powers of Weredas, even though it has not been implemented. The State of Amhara has introduced a revenue sharing arrangement between the State and Weredas (Amhara, Regulation No.37/2005). Again, the Regulation has not been put into effect as the State has not so far determined what revenue sources to be shared. Therefore, in effect, weredas do not have any tax powers, but the States have delegated the weredas to assess and collect some revenue sources, while deductions and tax rates are defined at states level (e).

Degree of tax delegation to the Weredas varies by State. The States of Tigray, Amhara, the SNNP, Gambela and Benshangul-Gumuz have delegated the collection of all revenue sources to respective weredas except PIT on State civil servants and on employees of enterprises owned by the State, BPT on enterprises owned by the State, rental incomes derived from housing and other properties owned by the State, and user charges for services provided by the State.

The State of Oromia has delegated less revenue sources collection to its LGs on the pretext of LGs do not have managerial and institutional capacities to collect taxes. In addition to the above mentioned ownership based revenue sources, Oromia retains royalty payments, and TOT revenue sources at the State level. The same is true in Afar and Somali.

Unlike the other states, Harari and the Dire Dawa Council Administration have not delegated any tax administration to Kebele, the lowest level of government. The explanations for such tax centralization are: (i) delegation of tax assessment and collection to respective Kebeles would increase administration cost as the Kebele Administrations are too small to yield benefits from economies of scale, and (ii) Kebele administrations do not have managerial capacity to carry out the tasks.

Until 2010, the City Government of Addis Ababa used to delegate all its revenue sources to the *Weredas* but PIT on civil servants of the City Council and employees of Agencies owned by the City Government. But with the merging of the Addis Ababa Revenue Authority and the FR&CA, *Weredas* are left only with collection of rental income tax and municipality related revenues.

Weredas collect taxes and non-tax revenues on behalf of the States and deposit the proceeds into their own accounts. They do not need to transfer to the States' treasury but the revenues are off-set from the States' block grant on monthly basis (f). It might be worth noting how off-setting mechanism operates at Wereda level. The Bureaus of Finance and Economic Development (BoFED), States agencies, send revenue collection target to respective Weredas based on the states GDP growth rate plan. The revenue targets are often higher than the Weredas' Office of Finance and Economic Development Office (OFED) because the former perceives that the latter look at the State to finance their expenditure needs without exhaustively exploiting their revenue potentials. Though, there is some room for negotiation in setting Wereda revenue collection plan between the BoMED and the OFED, the voice of the former prevails in case they do not reach a consensus on the size of the revenue collection target. Local Councils approve annual revenue target 'suggested' by respective BoFED as well as the size of recurrent and capital expenditure budget. Finally, the approved revenue plan of the wereda is off-set from the Wereda block grant. In many weredas performance of revenue plan is by far less than expenditure plan and therefore the difference is covered through block grant. A few fiscally strong LGs may collect revenues more than their expenditure needs. In such a case the weredas are supposed to transfer the surplus revenue to the States. They do not use for themselves.

### **From Swiss tax sovereignty perspective**

This subsection assesses tax sovereignty of States and LGs in Ethiopia from Dafflon's perspective.



**Table 7.7. Tax sovereignty of Ethiopian States and LGs**

<b>Tax sovereignty criteria</b>	<b>Taxation power of the States</b>	<b>Taxation power of Local Governments</b>
[a] The use of the ability-to-pay principle (taxes) versus benefit principle (user charges);	The States have constitutional right to exercise tax powers on all 'ability -to-pay' type taxes and on benefit principle (user-charges) assigned to them (Federal Constitution, art.97).	LGs have no taxation power to levy tax, but ULG determine user charges within the lower and uppers limits of respective state.
[b] The object of taxation, implicit in [B-D] in the formula	The Federal Constitution grants the States to levy taxes which imply determining B and Di. The Federal Financial regulation , however, notes that the States need to ensure the harmonization and standardization of their tax bases with the Federal Government tax base (Federal Proclamation No.57/1996)	LG do not have any power to deal with B, and Di. They have to compel with respective states' tax system.
[c]The circle of tax payers (including the definition of the taxpaying unit	States have power to determine the circle of tax payers.	LGs adopt respective state definitions of taxpaying units. [c] Cannot be in the hands of the LGs.
[d] computation of the tax bases, and the adjustments to taxable income, specific deductions and exemptions	The States apply Federal Government definitions of B and Di with the objective to harmonize the tax system, but there is variation in rental income deductive between Addis Ababa and the remaining States.	They respect respective State's tax laws.
[e] The tax rate schedules [t] including the amount of deductions and exemptions in the	The States have constitutional power to set tax rate (Federal Constitution, Art.97). But the states apply federal tax rate, with the exception of agricultural income tax.	LGs do not have power to set tax rate, but determine user charges within the ranges set by respective State.

Tax sovereignty criteria	Taxation power of the States	Taxation power of Local Governments
previous letter [D <sub>i</sub> ]		
[f] The annual coefficient of taxation [K]	'K' is may imply Article 100(3) of the Federal Constitution that grants the states to levy on Federal Government profit making enterprises, although it is not in practice. State Councils also give liberty to the Executive branch to quest for various off-budget revenue sources. (mobilize revenues from NGOs, and voluntarily contributions from residents)	"K" is not applicable. Alternatively, LGs organize various fund raising schemes such as Development fund (contribution from residents), donations etc as a-filling-gap mechanism of budget deficit.
[g] Collecting the taxes	The States collect taxes and user charges on all revenue sources reserved to them.	LGs collect municipality revenues. They also collect State taxes and user charges on delegation basis.
[h] The procedure in case of tax disputes	When conflicts arise on taxation power between the Federal Government and the States, the case will be referred to the Constitutional Inquiry Commission of the HoF for interpretation. If the House decides it does not need constitutional interpretation, any competent court may give decision.	If tax disputes arise between the State and respective LGs, decision of the former prevails, because the States can retake the tax power any time.

Source: First column Dafflon, 2007:146, the rest author

Constitutionally speaking, the Ethiopian States have power on [a], to [g] criteria. Criterion [h] is conditional. Therefore, taking the *de jure*, the Ethiopian States enjoy somewhat full tax sovereignty.

There is a wide gap between the *de facto* and the *de jure*, however. Criterion [b] has been taken by the Federal Government as the States need to ensure the harmonization and standardization of their tax bases

with the Federal Government tax bases (Federal Proclamation No.57/1996 and Council of Ministers Regulation No.17/1997)<sup>183</sup>. Specific deductions ( $D_i$ ) are also required to be harmonized and standardized. The rationale for the uniformity of tax base and  $D_i$  is to avoid vertical and horizontal fiscal externalities. The States have liberty to decide  $D_i$ , and the amount of  $D_i$  for tax bases which are not common to the Federal Government taxation power. Criterion [e] is uniformly applied. PIT brackets and deductions on all revenue sources are uniform across the states except agricultural income and cattle tax.

In spite of the fact that the Federal Constitution enshrines the States considerable tax powers, in practice the States do not fully exercise their taxation powers; rather they systematically align their taxation choices on the rule of Federal Government. They apply uniform tax base, deductions and tax rate. Therefore, by *de jure* the states can be categorized among the states/cantons of federations that enjoy high level of tax autonomy, but by *de facto*, they have little tax autonomy and have reduced to tax administration only.

Federal decision makers favour tax harmonization. The argument is to provide comparable basic public services at comparable tax effort. True, high level of tax autonomy and achieving politically acceptable horizontal parity do not go in parallel. On the one hand, tax autonomy is desirable to promote economic efficiency, fiscal accountability and budget discipline. It is also an instrument to link the cost of public services with benefits. On the other, high level of tax autonomy may distort efficient allocation of resource, exacerbate horizontal disparity and may undermine long-term macroeconomic management stabilization role of the Federal government. Therefore, choosing the “right” degree of tax autonomy is a political choice. Above all, setting minimum and maximum tax rate could be the best choice to address the fear of horizontal tax competition.

As far as the LG is concerned, legally speaking, two regimes exist. Theoretically, LGs in Tigray meet criteria ‘a’ ‘c’, ‘e’ and ‘g’ which place them at partial tax sovereignty position. LGs in the remaining States also

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<sup>183</sup> Although it is debatable if this Proclamation is a binding law upon the States, as it has no constitutional base.

meet 'a' and 'g' but limited to municipality revenues. In practice, no State has yet devolved tax power to the LGs. Instead, they have delegated tax administration power to respective LGs, which designates the LGs what Dafflon (2007:146) calls compulsory taxation.

### ***Creeping to Centralization of Taxation Power?***

There is no clause in the Federal Constitution that provides upward delegation of taxation power. Federal Constitutional Assembly Meeting Minute, (1994) reveal a purposeful choice against upward taxation power delegation, with the intention to restrain any recentralization of taxation power tendency that may arise from the Federal Government. Reassignment of any revenue source should be implemented in line with Articles 104 and 105 of the Federal Constitution. However, in addition to the desire to apply uniform tax B, Di and tax rate across the states, discussed above, there are couples of unconstitutional centralization trends.

(I) ***Centralization of 'Chat' excise tax.*** According to the Federal Constitution, Art.97, levying and collecting excise tax on individual trading falls on the States' taxation power. Contrary to this Constitutional provision, the Federal Government has taken away the '*chat*' excise taxation power. It determines excise tax rate (Birr 5 per Kg) on '*chat*', decides the checking points of '*chat*' and collects the revenue. As far as the distribution of *chat* revenue is concerned, the Federal Government transfers to the concerned state on monthly basis (Federal Proclamation No.767/2012).

#### **(II) *Value Added Tax***

Legally speaking, all State's sales tax competences which are replaced by VAT should remain states' VAT taxation power. The practice is quite different, however. The Federal VAT Proclamation No.285/2002 has granted the power to assess and collect VAT on individual tradesmen and states' public enterprises to the Federal Inland Revenue Authority and Federal Custom Authority<sup>184</sup>, without any Constitutional amendment in line with Art.104 and 105 of the Federal Constitution.

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<sup>184</sup> Latter the Internal Revenue Authority and Federal Custom Authority amalgamated to form the current Federal Revenue and Custom Authority.

(iii) Addis Ababa City Government had been granted equal tax powers like the States with the exception of the concurrent taxation power<sup>185</sup>. The City Government had legislative tax power to levy tax, to invent new taxes, to assess and collect taxes, and to remit and write-off tax<sup>186</sup> (see the Federal Proclamation No.361/2003). However, the Addis Ababa City Government taxation powers on PIT, BPT, VAT, and excise tax have implicitly ceased to exist, as all its legislative and tax administration powers have been taken by the Federal Revenue and Custom Authority (FR&CA)<sup>187</sup> with the objective “to establish strong, equitable, coordinated and efficient tax administration system” (Memorandum of Understanding (MoU), 2010). As a result, the City’s tax responsibilities have been reduced to conduct research on how to increase revenues and revenue projections of the City together with the FR&CA and to limit taxation power to user charges and rental income (see the MoU, 20110).

One might argue that the City has lost nothing since in practice the City Government has to harmonize its tax rate with the Federal Government and what has happened is simply merging of the tax management with that of the Federal Government. But the impact of centralizing is beyond that. According to my discussion with the high level heads of the FR&CA, the initiative to merge tax administration came from the Federal Government, not from below, and there is an intention to gradually scale up the practice across the country. Such centralization of tax adversely affects the tax autonomy of the City Government and weakens responsiveness of politicians to local preferences. The merging has made the performance of socio-economic development plans of the

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185 Unlike the States, Addis Ababa City Government does not have concurrent taxation power. The reason is to avoid fiscal asymmetry as lion’s share of revenue sources are concentrated in the City.

186 For instance, Addis Ababa City Administration has introduced a five percent greening tax (environmental tax) on tap water consumption.

187 The Revenue Authority of the City Government entered into agreement with the Federal Revenue Agency and Custom to merge the former to the latter. According to the agreement, the City Government shall entirely cover all costs related to tax administration incurred by the FR&CA, while the latter deposits all collections into the bank accounts of the City on daily basis. The Agreement neither explicitly refer to the size of annual collection target nor indicate what percent of the revenue collection shall be paid to the FR&CA as cost of tax management. The Agreement has become effective as of 10th January 2011

City to depend on the performance of revenue collection of the FR&CA. The problem will be of grave concern when two feuding political parties share power through election, say, one party at the City Government level and the other at the Federal level.<sup>188</sup> A political party which controls the Federal seat may systematically collect revenue below its capacity with the intention to undermine the deliverability capacity of its rival political party. When all legislative tax powers are fallen in the hands of political rival party, how can a winner party in the City Council manoeuvre tax rate or invent new tax source to finance its ambitious socioeconomic development plans that enables it to win another election?

Keeping the administration of mobile tax bases at the centre is advisable as it reduces tax administration cost, contributes to avoid tax evasion and enhances enforcement of tax law. There is no testimony that justifies the centralization of the *chat* excise tax and VAT to meet the criteria, however.

## 7.7 Conclusion

The prescription of FGTFE has little influence on the separation of taxation power between the Federal Government and the States as well as between the State of Tigris and respective LGs, because in addition to economic variables, tax separation in Ethiopia considers non-economic choices.

The taxation power is separated between the Federal, the states and concurrent. The principles applied in separating tax assignment between the Federal Government and the States is not on the basis of tax bases as what we see it in other decentralized system. The Federal Government and the States can levy independently on the same tax base. Taking a PIT as an example, the states have taxation power to levy PIT on state-owned enterprise, state employees on ownership principle, and on employs of sole proprietorship on type of business organization and on employees of private companies on origin principle. The tax separation is unstable as a shift of ownership and a change in the form of

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188 In 2005, Coalition for Unity and Democracy (CUD), a feud with the ruling party (EPRDF) had won the City Council of Addis Ababa. However, CUD failed to take over the City Administration because the Members of the Coalition entered into conspiracy over power struggle, which shortly all had fallen apart.

business organization (sole proprietorship vs. PLC or Sh.Co) cause changes in taxation power. Principles of domiciliation, benefit-received, administrative convenience and international trade are applied in the separation of taxation powers between the Federal governments and the States.

The States have access to various revenue sources including elastic bases like business profit tax, VAT, excise tax, and natural resource revenues. The logical reasoning is to commensurate States' expenditure assignment with taxation power as the huge economic, social and political responsibilities of the States cannot be met with devolving only the benefit-related taxes and property tax.

Constitutionally speaking, the states have power to determine the tax base, set tax rate and administer on their tax domains. They have also legislative power to jointly determine on the concurrent revenue sources. The separation of taxation power is designed in a way to ensure high level of tax autonomy of the states. In practice, however, tax base, deductions, and tax rates are uniform. The states' tax powers are reduced to tax administration.





Federal Government controlled, on average, 80percent of the total national revenues (see Appendix 5.1). Wide horizontal fiscal disparities are also visible. Asymmetric distribution of economic bases and wide cost differential for providing public services among the states are among the major reasons. Since the states cannot finance simultaneously their backlog development and the emerging expenditure needs from their own revenue sources, and minimum national standard of public services delivery are fixed at the national level, federal transfers are major revenue sources of the states. Without the IGT system, the State/LGs cannot properly carryout their assignment responsibilities. Nevertheless, designing of the Federal transfers and their distribution across the States are among the central policy issues and are public debates in Ethiopia and will continue to be so in the future as long as the States remain heavily dependent on the Federal transfers.

This chapter assesses the practice of IGT system in Ethiopia. The Chapter comprises four sections. The first section discusses the legal framework, principles and objectives of the IGT. The second section describes the four components of IGT system: the unconditional, conditional, road fund and wereda block grant. It also attempts to examine the implications of the IGTs on equity, efficiency, accountability, incentive, and predictability. Section three reviews and assesses the new fiscal equalization system which was introduced in 2007/8 and revised in 2009. The last section identifies some limitations of the fiscal-gap equalization systems.

## **8.1 Legal Ground, Principles and Rationale of Intergovernmental Transfers**

### **8.1.1 Legal framework of transfers**

The legal ground and principles of intergovernmental transfer system emanate from the Federal Constitution. The following provisions of the Constitution explicitly or implicitly refer to Federal transfers.

Art.62 (7) notes, “It [The House of Federation] shall determine ....the subsidies that the Federal Government may provide to the States”.<sup>190</sup>

Art.89 (4) stipulates, “Government shall provide special assistance to Nations, Nationalities, and Peoples least advantaged in economic and social development,”

Art.94 (2) reads, “The Federal Government may grant the States emergency, rehabilitation, and development assistance and loans, due care being taken that such assistance and loans do not hinder the proportionate development of States”

Article 62(7) refers to vertical transfers. But it is vague whether the “subsidies” refer to unconditional grant only or include also conditional grants. In practice, the HoF determines the distribution of unconditional grant formula only, while conditional grants are transferred to the States via line Ministries on ad-hoc basis.

Art. 89(4) implies equalization grant in favour of the disadvantaged Nations, Nationalities and People (NNP). By reading the Article, one can infer that the grant aims at equalizing NNP, not jurisdictions<sup>191</sup>, with the objective to rectify the unfair economic and social relations they experienced over the last century. The grant has also conditional nature since it aims at offering special assistance to disadvantaged NNP.

Art. 94 (2) refers to the Federal short-term grants and long-term development loans. But it raises the question of definition, perimeter and extent of the federal aid in case of “emergency, rehabilitation and development”. Emergency is short time aid. Rehabilitation may imply that there has been some form of environmental damage due over

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190 In many legal documents and financial reports, the term ‘Federal subsidy’ is often used. In this study, Federal subsidy, budget subsidy, and unconditional grant/transfer are interchangeably used.

191 Art. 89(4) does not direct to individuals or jurisdictions but to NNP. When the disadvantaged NNP coincides with territorial demarcation of the States/Zone/Special *Wereda* Governments, then double achievements will be met.

population density, and/or vulnerability to drought or social and economic damages because of civil war and, therefore, they should be corrected per definition. Rehabilitation grants may not necessarily be “financial assistance”, but they must restore a previous acceptable situation. Development is a long term and structural. Thus there is quite a large array in this Article of the Constitution.

### **8.1.2 Rationales for intergovernmental transfers**

In a decentralized system, intergovernmental transfers are designed to meet various national objectives which include to attain minimum national standard of public services delivery, to close vertical fiscal gap, to reduce horizontal fiscal disparities, and to address inter-jurisdictional externality effects (Shah, 2007a:28-31; Boadway, 2007:57-62). In addition to these economic objectives, governments also use transfers to maximize political benefits (Grassman, 1994, Sorenson, 2003).

Official documents and reports of the MoFED (2003) and HoF (2007) disclose that the objectives of the intergovernmental fiscal transfer system in Ethiopia aim at attaining the following objectives.

#### **Achieving minimum national standard of Public Services delivery**

There is no document that explicitly identifies list of minimum national standard public service delivery. In such situation, Art.90 (1) of the Federal Constitution may be invoked, which notes, *“To the extent the country’s resources permit, policies shall aim to provide all Ethiopians access to public health and education, clean water, housing, food, and social security.”* The various sector development program (SDP) documents, which have been designed in line with the Millennium Development Goal (MDG) objectives and targets, may partly support the argument. The policy documents of the sector development programs describe the minimum level of quantities and qualities of public services that have to be provided at national level. For example,

❖ The education sector development program document stipulates access to universal primary education (grade 1-8) within 4 km walking distance, at most 50 pupils in a standard class room, teaching in a self contained modality for First cycle primary education (grade 1-4), one text book per subject for each pupil, and a certificate (12+1) holder for the First cycle primary school, a diploma holder in education for grade 5-8, and a degree holder for secondary school (grade 9-12) as minimum qualifications of instructors; etc....

❖ Access to clean drinkable water is defined as delivering 30 litres of drinkable water per day/person within 500 meter distance for urban areas and 15 litres of drinkable water daily within 1.5 kames walking distance in rural areas from his/her place of residence (Mowed, 2008).

❖ The health Sector Development program defines Minimum national standard health as ensuring access to (i) a Health Post service at Keble level to serve 5,000 residents staffed by two health extension workers, (ii) Health Centres at Wired Government level to serve as a referral centre for 5 Health Posts or for 25,000 residents, directed by a Nurse or a Health Officer, composing 5 mid-wineries, two environmental Health Officers, a laboratory technician, and a Druggist; (iii) Zonal hospital service for about half a million residents, and (iv) a referral hospital at state level (MoH, 2005 and HoH, 2008)

❖ Universal rural road access implies ensuring accessibility to all weather road coverage of 45.7 km per 1000 Km<sup>2</sup> by 2015 (HoF, 2009:33)

The qualities and quantities of the minimum national standard of public services are not static, but dynamic. They are expected to be improved with the economic growth of the country. The setting of minimum national standard basket of public service is based on the principle of:

*“Every Ethiopian national has the right to equal access to publicly funded social services”* (Federal Constitution, 1995, Art. 41(3).

At the outset of the federation, there was a wide horizontal disparity in terms of access to public services among the States, partly because the distribution of public services were concentrated in a few urban centres,

and partly because the States' fiscal capacity was too weak to finance the backlog development needs as well as to meet emerging social and economic development needs from own revenue. The strong commitment of all levels of government to the success of the sector development programs, the dedication of the Federal Government to allocate considerable transfers in unconditional and conditional forms (since minimum standard requirements are fixed at national level) have exhibited a visible convergence in access to the minimum standard public services across the States.

### **Bridging the Vertical Fiscal Gap (VFG)**

VFG refers to revenue deficiency of SNG arises mainly due to mismatching of assignment of responsibilities and tax assignment to SNGs, and wasteful horizontal tax competition (Shah, 2007b:17). Therefore, VFG can be addressed either by reassignment of responsibilities or devolving commensurable taxation powers or designing appropriate transfer system or checking/avoiding unnecessary tax competitions among states/LGs.

VFG indicator ranges from zero to one. A VFG closer to zero means States/LGs finance large part of their expenditure needs from own revenue sources and/or shared tax, while a VFG approach to one means there is a wide mismatch between the revenue means and expenditure needs of SNGs. What degree of VFG is desirable is a matter of fiscal constitution of a specific country. That is, it is a political choice whether to devolve more responsibilities to SNGs by retaining lucrative tax bases and filling the gap through designing various forms of transfers, or devolving assignment of responsibilities with commensurable taxation powers (Boadway and Shah, 2009:341). If politicians in states and LGs are to be accountable for their own expenditure decisions, large part of the devolved functions and powers should be financed through own-revenue sources. Delegated functions should be also financed by the delegating unit. A fiscal constitution may make trading-off between enjoying a higher level of decision-making power and achieving politically desirable horizontal equity. High degree of VFG is associated with less horizontal

fiscal disparity. More SNGs' tax autonomy can be achieved at the cost of horizontal fiscal equity.

As discussed in chapter 5 above, the separations of powers and functions between the Centre and the states make the Ethiopian federation among the most decentralized federations in the World. The fiscal Constitution also grants the States a wide range of revenue sources. Nevertheless, the Ethiopian fiscal federalism is characterized by a high degree of VFG. The data for 1998/9 to 2009/10 revealed that the Federal Government controlled about 80percent of the total national revenue but covered 62 percent of the total national expenditures, whereas the States had control over only 20percent of the total national revenue but covered 38 percent of the national expenditure (see Appendix 5.1 and Appendix 5.2). It must be noted that such a high concentration of revenues in the hands of the Federal Government is not an outcome of the fiscal constitution but the existing tax structure of the country. It is dominated by custom duties and VAT on imports, where, on average, it contributed to about 80 percent of the total national revenue.

Currently, states' fiscal capacity is very weak owing to the existing low economic development.

In principle, there are four policy options to address the existing high VFG in Ethiopia:

- (i). Passing over some of the States' assignment responsibilities to the Federal Government,
  - (ii) Further decentralizing of buoyant taxation field in favour of the States (such as PIT, BPT, VAT, etc) levied from private companies organized in PLC and revising the distribution of concurrent revenue,
  - (iii) Designing appropriate federal transfers to the States, and,
  - (iv) Increasing states' revenue collection by broadening their tax bases and reforming their tax administration.
- Policy option (i) is not politically feasible as it stands against the very basic purpose of the Ethiopian multiethnic federal arrangement. Option (ii) is possible but does not seem to be a feasible choice for the Federal politicians. There is a dominant perception among some policy designers and decision makers that further devolution of taxation power to the States may paralyze the Federal Government's fiscal capacity, exacerbate horizontal fiscal disparity and may instigate secessionist feelings among the resource endowed states. Option (iii) has

served as a gap-filling mechanism. The Federal Government attempts to address the gap by transferring unconditional and conditional grants to the states. For the fiscal years 1998/9 to 2009/10, 69 percent of the States' total expenditures were financed through Federal subsidy. This means for each States' expenditure of one Birr, the Federal Government transferred 69 cents in the form of unconditional grant<sup>192</sup> (see Appendix 8.2). The fiscal relation between the States and respective LGs is also characterized by a wide VFG, because the LGs are major local public service providers without devolving taxation powers to them, except municipal revenues. Option (IV) is also feasible project and has been implemented.

### **Reducing horizontal fiscal disparities**

The concept of horizontal fiscal imbalance and horizontal fiscal disparity are often interchangeably but mistakenly used. Horizontal fiscal imbalance refers to the gap between states' expenditure needs for devolved functions and fiscal mobilization capacity from own revenues. In a federal setting, horizontal fiscal disparity implies significant deviations in tax bases among states. It occurs when States with low fiscal capacity are obliged to impose higher tax rate(s) in order to provide comparable public service or when the states cannot provide the required minimum national standard service at comparable tax rate (Boadway and Shah, 2009:233). Thus when one compares a State/LG on a horizontal base, he/she talks about disparities in the tax base, disparities in cost of public services or disparities in needs among the states. So, we do not use fiscal imbalance for horizontal difference in capacity but horizontal disparities.

In Ethiopia, a wide horizontal fiscal disparity is visible. The main causes are: (i) variation in tax bases. Other variables remaining same; revenue raising capacity of the States is a function of their economic base. Economic bases are concentrated in Addis Ababa, followed by Oromia, Amhara, Tigray and SNNP. The Emerging States have very weak economic bases mainly associated with marginalized public investment policy of the previous regimes. In the post-1991, they have also exhibited less investment destination regions partly they are relatively unstable due to inter-ethnic

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<sup>192</sup>Note that due to lack of data, the figures did not include federal conditional grants. The degree of State dependency on federal transfer would have been higher had the conditional transfers been included.

and intra-ethnic conflicts associated with controlling power and partly development infrastructures still lag behind, (ii) Expenditure needs of the states differ for various reasons. Costs of public service delivery among the States greatly differ due to variations in physical topography, cost of inputs and economies of scale. For example, in mountainous states like Tigray, Amhara and some parts of Oromia; unit cost of road construction per KM is higher than in the lowland states. Cost of industrial inputs increase with distance from Addis Ababa. This has forced the periphery states to expend more public money for building standard elementary schools and Health Centres. Settlement pattern is also a cause for cost differences among the States to provide same quantity and quality of public services. The scattered settlement of the Emerging States has forced them to provide public services at higher cost than the States characterized by sedentary settlement because the former hardly benefit from economies of scale. Population size is another factor as the populous states need more money to ensure minimum national standard of public service delivery than the less populous states.



**Table 8.1. HFI before and after Federal Subsidy, 2008/9, in million Birr**

	Own Revenue <sup>a</sup>	Concurrent tax share <sup>b</sup>	Total own-revenue	Total Expenditures <sup>c</sup>	Federal Subsidy	HFI before Federal subsidy <sup>d</sup>	HFI after Federal Subsidy <sup>e</sup>	Rank	
								Before Federal subsidy	After Federal Subsidy
1	2	3	4=2+3	5	6	7=4/5	8=(4+6)/5	9	10
Tigrai	605	83	688	1578	1109	0.44	1.14	2	2
Afar	69	3	72	563	450	0.13	0.93	10	8
Amhara	950	49	1000	4615	4139	0.12	1.11	6	3
Oromia	1421	121	1542	7188	5571	0.21	0.99	7	6
Somali	101	1	101	1066	1153	0.09	1.18	11	1
B-G	51	0.62	51	335	268	0.15	0.95	8	7
SNNP	671	56	727	3163	3301	0.23	0.8	5	9
Gambela	34	1	35	248	177	0.14	0.85	9	10
Harari	38	2	41	160	135	0.25	1.1	4	4
Dire Dawa	102	5	107	160	135	0.25	1.1	3	5
AA	3553	111*	3,664	6180	202**	0.59	0.61	1	11
Total	9835	434	1029	25389	16505	0.4	1.04		

Sources: <sup>a,d and e</sup> author's computation based on MoFED data base <sup>b</sup> data include withholding tax, Federal Revenue and Custom Authority

<sup>c</sup> MoFED data base [www.mofed.gov.et.net](http://www.mofed.gov.et.net) visited (September 2010); \*3% withholding tax on imported goods.

\*\*Addis Ababa does not receive Federal subsidy from the Federal treasury, but it receives external loans and external assistances Federal subsidy.

Note 1 Column 5 (total expenditures) did not include expenditures of external loans and assistances which are part of the Federal subsidy.

*Using a minimax indicator, the discrepancies before and after Federal subsidies are 6.55 and 2.60 respectively. The figures reveal the role of Federal subsidy in narrowing horizontal fiscal disparities. Looking at the fiscal rank of the States before and after the Federal subsidy, one may observe frog-leaping of some States.*

### **Political rationale**

Governments may use transfers to swing states/LGs or appeasing states/LGs held by strong opposition or rewarding supporter jurisdictions (Grossman, 1994; Rangarajam and Srivastava 2004). Johansson (2003) finds that swing voters in Swedish municipalities get larger grant as a reward. Sorenson (2003) also finds the influence of local lobbying groups in grant distribution among municipalities and counties in Norway are visible.

Whether the Federal Government of Ethiopia uses transfers for swing, appeasing opposition jurisdictions or supporting jurisdictions remain controversial. The opposition block accuses the ruling party for using federal subsidy for political agenda. Some may argue that the advantageous financial logrolling by the ruling party in the form of federal transfers to the States contributed to win the national (96.6 percent) and regional (100 percent) elections of the 2010. Examining the design of the federal unconditional subsidy, one may find no association with swinging, appeasing or rewarding of voters, as the distribution of the federal subsidy among the states and Dire Dawa is transparent and there is no room to manipulate for electoral purposes.

The generosity of the ruling party for pro-poor public spending in general and on the productive safety net program, on micro and small enterprises development, and on housing development seems to implicitly serve for political purposes. Moreover, the Federal conditional grants can be manoeuvred for maximizing the ruling party's political agenda, as the selection of eligible States is at the discretion of line ministries.<sup>193</sup> The Federal Government transfers to the states not only to

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<sup>193</sup> The conditional grants have equity nature. Once eligible States are selected, the distribution of conditional grant among the eligible States is made on the percentage

achieve minimum national standard of public services at comparable tax effort but also has political objectives.

### **Inter-jurisdictional externalities-A missing rationale**

The central argument for inter-jurisdictional externality is that jurisdictions which generate positive impact on national goal or to a neighbouring jurisdiction have to be compensated. The issues of inter-jurisdictional externalities involve: Who should compensate whom? What type of grant is appropriate (unconditional or conditional) for inter-jurisdictional externality? And how much compensation should be enough? If the benefit of inter-jurisdiction externality has country-wide scope, the central government has to compensate to the provider. If the externality is limited only to a few jurisdictions, then the beneficiary jurisdictions have to compensate to the producer of the positive externality. In case of negative inter-jurisdiction externality, the polluter should be penalized. Specific purpose matching grant is an appropriate instrument to address the problem of inter-jurisdictional externality. Depending on the impact of the public service to the national goal, the matching grant can be open-ended, or closed-ended. With regard to how much compensation is enough for positive inter-jurisdictional externality, theory of intergovernmental transfer suggests the equilibrium point of marginal social cost and marginal social benefit gives the right incentive to keep on allocating budget to the producer (Oates, 1972:72; Bird and Smart, 2002; Slack, 2009:336).

As discussed in Chapter 5 above, spending choices of some Ethiopian States have produced positive and negative inter-state externalities. Three cases of inter-jurisdictional externalities are presented below.

The State of Tigray has been engaged in providing elite-oriented tertiary education service as part of its human capital development strategy by establishing Mekele Institute of Technology (MIT). Admission policy of the Institute targeted at outstanding Tigrian students within and outside Tigray on competitive basis without any tuition fee. The benefits are not limited to Tigray, however. The State's spending choice produced

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share of the States which is computed for the distribution of unconditional Federal subsidy among the States.

positive externalities nationwide.<sup>194</sup> MIT Graduates migrate to other States to work in their profession and use the competences acquired in the MIT and they are hired by various Federal, States and private sector organizations. Nevertheless, the State of Tigrai did not get a single cent from the Federal Government as a compensation for the inter-jurisdictional externality effect it has produced. As the externality effect is nationwide, the practice of an open-ended conditional grant would have been ensured the sustainability of the Institute.<sup>195</sup>

The spending decisions of Harari and Dire Dawa Administration Councils on education and health care have benefited Oromia and Somali. The House decided, 15 percent<sup>196</sup> of Harari's and Dire Dawa's public spending on education and health services to be treated in the 2007 fiscal equalization system with the objective to compensate the producers for the spill over effects consumed by the residents of the neighbouring state (HoF, 2007:61). Two shortcomings have been observed on the principle of the spill over effect compensation scheme. First, fiscal equalization is not a good instrument to address spill over effect for a couple of reasons:

(i) It does not promote allocative efficiency. Rather, it develops free riding behaviour on the part of the neighbouring States, and (ii) the system does not promote justice. Why should the non-beneficiary States sacrifice to compensate Harari and Dire Dawa for the public service

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194 Tigrai allocates considerable public investment on MIT through its Development Chambers such as EFFORT (Endowment Fund for Rehabilitation of Tigrai), TDA (Tigrai Development Association) and Relief Society of Tigrai (REST). The degree of externality from the MIT is believed to be significant for couple of reasons. One, the State of Tigrai is very small to absorb all MIT graduates. Second, the areas of specialization also matters a lot in the labour market. The MIT produces relatively expensive and scarce professions in the country.

195 For budget constraint reason, the sustainability of the Institute was at risk. As an effect, the Board of MIT decided the transfer of the Institute to Mekele University, a Federal Government Institution as of July 2013 academic year.

196 Harari and Dire Dawa receive partial compensation through the Federal subsidy formula. They received 15 percent compensation during the 2007 and 2009 equalization formula, but it has been reduced to 10 percent in the 2011 equalization (HoF, 2007 2009, and 2011).

consumed by residents of Oromia and Somali? <sup>197</sup> Should not the beneficiary states bear the cost? Is not conditional grant a good tool to address such a spill over effect? The second point relates to the accuracy of the computation of the compensation. How did the decision makers set the 15 percent compensation? In a situation where the costs of spill over effects are not estimated by an independent body based on hard facts, the rate may produce a wrong incentive to Harari and Dire Dawa to manipulate their public spending on the services in order to receive more money from the equalization system or they might not be fully compensated for the positive spill over effect they produced really.

Highland Weredas allocate large amount of money, labour and time on land reclamation and environment rehabilitation activities through soil and water conservation programs to increase agricultural productivity and development of ground water resources. Such public investments of the highland States/*Weredas* on soil and water conservation activities have direct positive impact on the bottom hill neighbouring jurisdictions. It reduces, if not avoids the problems of seasonal flood and gully erosion at the lowland jurisdictions. Again, there is no practice of cost compensation mechanism for such positive consumption spill over effects. Unless some sort of horizontal compensation mechanism is designed, the highland jurisdictions might not have incentive to allocate much public spending on environment rehabilitation in the future.

The intergovernmental transfer system of Ethiopia does not respect inter-jurisdictional externalities, or wrongly addresses the problems. The education and health externalities should have been solved by introducing horizontal transfers between the states instead of the treating it through equalization transfers from the centre. In economic logic, beneficiary jurisdictions should compensate to the positive externality producing jurisdiction; and jurisdictions which produce negative externalities should compensate to the polluted jurisdiction.

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197 Here the argument is not to undermine any sense of horizontal solidarity. One State has to value the concern of other State(s), if the Ethiopian multiethnic federal arrangement is to be footed on strong foundation.

## 8.2 The Intergovernmental Transfer System (1994/5-2006/07)

As far as IGT is concerned, distribution of federal transfer among the states has been a political issue. The intergovernmental fiscal transfer system takes place at Federal, State and Wereda levels. The transfer system comprises the Federal subsidy (unconditional), the Federal conditional grant, the Road Fund, the *Wereda* block grant and *Kebele* block grant. During the last two decades, the distribution of Federal Subsidy has passed through various changes. From 1992/3 to 1993/4, the Central Government transfers were allocated on *ad-hoc* basis. A Federal subsidy based on some socio-economic variables was introduced in 1994/5 and lasted until 2006/7.<sup>198</sup> The prime reason for shifting from the ad-hoc basis to the formula based subsidy was aimed at designing a relatively more transparent grant system using ‘objective’ indicators. In 2007/8, the HoF replaced the socio-economic variables based formula by a fiscal equalization grant with the objectives to (i) “address the subjective selection of variables and assigning weights to the variables” (HoF, 2007:6), and (ii) reduce the per capita Federal subsidy distribution among the States by considering the expenditure needs and the revenue raising capacities of the States (Kirchgassner, 2008:2).

### 8.2.1 The federal subsidy

The Federal subsidy is a formula based ‘unconditional grant’. It is a major revenue source of the States. The right to decide Federal subsidy formula is reserved to the HoF (Federal Constitution, 1995 Art. 62(7)). Since 1994/5, the Federal subsidy has been designed in two generic ways: (i) the 1994/5-2006/7 federal transfer used certain socio-economic variables to measure some expenditure need indicators and the revenue generation capacity of the States. Weights for each variable were

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198 In 1994/5, two separate grant formulas, capital budget and recurrent budget were designed. Allocation of recurrent expenditure for 1994/5 was made on the basis of number of zones and Woredas, structure of bureaus/offices, number of civil servants, length of rural roads to be maintained, previous year budget implementation capacity, and number of agricultural demonstration centers (MoF, 19995).

assigned subjectively. (ii) Since 2007/8, Australian equalization model has been applied. It has equalized the revenue raising capacity and the expenditure needs of the States with the objective to fill the fiscal need gap.

***Source of Fund and nature of the Federal subsidies-*** The Federal subsidy has been derived from three sources: Federal treasury, external loans and external assistances. The Federal treasury comprises a lion's share. For example, from 1998/9 to 2009/10, it accounted for about 75 percent of the total Federal subsidy, while the shares of external loan and external assistance together covered the remaining balance (MoFED data, see Appendix 8.2).

The Federal subsidy has both elements of unconditional and conditional grants. The Federal treasury part of the Federal subsidy is an unconditional grant. The States spend it where they deem appropriate without any ex-ante verifications of its utilization by the Federal Government, although the grantor has authority "to audit and inspect the proper utilization of subsidies it grants to the States" (federal Constitution, Art.94). The external loans and external assistances part of the Federal subsidy have conditional elements, because the external grantors not only predetermine the intervention sector areas but also verify the utilization of the resources before fund replenishments are done. That is, the external loan and external assistance parts of the Federal subsidy are ear-marked and thus the States have no discretion or full expenditure control over the selection of the project areas and on the size of loan/grant.

As can be seen from Table 8-2 below, the Federal subsidy formulas used to consider various variables such as population size, development index, revenue raising capacity; capital budget implementation capacity, geographical size and poverty index. The variables were skewed to expenditure needs. Emphasis was given on the first three variables, as they were dominant variables in designing the formulas.

The premise of assigning the highest weight to population size in the Federal subsidy formula was, other factors remaining same, populous States need more public fund to provide basic public services to their residents than the less populous States. But this does not mean to say that the expenditure needs increase proportionally with population size.

That is, the State of Oromia which is about 6 fold in population size to the Somali State cannot have 6 times greater expenditure needs to provide a certain public service than the latter State, because costs of delivering public services are affected positively or negatively by economies of scale, distance and topography. For some public services, populous States can reap benefit better from economies of scale than less populous ones.

Looking through the various Federal subsidy documents of the MoFED (2003) and HoF (2007), one may infer that the consideration of development level index in the formula was aimed at ensuring universal access to the basic public services such as primary and secondary education, primary health care, and rural road and clean drinking water across the States. In line with this objective, States with lower coverage rate on these variables used to receive more Federal subsidy from the pool of development level. The development index had couple of shortcomings:

- (i) It considered only States' needs for capital investment required to deliver basic public services. Recurrent expenditure needs for running the public services were ignored, and

- (ii) The index was input based, not output based. These had created wrong incentive on the states. Somali and Afar states used to receive relatively larger development grant by keeping up low development level.<sup>199</sup> By its nature, unconditional grant is not appropriate to pursue performance-oriented goal as the states have absolute freedom to allocate funds where they think appropriate. Matching earmarked grant is appropriate transfer system to promote output based grant because it would enable the Federal Government to check whether the states have really used the transfer for the desired purpose or not.

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199 Afar and Somali states used to get relatively large development grant with the objective to address the development backlog. Nevertheless, accesses to education, health, clean water, rural road, etc have remained far below the national average, not only because of the low initial development level they had, but also their choices to spend less public investment on these public sectors.



**Table 8.2.Federal Unconditional grant formulae, 1994/5 to 2008/09 EFY**

		Weights						
	Socio-economic Variables(criteria)	1994/5	1995/6 to 1996/7	1997/8 to 1999/00	2000/1 to 2002/3	2003/4 to 2006/7	2007/08 to 2008/9	2007/08 to 2008/9
1	Population size	30	33.3	60	55	65	Fiscal capacity-expenditure need	Fiscal capacity-expenditure need
2	I-distance/	25	33.3					
	Fiscal need for education, health care, safe drinking water, rural road			25	20			
	development index <sup>200</sup>					25		
3	*Revenue generation capacity	20	33.3	15		10		
	Revenue raising effort (11%) and sectoral performance(4%): change in health centres, education participation, length in rural road, and safe drinking water				15			
4	Capital budget allocated in 1993/4	15						
5	Geographic size	10						
6	Poverty line				10			

Source: Various Reports of Ministry of Economic Development and Cooperation, Department of Regional Affairs, and HoF Regular Meetings Minutes and HoF, 2007 and 2009 Federal Budget Distribution Formula.

<sup>200</sup> I-distance variable was in application from 1994/5 to 1997/97.It was replaced by development index which was in use in different terms until the introduction of the fiscal equalization.

Talking about the revenue raising capacity criterion, its weight fluctuated over time, ranging from 10 percent to 33.3 percent. The rationale for including this variable in the formula was to encourage the States to make tax effort as much as possible.

***The external loan and external assistance parts of the Federal subsidy were/are uncertain-*** There had been and there is still a wide discrepancy between the states' subsidy entitlement and the actual transfers. The Federal treasury portion of the Federal subsidy is certain to reach at the hands of the States and has remained dependable revenue source to the States. If there is unutilized fund, it is carried over to the next budget year. This is not a case with the external loan and external assistance part of the federal subsidy. The external sources of the Federal subsidy are double edged sword for the States. First, the States' subsidy entitlements which derive from the external source (loan and assistance) are not certain to reach to the States' treasury. For example, only 18.5 percent of the "promised" external loans and assistance were utilized during the same period with wide variation among the States (13 percent in Dire Dawa and 46 percent in Benshangul-Gumuz in 1998/9-2002/03 fiscal years) (see Appendix 8.1). Dire Dawa, Afar, and SNNP were the three bottom States which utilized the external sources of the Federal Subsidy least, whereas Benshangul-Gumuz and Harari utilized about 40 percent of the external fund sources.<sup>201</sup> The reasons for such a low utilization rate of external source could be partly due to the existing weak institutional and human resource capacities of the States to meet donors' detailed performance report requirements on time, and partly due to the donors' long bureaucratic decision making process and the stringent purchasing policies and procedures. These conditions have caused to delay the release of fund.

The external sources portion of the Federal subsidy crowds-out the Federal treasury grants too. If the money is not utilized within the project period even because of the financing institution's fault or long bureaucratic procedure, it is not carried forward to the next budget year. Thus, large parts of the external sources are nominal, uncertain to

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201 Paradoxically, Benshangule-Gumz and Gambela, which have weak managerial capacity, utilized their external sources of the federal subsidy better than the relatively advanced States (see Appendix 8.1).

receive and they are “perceived as inferior substitute for treasury funds.”(World Bank, 2000: 45).

***The socio-economic formula-based grant system was implicitly expenditure need equalizer***-The considerations of population size and development variables were aimed to ensure equitable access to education, primary health care, access to safe drinking water and rural road service among the States. As can be seen from Table 8.2 above, population size and development index constituted a lion’s share of the Federal subsidy, because: (i) a populous state needs more fund to provide basic public services at comparable tax burden than a less populous one, and (ii) the periphery States have to receive more federal transfer to significantly narrow the development disparity across the States.

However, the equity concern was compromised for a couple of reasons. First, the Federal subsidy formulas did not consider the cost differential factors in providing public services across the States. Failing to consider the impact of economies of scale on the cost of delivering public service in the formula adversely affected the Emerging States as they are scattered populated. Secondly, the subjective allocation of the external sources across the States undermined the equalization system. Some States used to have a large proportion of the external sources than the others (see Appendix 8.1). In effect, the higher the share of external sources to the total State subsidy entitlement, the lower the actual States’ subsidy entitlement is, because large portion of the promised external resources are not disposable to the States. For instance, over the 1998/9 to 2002/3 fiscal years, Dire Dawa’s external loan and assistance constituted fourfold of its Federal treasury revenue, followed by Tigrai (23 percent), SNNP (21 percent), and Somali (19 percent). But they utilized only 6.4 percent, 6.7 percent, 5.1 percent and 19 percent respectively. The remaining balances did not reach the hands of the States and were freezed out, when the project phases out. What is the rationale to allocate 23 percent and 21 percent of the subsidy entitlement in the form of external source for Tigrai and SNNP respectively, but only 16.6 percent and 16.4 percent for Amhara and Oromia respectively (see Appendix 8.1). Was not this injustice as it is known large part of the external sources is not transferred to the States’

treasury? Thus the subjective allocation of the external loans and assistances as part of the Federal subsidy to the States has built in discrimination and injustice.

***The socioeconomic based formula was discouraging the states from generating more revenue***-The socio-economic formula- based Federal subsidy was ill designed to generate more revenues for two reasons. First, States' revenue raising capacity was estimated on actual collection not on the potential revenue capacity of the States. Second, because of the practice of the so-called budget netting from the total Federal subsidy entitlement and budget off-setting mechanisms, the transfer system used to penalize the States which collected more own-revenue.

The netting system refers to the deduction of State's expected (targeted) own-revenue collection<sup>202</sup> from the total Federal subsidy entitlement. MoFED and the States used to set 'jointly' Five Year the State's revenue collection plan, although the former was more vocal in the decision making process. Once, the States' expected revenue was determined, MoFED used to transfer the difference between the Federal subsidy entitlement of the state and the targeted revenue collection of the state on a monthly basis. If a State collected above the revenue target, MoFED used to deduct equal amount from the State's subsidy entitlement. In principle, States which performed better tax effort<sup>203</sup> should have been rewarded. But in practice it was not the case. Rather the Federal subsidy system used to penalize the States which exerted better tax effort.

The off-setting mechanism<sup>204</sup> implies deduction of State's Federal subsidy entitlement equivalent to multilateral and bilateral funds (UN agencies, CIDA, EU, etc) directly channelled to the BoFED and to Wereda

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202 States' own revenue collection plans or revenue targets were estimated in considerations of previous year actual revenue performance and forecasted regional economic growth. Revenue targets often were not attainable, partly due to unrealistic target setting (top-down decision) and partly weak collection performance of the States.

203 In this context, tax effort is defined as the change in revenue collection between current year and previous year.

204 The practice of offsetting mechanism is argued to correct the concentration of individual donors' fund channels in a few States.

sector offices.<sup>205</sup> The external sources include packages of software's like new management system, capacity building projects, management auditing, and reporting system, capital investments on economic and social infrastructures, etc. However, the States have shown little interest to make use of the external funds. Because the budget off-setting system has caused equivalent deduction from their Federal subsidy entitlement, even if they do not make use of the fund because of the donors fault and/or the states' capacity limitations Therefore, the budget off-setting mechanism blunts the incentive to use external resources (World Bank, 2000:30):

***The Federal subsidy was less predictable***-As can be seen from Table 8.2 above, the formula changed five times within a dozen years, or, on average, about every two years. Such frequent changes had made the formula less predictable and adversely affected the States' capacity to make medium and long term development plans. Moreover, the frequent change of the formula made some States win and some States lose. For example, raising the weight for population from 55 percent to 65 percent in the 2003/4 had benefited the three populous states at the cost of the less populous States (see Appendix 8.3). To make the matter worst, there was no hardship fund mechanism that would rescue the losers due to the change of a formula.

In summing up, in the socio-economic based Federal Subsidy formula, the selection of the socioeconomic variables and the assignment of the weights were subjectively determined. There was no consensus among the States about the variables and the weights to be given to each variable. For example, Tigray had requested a higher weight assignment to revenue raising effort. The periphery States had argued for consideration of distance from the centre. Somali and Oromia preferred the consideration of geographical size. Moreover, Oromia, Amhara and the SNNP were in favour of higher weight to population size. The SNNP demanded for consideration of unit cost administration and general

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205 Note that multilateral and bilateral grant are transferred to the States through various channels. Channel-1 refers to those funds which pass to the States through the MoFED. Channel-2 is transfers made directly to BoFED. Channel-3 is fund granted (mainly by NGOs) to specific wereda sector Offices. Channel 1 and Channel-2 are incorporated in the Federal Subsidy entitlement and they were subject to budget-off-setting from the Federal subsidy entitlement. Channel-3 is off-budget.

service as large part of its recurrent budget is consumed by Zone/Special Wereda levels of government, whereas Afar and Somali demanded a higher weight for the development index (HoF, 1994). The states and the HoF felt that the socio-economic based formula was not equitable. To this effect, the House decided the replacement of the socio-economic variables formula by a fiscal equalization grant (see more Section on 8.3).

### 8.2.2 Conditional (specific purpose) grants

The Federal Government channels various kinds of conditional grants through Line Ministries, which constituted about 25 percent of total States' expenditure in 2005<sup>206</sup> (World Bank, 2006). Federal conditional grants are attached to specific sector development programs/projects where the Federal Government sets the priority. All conditional grants are attributed to states not to individuals except the PSNP. The Federal Government makes ex-post verification of the use of the conditional grants.

***Conditional grants are exogenously financed.*** Large portion of the conditional grants are financed by multilateral and bilateral loans and/or assistances. The grants are close-ended matching where the Federal Government and eligible states contribute in kind up to 20 percent of the total project cost. Thus, the pool size and the intervention sector areas are influenced by the donors/grantors. Such an over dependency on external sources raises a sustainability issue and political cost on the sovereignty of the country<sup>207</sup>.

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206 So far the conditional grant includes AMIP(Agricultural Marketing improvement program),ASSP (Agricultural sector Support Program),CBSDS,(Capacity Building for Decentralized service delivery),CIP( Coffee improvement project),ESRDF(Ethiopian social rehabilitation and development fund),HSDP(Health Sector Development Program),NLSDP( National Livestock Sector Development Program),PCDP( Pastoral Community Development Program),PSCB(Public service capacity building program ),PSNP(Productive Safety Net Program),PSSIDP(Participatory Small Scale Irrigation Development project),RCBP(Rural capacity building program), SLMP (Sustainable land Management Program), ULGDP( Urban Local Government Development Program), etc

207 It is open secret that the donors use grants and loan an instrument to fulfill their political, security and economic motives. The donors had suspended all grants during the Ethio-Eritrea war and the 2005 controversial National and Regional elections.

***Conditional grants are not all state-inclusive.*** In many cases the eligible states are selected at the discretion of the Federal Line Ministries and many of the conditional grants are asymmetrically arranged to some States. Only a few conditional grants such as Ethiopian Social Rehabilitation Development Fund (ESRDF), Public Sector and Capacity Building (PSCAB), Health sector Development Program (HSDP) and Education sector Development Program (ESDP) were all States inclusive. The remaining conditional grants do (did) not encompass all the States<sup>208</sup> Selection of beneficiary states of a conditional grant is guided by pragmatic economic and political considerations to meet specific national objectives. For example, PCDP targets pastoral communities only (Afar, Somali, and Pastoral Weredas of Oromia and the SNNP) to enhance local decision making, to build managerial capacity of local people in identification, implementation, supervising, and monitoring local projects; to promote accountability through public censorship, and to promote local economic development, whereas PSSIDP, RCBP and SLMP have targeted States having long history of sedentary and mixed agricultural economy practices. The discretionary selection of beneficiary states may raise equity issue.

***Conditional grants are less transparent and less predictable-*** Conditional grants are less transparent because the selection criteria for eligibility are determined by political choice of the Federal Government, of course, with the consent of the external financing agencies. Line Ministries prepare policy documents and project proposals, then the Ministry of Finance and Economic Development seeks finance. Once beneficiary States are identified, the total conditional grant is redistributed among the selected states.

Conditional grants are designed for a short maturity period, often ranging from three to five years and they lack predictability. The grants heavily depend on the willingness<sup>209</sup> of the lending institutions. This hampers the States/LGs ability to make long-term development plans.

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208 For example ULGDP, PCDP, PSSIDP, RCBP, SLMP target specific States.

209 Availability of conditional grant reflects political and economic motives of the financiers. For instance, multilateral lending institutions and donors substantially cut the loans and assistances in reaction to the Ethiopia's action to reverse the Eritrean

***The conditional grants alter less States' resources.*** In principle, matching conditional grants alter States'/LGs' resources towards meeting national objectives by sacrificing state/local priorities. This is not a case in the Ethiopian transfer system, because matching grants rarely practiced and they have little effect in altering States' meagre resources to meet national objectives. The States are required to contribute a small portion of matching grant, less than 20 percent of the total entitled to the matching grant often in kind (labour and local materials) which are abundant resources of the States. The introduction of such in-kind contributions is unique experience from the conventional matching grant system we find in the literatures of intergovernmental transfers. The Ethiopian experience could be a good innovation as it is designed in a way to overcome the capital constraints of the States and softens the problem of shifting meagre capital resources to achieve national goals. Thus, the conditional matching grants are designed in a way not to crowds-out States' budget.

***The conditional grants are development oriented and are output based-*** Conditional grants are channelled to finance capital projects that would contribute to promote local development. They are measurable and goal-oriented. Both financers and beneficiary weredas enter into an agreement on the objectives, output, outcomes, and impact of each program/project. The Weredas prepare grass root, flexible annual work plan. The plans have to be endorsed by the respective State Steering Committee and then by the respective Federal Steering Committee. The plans are used as instruments to track with expected performance targets. The Line Ministries also apply carrot and stick management approach. Those weredas that perform according to the annual work plan get replenishments of project funds and receive recognition for their excellent performance in their joint consultative meetings (the Federal Government and the States). Those which fail to perform according to the approved annual work plan would be sanctioned from getting additional replenishments until they produce standard performance report for the previous transfer.

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aggression in 1998-2001as well as the 2005contested results of National and Regional election.



Conditional grants are also designed in a way to promote local participation and accountability by making local people main actors in the process of project identification, implementation, procurement and supervision. It might be worth noting that there is visible gap between the blue print and the reality on ground.

### **8.2.3 The Road fund<sup>210</sup>**

The Road fund is earmarked to road maintenance and road safety purposes. It is distributed among the Ethiopian Road Authority (Federal Government), the States, and selected ULGs.<sup>211</sup> As stated in the previous chapters (see Section 7.5.2), the Road Fund is derived from various sources. It is also managed by a Board drawn from public and private sectors, accountable to the Ministry of Works and Urban Development. The Federal and the States are represented by five and four appointed members respectively, while the Private transport sector has four elected, by the Association, representatives. All stakeholders make decision on the (i) determination of the pool size for distribution, and (ii) the distribution of the Road fund among the eligible levels of government. Currently the distribution of the Road fund takes place in the proportion of 70 percent to the Federal Road Authority, 20 percent to the States and 10 percent to eligible ULG (Road Fund Office, 2010). The skewed of the distribution of the Road Fund in favour of the Federal Road Authority is associated with the proportion of the road network it administers and its traffic load with respect to all roads in Ethiopia. With regard to the distribution of the Road fund among the States and the ULGs, the Board designs separate criteria. The 20 percent of the Fund is distributed among the States depending upon the proportion of the length of road net-work they manage. As far as allocation of Road fund among the ULGs is concerned, 50 percent goes to the Addis Ababa City

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210 This dissertation uses the definition of tax sharing( revenue sharing) developed by (Blöchliger and King,2006) (see Section 6.4.2, page 142-3)

211 The Road Fund has come into effect in 1997. Eligibility of ULGs to the Road Fund increases from time to time.It increased from 11 cities (Addis Ababa, Dire Dawa, Mekele, Hawassa, Adama, Bahir Dar, Jimma, Shashamene, Gonder, Combolicha and Harer) in 1997 to 25 in 2012. The Road Fund Board determines the eligibility criteria.

Government, on the basis of some criteria like: road network, traffic load, and social and economic importance of the city. The balance has been distributed among the remaining ULGs based on various criteria: 80 percent on population size of an eligible town and 5 percent value has been assigned to each to the following criteria: (i) regional administrative centrality (seats of Regional State), (ii) degree of transit traffic load, (iii) township grade, and (iv) proportion of asphalted road to the total road of the towns.

Given the Road Fund is earmarked to road maintenance and traffic safety, one may question the wisdom of assigning 80 percent weight to population size of an eligible town and only 5 percent value to the degree of transit traffic load, because the latter causes adverse spill over effect on life time of the road and congestion is not obvious. Moreover, the distribution formula ignores States'/LGs' maintenance cost of road and road fund generating capacity of the ULGs.

***Road Fund is performance oriented, predictable and certain-*** Beneficiaries are supposed to prepare a detailed five year action plan disaggregated by annual work plan. The system promotes accountability. The Road Fund Office applies a strict policy of "No performance report vis-à-vis work plan, no additional transfer". Road Fund does not freeze out because unutilized funds are carried forward to the next year. This makes the Road fund certain to reach at the treasury of the eligible agencies as long as they produce realistic performance report. It is also predictable.

#### **8.2.4 Wereda Block Grant (WBG)**

The Wereda Block grant (WBG) is a transfer from the States to respective *Weredas* (rural and urban). It was introduced as a component of the Wereda level decentralization.

Before the introduction of the existing expenditure need equalization, the states used to apply the socioeconomic variables based formula (population size level, development index, and revenue generating capacity). At present, all the states compute Weredas' recurrent budget need on unit cost approach basis, which considers major recurrent expenditure cost drivers. Unit cost is a ratio that

expresses the relation of physical output and financial input such as the cost of education per student, health service per patient, cost of agricultural extension service per household etc.

The WBG considers similar expenditure representatives and indicators between the rural and urban Weredas. The only difference is that ULGs considers trade and industry development expenditure needs instead of pastoral/agricultural development. Water supply expenditure need is also ignored as urban dwellers finance the cost on benefit-received principle. Municipality functions are exclusively financed from own revenues.

The total worked recurrent expenditure needs is the sum of estimated costs of all sector. WBG is transferred into two ways. In the relatively homogeneous states, it is directly transferred from the states to respective whereas. States having constitutional Ronal Government use two-steps approach to distribute block grants. First, the states allocate transfers to the Zones, and then the Zones reallocate block grants to respective Weredas.

**Table 8.3 WBG Recurrent Expenditure needs and indicators**

Expenditure needs	Indicators
Education	School age population, actual N° of enrolled students, expected N° of students to be served, actual N° of teachers, number of schools and classrooms, unit cost of construction, actual financial expenditure salary and operation costs for the previous year
Primary health Care	N° of health centre and health post, health staff salary, standard operational expenses for the health institutions
Rural water Supply	Water infrastructures, costs of major maintenance for unfuctional schemes, minor maintenance cost for functional schemes
pastoral/agriculture and rural development	N° of development agents(DA's), salary of development agents, N° of FTC and kebels, N° farmer households and standard ratio to DA, operation costs

	for extension service delivery; salary of veterinary staff , operational expenses for veterinary services.
Administration and general expenses.	Estimation of salary and operational cost for all sectors those are not covered in unit cost service delivery institutions.
Micro and small scale Enterprise	costs required to facilitate job opportunities for economically active unemployed population,
Cost factors	Implies the consideration of cost differences among Weredas due to number of kebeles, distance from the zonal and regional centres and area size of Weredas.

Sources: Oromia, Tigray, Amhara BoFED

### ***Distribution of Capital Budget among Weredas***

Capital budgets are transferred based on inter-wereda infrastructure deficit comparison. Access to education, primary health, portable water supply, rural road, and agricultural facilities are taken into account. The infrastructural deficit index favours weredas with relatively poor infrastructural development.

Based on each index, the capital budget need of each wereda is estimated. *Wereda* capital transfers are made on *ad-hoc* basis. They are conditional transfers. The States do not set floor pool size of WBG for capital expenditures. It is a function of expected Federal transfers to the States, States' revenue mobilization forecast, and States' sector development plan. Whenever decision makers allocate capital budget among Weredas, they keep equitable access to public services in mind, although it is completely free from influence of vocal Wereda politicians, negotiation and lobbying.

**Table 8.4.WBG Capital Expenditure needs and indicators**

Expenditure need	Indicators
Education infrastructure	N <sup>o</sup> of schools, class rooms and school age population
Agricultural infrastructure	N <sup>o</sup> of farming households, No. farmers training centre, N <sup>o</sup> . of livestock in TLU, N <sup>o</sup> . Vet;
Health infrastructure	Population size, N <sup>o</sup> . of Health Centre and N <sup>o</sup> . of Health Post;
water supply	Water coverage percentage ;
Rural Road infrastructure	Population, Area(Km <sup>2</sup> ),Road Length(Km) Road Density;
Cost factor	Distance from the centre.

Sources: Oromia, Tigrai, Amhara BoFED

### 8.3 The Fiscal -Gap Equalizations (2007/8 -2010/12)

The HoF felt that many of the states perceived the socio-economic based federal subsidy formula was not equitable (HoF, 1994). Understanding this fact, the HoF reached a consensus on the need for a new grant system that would address the concerns of the States.

Fiscal equalization can be designed either by equalizing States'/LGs' fiscal capacity (revenue raising capacity) like in Canada and Germany, or the expenditure needs (fiscal need) of state/LGs like in India, or by equalizing both the fiscal capacity and expenditure needs (fiscal-gap) of states/LGs like in Australia and Denmark.

Fiscal capacity equalization standardizes major tax bases and respective tax rates. It lifts up the fiscally weak jurisdictions to politically acceptable predetermined national level fiscal capacity. States/LGs with lower-than-national average fiscal capacity receive more transfers, while those states/LGs with higher-than-national average capacity receive no transfers or may be asked to contribute to the equalization pool if the equalization scheme is horizontal.

Expenditure need equalization standardizes three sources of expenditure differentials:

- (i) cost of public service delivery of states/LGs by considering various disability factors such as topography, distance from centre, variation of cost of inputs etc.,
- (ii) need differences which arise due to population size in general and demographic factor such as population age/sex structure in particular, and
- (iii) Cost of public services difference incurred due to economies of scale (Dafflon and Mischle, 2008: 215, and Dafflon and Vaillancourt, 2009).

Fiscal gap equalization measures both relative fiscal capacity and relative expenditure needs of states/LGs with the objective to bridge the gap between the fiscal capacity and expenditure needs of states/LGs.

There is no consensus among public finance economists about which fiscal equalization modality (fiscal capacity or expenditure need or fiscal-gap) is appropriate. Dafflon and Vaillancourt (2003: 405) indicate a preference for fiscal capacity equalization as “cost differences are more arbitrarily measured than fiscal capacity differences.” Shah (2007b:312) also argues for fiscal capacity equalization because expenditure need could be compensated “through sectoral transfers or by providing a special grant” to fiscally weak states. But, for Boadway (2004) expenditure need equalization is superior to fiscal capacity. According to him, expenditure need equalization has potential to eliminate distortion of resource allocation that might arise due to fiscally induced migration (Boadway, 2004: 237-238).

Since the choice for fiscal equalization modality is left to politicians; the HoF has been inspired by the Australian fiscal-gap grant system. It hired an International Consultant and directed to customize the Commonwealth grant system to the Ethiopian situation believing that it would “satisfy” all the States, as the system compensates both cost and revenue differentials of the States.

One of the principles of fiscal equalization is to provide adequate financial means to the States that would enable them to deliver comparable basic public services such as health, education, clean water, housing, and rural road to their citizens regardless of the choice of location (Federal Constitution, 1995 Art. 90(1)) at comparable tax effort. Equalizing expenditure needs of the States is necessary in today's Ethiopia, because there are visible gaps in the distribution of basic public

services among the States due to cost and need differentials. Equalizing the revenue side is also a politically feasible, because there is wide asymmetry in the economic bases among the States. The fiscal-gap equalization is not immune from side effect. The impact of the fiscal-gap equalization on disincentive is discussed in 8.3.1 and 8.3.2 below.

Once the modality of fiscal equalization is determined, the next critical policy choice is to determine what the direction of fiscal equalization to be pursued. There are three options: vertically (parental) or horizontally (fraternal) or both vertical and horizontal equalizations. In the case of vertical fiscal equalization, transfers are made from a higher level of government to a lower one. Canada and India apply vertical fiscal equalization. Horizontal fiscal equalization refers to transferring resources among the same levels of government. Under this option, fiscally better-off states/LGs contribute to the equalization pool in favour of the less fiscal endowed ones (Dafflon, 2009b). Germany is a typical example of horizontal fiscal equalization.<sup>212</sup> Political cohesiveness between constituent state members is a critical factor to adopt a horizontal fiscal equalization (Vaillancourt and Bird, 2005). Switzerland practices both vertical and horizontal fiscal equalization approach.

There is no perfect direction of fiscal equalization. All have merits and demerits. Vertical fiscal equalization does not cause disincentive to raise more revenue. However, it makes lower levels of government grant dependent upon a higher level of government as it implicitly presupposes control of lucrative tax revenue sources at a higher level of government. Horizontal fiscal equalization enhances solidarity among constituent member states of a federation. Nevertheless, it is criticized for (i) creating disincentives to exert more tax efforts (Vaillancourt and Bird, 2005:5), and for (ii) 'levelling down' of rich states/LGs to national average target.

There are sound equity and efficiency arguments for pursuing a horizontal or a vertical revenue raising (fiscal capacity) equalization whereas expenditure needs equalization should be vertical only (Dafflon, 2007), because horizontal expenditure needs equalization would bring

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212 In addition to the horizontal fiscal equalization, German Landers also receive VAT vertical fiscal equalization.

distortion in the relative tax-price of local public services and result in inefficient allocation of resources. Adopting simultaneously the vertical and horizontal equalization has a potential to correct the shortcomings of the vertical and horizontal fiscal equalizations.

With this regard, Ethiopia applies vertical fiscal equalization. The conventional horizontal fiscal equalization does not seem feasible in Ethiopia, at least, in the foreseeable future for two reasons. First, so far, no State is in a fiscal position to fully finance its expenditure needs from own-revenue, leave alone to contribute to a horizontal equalization pool.<sup>213</sup> Second, applying horizontal equalization seems politically sensitive; because it might serve as a breeding ground to the political forces which think their state is subsidizing others and subscribing to secession. That is, ethnic entrepreneurs who claim their State is 'well-off' may rally their 'fellow men' for secession by instilling that they will be 'better-off' if they secede from the federation. The existing strong ethnic identity may also make it difficult to pursue the conventional horizontal fiscal equalization.

Another equalization issue that needs political decision is to determine the optimal degree of fiscal equalization. Degree of fiscal equalization ranges from zero to 100 percent. Zero implies no equalization policy, while 100 percent refers to full equalization or bridging 100 percent difference between potential fiscal capacity and expenditure needs of states/LGs. Other factors remaining constant, full fiscal equalization makes states/LGs to have national average financial means per capita. It may also curb secessionist tendency from a state whose elites believe they do not receive what they deserve from the national cake. Nevertheless, full equalization is likely to create

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213 It seems worth mentioning the practice of an ad-hoc basis horizontal solidarity in Ethiopia. The relatively advanced States provide technical assistances in areas of capacity building programs, carrying out investment projects, providing trainings to civil servants, etc to neighboring Emerging States based on solidarity principle. For example, Tigray and Amhara provide technical assistance to Afar State. The State of Amhara also assists to Benshangul-Gumuz, while SNNP and Oromia provide technical assistance to Gambela and Somali respectively. Furthermore the four relatively advanced states, Harari and Dire Dawa have voluntarily given 1 percent of the total federal subsidy to the Emerging states.



disincentive among high contributors to the equalization pool and laziness among the beneficiary States/LGs.

Applying fiscal equalization more than zero but less than 100 percent is referred to partial fiscal equalization. For instance, the German VAT based equalization program lifts up the revenue capital capacity of the Länders to 92 percent of the national average, while the horizontal equalization program equalizes the poor Länders up to 95 percent of national average fiscal capacity (Bird and Vaillancoutr, 2007b:281). A fiscal equalization approach closer to 100 percent means a higher disincentive degree to improve own situation (tax effort or utilization of resources) and less tax autonomy of States/LGs. The German fiscal capacity equalization system is an illustrative case in creating disincentive to collect more revenue. Partial fiscal equalization balances the issue of equity (justice) and efficiency (incentive to raise revenue), although both of them cannot be achieved simultaneously without trading-off one for the other. It also reduces fiscal burden of those states/LGs that contribute more resources to the equalization pool size (Dafflon, 2009: 380).

In Ethiopia, the fiscal-gap equalization system fully equalizes (100 percent) both the revenue raising capacity and the expenditure needs of the States with the objective to create “...*comparable financial capacity among regions in order to provide standard public services, (in addition to the effort to be put by each region to collect average revenue)*” (HoF, 2007:9). The full equalization has created disincentive to maximize their revenue potential and to compete on the common federal resources.

The following subsections assess the fiscal gap equalizations of 2007 and 2009. It begins with assessment of the 2007 fiscal revenue and expenditure need equalizations and followed by the 2009 equalization formula.

### 8.3.1 Assessment of the 2007 fiscal gap equalization

#### *The Revenue Raising Capacity Equalization*

The 2007 revenue raising capacity equalization considered six major revenue sources, which constituted more than 80 percent of the States' total tax own-revenue sources. When the revenue capacity equalization includes more tax bases, it reduces more the annual revenue fluctuation and smoothes the Effective Yield Tax (EYT) system through time.

**Table 8 5 Revenue sources and their contribution to total revenue in the 2007 equalization**

Tax base in the ETY 2007	State's proportion from their total revenue <sup>a</sup> (2002-2006average)
Personal income tax	30.2
Business profit tax	24
Agricultural income tax	5.3
Rural land user fee	5.4
Tax on Chat	NA
Value Added Tax (VAT)	14
Total	80

Source: HoF 2007, the New Federal Budget Grant Distribution Formula,

<sup>a</sup> own computation based on HoF 2007:19 and MoFED data base.

Revenue sources to be included or excluded in the fiscal capacity equalization should be, as much as possible, free from subjective judgment. Arbitrary selection of revenue sources can be escaped through: (i) carefully selecting important revenue sources from the tax structure of States, and (ii) checking whether the annual yields of the selected tax bases are regular and predictable.

The 2007 revenue raising capacity equalization is appreciated for disregarded insignificant revenue sources such as income taxes on dividends, chance winning (lottery), and interest income on bank deposits, as well as unpredictable and irregular tax bases such as capital

gains tax. However, there is no explanation why the emerging revenue sources such as rental income tax, turn over tax, royalty payments, and urban land lease fees were ignored in the revenue raising capacity equalizations. One may challenge the wisdom of disregarding these revenue sources from the ETY as they significantly vary across the states. Moreover, urban land lease fee contribution to the total revenue of the States is greater than the agricultural income tax and rural land use fee. For instance, in 2009/2010 fiscal year, urban land lease fee accounted for 6 percent of Sub national’ total revenue, while the share of agriculture income tax and rural land use fee were 4 percent and 2.7 percent respectively for the same period (see Table 6.3, page196-197).

The consultant Team designed two formulas (equations 8-1 and 8-2 depicted below)<sup>214</sup> to determine the revenue raising capacity of the States.

- (i) Revenue raising capacity of the States on the personal income tax (PIT), business profit tax (BPT), tax on chat and value added tax (VAT) were computed as:

$$\text{AvgRevpc}_{ij} = \alpha_j \left[ \begin{array}{l} \text{Tax Rev}_{ij} \\ \text{Ave.T pop} \end{array} \right]$$

$0 \leq \alpha \leq 1$   
  
Equation 8-1

where

Revpc <sub>ij</sub>	average revenue per capita of category in state
T taxRev <sub>j</sub>	ave. total tax revenue of category (2002-2006)
Tax Rev <sub>ij</sub>	ave tax revenue (2002-2006) of category in States
Ave.T pop	average total population (2002-2006) at national
	average population (2002-2006) in state <sub>i</sub>
α <sub>j</sub>	degree of revenue category

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<sup>214</sup> Equation 8-1 and Equation 8-2 are taken from Professor Kirchgassener (2008) (St.Gallen University), who served as a consultant to the HoF in designing the 2007 fiscal equalization.

- (ii) Agricultural income tax and rural land use fee were measured using Equation 8-2. In order to compute the average revenue per capita of agricultural income tax in State<sub>i</sub>, agricultural land size was taken as a parameter and it was computed as:

$$\Delta \text{RevPc}_{i,j} = \alpha_j \left[ \frac{\text{TTaxRev}_j}{\text{TaxR}_{ij}} - \frac{\text{TAgArea}}{\text{SAGArea}_i} \right] \quad 0 \leq \alpha_j \leq 1 \quad \text{Eq. 8-2}$$

Where

TTaxRev <sub>j</sub>	Total tax revenue per capita of category <sub>j</sub> in State <sub>i</sub>
TaxR <sub>ij</sub>	Tax revenue per capita of agri. In state <sub>i</sub>
TAgArea	Total agricultural area in the country
SAGArea <sub>i</sub>	Share of total agricultural area in State <sub>i</sub>
α <sub>j</sub>	Degree of revenue category <sub>j</sub>

Average revenue per capita of rural land fee of the States was estimated by applying the same equation 8-2.

In summing up, the per capital revenue raising capacity of the states and Dire Dawa Administration Council was computed through the following steps:<sup>215</sup>

- [1] Five years (2002-2206), average population size of each state (state<sub>i</sub>) was estimated. i.e.

capita. The results of some states' revenue sources were found to be positive sign and negative sign for others.

[5] Finally, the individual value of the six per capita revenue raising

Capacity of each state was summed up to determine the aggregated per capita revenue of state. The result was positive for Afar, Amhara, Somali and the SNNP, implying lower revenue raising capacity than the national average per capita. Tigray, Oromia, Benshangule-Gumuz, Gambela, Harari, and Dire Dawa designated negative signs, referring a higher revenue raising capacity than the national average. (HoF, 2007:25, Table 2.8). The revenue raising capacity equalization system has rewarded Afar and Somali for their political choice not to levy tax on agricultural income and on land use fee (see HoF, 2007:22 Tables, 2.4).<sup>216</sup> It is paradoxically enough to index the fiscally weak States of Benshangule-Gumuz, and Gambela negative sign as compared to the Amhara and the SNNP.

Literatures provide various methods of measuring revenue raising capacity of states. Macroeconomic variables (state gross domestic product, state income factor (state personal income as indicator) and Representative Tax System (RTS) are the most common ones. The RTS measures states' standard tax rate ( $t_j^*$ ) and standard tax base ( $b_j$ ) (Boadway and Shah, 2009: 358-359).

Despite the 2007 Federal subsidy document claims that the revenue raising capacities of the States were assessed using RTS, it was no longer a RTS, because the fiscal equalization considered actual average revenue collections of 2002-2006. Therefore, in practice the revenue raising equalization measured Effective Tax Yield (ETY) of the States, not the potential revenue capacity, although one cannot say with confidence that the tax assessment book is comprehensive, identifies and registers correctly all and every revenue sources.

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216 These states collect negligible revenues from agricultural income tax and land use fees not only because the States are predominantly pastoral communities but also, in effect, land resource is controlled and managed by clan leaders, not by the Government Agencies. Leasees make deal with clan leaders on how much land use fee to pay and the modality of payment.

The revenue raising equalization has failed to consider states' concurrent revenue sources. It favours to Tigray, Amhara, Oromia, SNNP, Dire Dawa and Harari, which receive relatively higher concurrent yields, as it enables them to get more federal subsidy at the cost of the Emerging states.

Revenue raising ability for one year, six taxes<sub>j</sub> in State<sub>i</sub> could be computed as:

1. 
$$ETY^i = (PIT^i \times t_{PIT}^*) + (BPT^i \times t_{BPT}^*) + (TC^i \times t_{TC}^*) + (VAT^i \times t_{VAT}^*) + (AIT^i \times t_{AIT}^*) + (RLF^i \times t_{RLF}^*)$$
 Equation 8-3
- 2.



[1] Six functional categories<sup>217</sup> of public services were identified for equalization and objective indicators of each functional category were determined.

Determining objective indicators of each functional category helps to quantify the expenditure needs in terms of units of workload. The six major function categories constituted more than 85 percent of the total expenditures needs of the States. The HoF has legislative power to identify the public services that should be equalized. The 2007 expenditure categories are more or less consistent with the Federal Constitution stipulated in Art.90 (1). They are considered as minimum national standard for regional public services.

[2] Average population size (2002-2006) of state<sub>i</sub> was computed.

[3] The expenditure need of each functional category in terms of money using the monetary value of a workload unit of the various indicators was estimated based on actual costs of the 2002-2006 fiscal years. In doing so, disaggregating the production function is important in order to assess with accounting line in each function what attributed to which criteria. Without examining production function of public service<sub>j</sub> for state<sub>i</sub>, the expenditure needs of the States do not reflect the reality. The Consultants designed one formula for each functional category to standardize the expenditure needs of the states.

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<sup>217</sup> It should be noted that Items 6.1, 6.2.3 and 6.3 above are not functions but elements (criteria) that influence certain costs.



**Table 8.6 Expenditure needs equalization of 2007**

	Function	Indicators	Causes of cost differential
1	Agriculture: expenditure need		
1.1	Extension services	No of farm house hold	Rural population size
1.2	Crop development	cultivated land area size	Pop.size engaged in crop cultivation
1.3	Animal Development	No. of animals	Livestock size
1.4	Research, administration and others	simple average of these	
2	Rural water supply expenditure need assessment	Additional rural population served between the current situation and the target for 2011	Rural population size and underground/surface water resource potential
3	Rural Road expenditure need assessment	Potential increase “desirable Road” length in km and road construction unit cost	Geographic terrain,
4	Education expenditure need		
4.1a	Primary education recurrent	Actual primary school enrolment in 2006	Primary school pop. size, economies of scale
4.1b	Primary education capital	No. of primary school age population (7-14 years )who should be enrolled	Primary school pop Size, economies of scale and cost factor

4.2a	Secondary education recurrent expenditure	Actual secondary school enrolment in 2006	Secondary school pop. size and economies of scale
4.2b	Secondary education capital expenditure	50 percent target participation rate of the secondary school age population (15-18),	Secondary school Pop. size economies of scale and cost factor
4.3	Education, Admi, unallocated and other exp.	Share of the young population in State of age 5-24	Population size
5	Health expenditure need		
5.1	Malaria Recurrent Expenditure need	Percentage of population in malaria prone areas in 2005 and, percent of malaria reported cases in 2006	Malaria prone population size
5.2	Health Capital Expenditure	Health service uncovered population	Population size, economies of scale
6	Administration and General services expenditure .need		
6.1	Economies of scale on General administration and services	Administrative expenditures based on the level of Harari serves as benchmark	Government structure, Ethnic-based No. of government tiers,
6.2	Differences in cost Factors		
6.2.1	Wages and salaries	Wage rate to civil servants	Population size
6.2.2	Non-wage recurrent cost (Cost of Fuel)	Average expenditures on benzene and motor oil	Geographic size and distance from the centre

6.2.3	Dispersion and Distance Factors	Cost of transporting materials from the centre (Addis Ababa), cost of travel within, distance, costs of telecommunications within	Economies of scale and distance from the centre
6.2.4	Construction Cost	Eight major inputs of construction	Distance from the centre
6.3	Spill over Effects	15 percent of health and education total expenditures of Harari and Dire Dawa (2006)	

Source: Organized by the author based on the HoF, 2007:25-57. The New Federal Budget Grant Distribution Formula, Addis Ababa, Ethiopia.

Note that the list of expenditure needs of the States in second column of Table 8.4 above were taken from the HoF, 2007 document as they are.

[4]The results of [3] were divided by the average population size of State<sub>i</sub> to arrive at State<sub>i</sub> standardized per capita expenditure need category<sub>j</sub>.

[5] Standardised national expenditure per-capita for each functional category was computed as a ratio of sum of standard States' per-capita for functional category to<sup>218</sup>the sum of all States' population (national population).

[6]Per capita difference for functional category<sub>j</sub> in State<sub>i</sub> was estimated by subtracting the estimated State's standardized expenditure needs [4] from the national average expenditure needs.

[7] The results were positive for some states and negative for others. When [4] > [5] the sign is positive and it means, State<sub>i</sub> has higher per capita need for expenditure categorie<sub>j</sub>, than the national average. When [4] < [5], the sign is negative implying State<sub>i</sub> has below the national average per-capita for expenditure category<sub>j</sub>.

[8] Finally, the values of per-capita differences of all category<sub>j</sub> of State<sub>i</sub> were summed up to determine the aggregated per-capita expenditure need for State<sub>i</sub>. I.e.,  $\sum [6]$ .

The expenditure need assessment resulted in positive sign for Tigray, Afar, Somali, Harari, Gambela, and Dire Dawa, while negative sign for Amhara, Oromia and SNNP (See HoF, 2007:63, Table 3.19).

### **Comments on the 2007's expenditure need equalization**

1. ***The agricultural expenditure needs***-The exclusion of capital expenditure needs for small scale earth dam irrigation development and sustainable land management is correct because these needs are addressed through specific conditional grants.

2 ***The rural water supply expenditure need*** assessment equalized only capital expenditure needs. Ignoring the recurrent expenditure need for rural water supply from equalization was prudent policy as maintenance and operating costs are financed through water fee collections on the benefit-received principle.

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<sup>218</sup> Note this cannot be done for economies of scale, dispersion and distance; spillovers in Table 8.6 above.

However, the expenditure need for water supply did not take into account the cause for construction cost variations (such as surface or ground water potential). It did not also consider the production function of water because States characterized by scattered settlement pattern need more money to provide the minimum quality and quantity of clean water supply service within a standard radius.

3 ***The rural road construction expenditure need*** for State<sub>i</sub> was computed based on (i) the gap between the potential increase in 'desirable' road length and actual road systems of State<sub>i</sub> and, (ii) unit cost of road construction. Standardized road expenditure was calculated by standardizing the total average 2002-2006 expenditure of State<sub>i</sub> by the percentage share of State<sub>i</sub> (HoF, 2007: 32-35). Excluding periodic and routine maintenance expenditure need for rural road in the 2007 RES was a wise decision as the States receive money for these purposes from the Road Fund.

The 2007 RES also excluded intra urban road expenditure need. The logic is that unlike the rural people, urban households have to bear the cost of the service on the benefit-received principle because they have the ability to finance the road capital expenditure need.

Unit cost of road construction for State<sub>i</sub> was based on previous bidders' average price per km data in State<sub>i</sub>. It did not take into account the variation in physical topography<sup>219</sup>. This has created incentive to overstate road construction unit cost.

4 ***The education expenditure needs*** included three sources of expenses, namely (i) recurrent expenditures, (ii) capital expenditure and (iii) education administration, unallocated and other expenditures.

(i) *Recurrent expenditure*- the difference between the actual gross primary education participation rate and a 100 percent target participation rate by 2015 were taken as indicators to compute recurrent expenditure needs for primary education for State<sub>i</sub>.

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219 The unit cost of rural road construction per km was assumed Birr 0.4 million for Tigray, Amhara, Oromia, SNNP, Harari and Dire Dawa; Birr 0.45 million for Benshangul-Gumuz and Gambela and Birr 0.50 for Afar and Somali per Km (HoF, 2007:35).

Per capita recurrent expenditure of secondary education need for State<sub>i</sub> was computed based on 2006 student enrolment rate and corresponding actual expenditure.

(ii) *Capital expenditures*- Capital expenditure need of primary education aimed to equalize the gap between the actual participation rate in 2006 and 100 percent target participation rate by 2015<sup>220</sup>. Annual expenditure per capita was calculated as a ratio of annual expenditure required for additional enrolment for State<sub>i</sub> and average population of 2002-2006 of State<sub>i</sub>.

Capital expenditure needs of secondary education for State<sub>i</sub> aimed to achieve 50 percent target by 2015 against the actual participation rate in 2006. Hence, additional expenditure required to meet 50 percent participation target for State<sub>i</sub> was computed

(iii) Educational administration expenditure need was assumed to be proportional to the share of young population age 5-24 of State<sub>i</sub> (HoF, 2007:47). Despite the fact that educational administration is strongly associated with actual number of enrolled students, the use of the 5-24 age groups in estimating the administration expenditure need is not realistic. It also favours the populous states.

The computation of education expenditure need ignored the cost differential of primary and secondary education delivery that arises due to economies of scale. A state with scattered settlement communities need more school infrastructures and school teachers, supervisors, and administration support staff to deliver standardized education service within the determined benchmarked school distance from residence. Failing to consider the impact of economies of scale in delivering education service understated the expenditure need for primary and secondary education of the scattered settlement States of Afar, Somali, Benshangul-Gumuz and Gambela as well as in the pastoralist communities of Oromia and SNNP.

The education expenditure need also failed to consider the special school needs (schools for visual impaired and deaf), where the numbers

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<sup>220</sup> Note that the document did not clearly define series time frame leads to 100 percent target.

of disabled young people significantly vary across the States. It is also constitutional right to educate.

**5. The health expenditure need** considered only the recurrent expenditure on malaria prevention, control and treatment services because other health services were assumed proportional to the total population of state<sup>221</sup>(HoF, 2007:48). Prevention and control of malaria expenditure need for State<sub>i</sub> was estimated based on population size living in malaria prone areas in 2006, whereas expenditure need for malaria treatment service is a function of the number of malaria cases reported in State<sub>i</sub> in 2006 (HoF, 2007:48).

The logic for equalizing malaria prevention and treatment expenditure need poses question as the states receive a large sum of money from the Global Fund for eradication of malaria via the Ministry of Health.

The assumption of proportionality of health expenditure to population size is also wrong as the dispersedly settlement of states and costs of construction of health institutions are main cause for health cost differentials.

The health expenditure need considered investments required only for construction of Health Posts and Health Centres with the objective to meet 100 percent primary health service coverage by 2015. It ignored the capital investment required for Zonal Hospitals and Regional Referral Hospitals as well as costs of health equipments, although these services are provided below standard in all the States.

**6. The administrations and general service expenditure needs** of the states cannot be uniform across the States due to variations in organizations of the executive body (civil service Agencies), legislative body, and the judiciary body (including police and prisons), number of government tiers, population size, climate, dispersion and location, to mention some. The 2007 RES administration and general service expenditure needs assessment considered the following variables:

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221 The assumption seems to be flawed, because states with same population size may have different health expenditure needs due to difference in population structure (health expenditure per capita for states with more infants, and aged population size might be higher), sex (maternal cost) attitude towards modern health service, and urbanization degree, etc

### ***Economies of Scale***

Densely settlement and populous States may operate at relatively lower per capita administration cost as they can better reap benefit from economies of scale on administration and general service than the scatter settlement and less populous States. Similarly, per capita administrative and general service expenditure in the relatively homogenous States is less than the relatively ethnic diverse States because the latter set more ethnic-based government tiers than the former.

Both the densely populous and scattered populous as well as the relatively homogeneous and the heterogeneous States require some fixed administrative costs to smoothly run public functions, while variable cost for administrative and general service is mainly a function of settlement pattern, degree of heterogeneity and population size of State<sub>i</sub>.

Harari's total expenditure of administration and general services was considered as a fixed cost for state<sub>i</sub>'s administrative and general service expenditure need. The variable cost for administrative and general service was computed as a ratio of percentage of state<sub>i</sub> population size over Harari to total administration and general expenditure of Harari (HoF, 2007:54).

Then total administration and general expenditure of state<sub>i</sub> was computed as summation of the fixed and variable costs of state<sub>i</sub>. Expenditure per capita of state<sub>i</sub> was estimated as a ratio of state<sub>i</sub> total administrative and general service expenditure to state<sub>i</sub> average population. Finally the per capita difference was computed as a difference between the national and state<sub>i</sub>. It can be argued that taking Harari's total expenditure as a bench mark to estimate the fixed cost of state<sub>i</sub> administration and general expense would create an incentive to Harari to expand its administrative and general expenses unnecessarily (Kirchgässner, 2008: 13). The 2007 RES ignored administration costs related to Zones/Special Wereda and Wereda Governments peculiar to ethnic diverse States.



### ***Differences in cost factors***

**(i). Wages and salaries** –at present, wages and salaries to public servants are not sources of cost differential among the States as the States apply uniform salary scale. Wages and salaries are mentioned in the 2007 equalization document, presumably, to enlighten the readers/decision makers that the labour cost factor was in the minds of the consultants.

**(ii). Non-wage recurrent cost-** The 2007 RES considered fuel cost variation across the states. Prices of benzene and motor-oil were taken into account. Cost of diesel was not included due to lack of reliable data (HoF, 2007:56) although it is a substantial cost of the States.<sup>222</sup>

Consideration of fuel cost variation in the equalization is appropriate because it crowds-out recurrent and capital budget of the remote States, albeit the fuel expenditure needs of State; failed to take into account the geographical size of the states.

***Dispersion and distance Factors-*** Costs of some public services delivery are sensitive to minimum threshold. For example, rural areas and urban centres, or pastoral and sedentary settlements cannot have same production function for identical public services. Those States which are characterized by scattered settlements are compelled to provide the same quantity and quality of public services to their residents at higher per capita expenditure, because they yield less benefit or none from economies of scale.

Distance from the centre is also a source of cost differential among the States. Cost of travelling to supervise performances within a State, travelling to and from the centre (Addis Ababa) to attend frequent nationwide meetings, conferences and short-term training, and transportation cost for moving materials from the centre crowd out the capital expenditure of the periphery states. Therefore, population densities and geographical sizes of the States were taken as proxy to estimate the cost difference of State; due to dispersion and distance (HoF, 2007:58).

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<sup>222</sup> Prices of fuel increase with distance from the Ethio-Djibouti border..

**Construction cost variations-** Unit costs of public investment (construction of schools, health institutions, water reservoir and administration buildings, etc) vary significantly from State to State. This is associated with variation in price of construction materials and cost of mobilization. In order to address the impact of price differences on cost of public investment, eight major construction materials<sup>223</sup> were considered and construction cost index of the inputs were computed for State, (HoF, 2007:59-60).

#### ***Spill over effect***

The expenditure need assessment compensate 15 percent of Harari's and Dire Dawa public spending on education and health for the positive spill over effect they have produced to the residents of neighbouring States of Somali and Oromia (HoF, 2007:61).

From the efficiency point of view, equalizing spill over effects has negative impacts. First, it develops free riding behaviour among the beneficiary States. Second, it is unjust as the cost is born by the other States. Horizontal compensation would have been the appropriate method of compensation. Third, the practice poses questions: how are the effects of spill over effects measured? Who estimated the spill over effects? And how much of the cost does the compensation covers?

### **8.3.2 Assessment of the 2009 fiscal-gap equalization**

#### **The Revenue Raising Capacity Equalization**

The 2009 revenue raising capacity equalization included seven revenue sources which captured about 80 percent of the States' own-revenue source.

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<sup>223</sup> Cost of cement, corrugated iron sheet, nails with cape, wood, wall paints, hollow concret block, iron pipe and chip wood were considered ( HoF, 2007:59).

**Table 8.7. Revenue sources considered and their Contributions in the 2009 Revenue raising equalization**

Tax base in the ETY 2009	Proportion in total revenue (2005-2007average)
Personal income tax	36.2
Business profit tax	17.8
Agricultural income tax	2.9
Rural land user fee	4.2
Value Added Tax (VAT)	18.3
Turn over tax(TOT)	NA
Fees from medical supplies and treatment	NA
Total	79.4

Source: HoF, 2009 The Federal Budget grant distribution formula

The 2009 revenue raising capacity measures ETY of State<sub>i</sub> by taking several assumptions. Brief review is made for each revenue source.

**[I] Personal income tax-** per capita of State<sub>i</sub> was computed on the actual average revenue collection of state<sub>i</sub> in 2005-2007.

**[II] Business profit tax (BPT)-**Availability of robust data on socio-economic variables is scant in Ethiopia. Data on states' PIT and VAT are not exception. Thus, states' ETY of BPT was assessed based on the following assumptions.

(a) Revenues from wholesale enterprises, retail enterprises, service enterprises and small scale firms were assumed as the tax bases of BPT.

(b) 10 percent profit margin on wholesale enterprises, retail enterprises, service enterprises and small scale manufacturing was assumed at national and state levels.

(c) 10 percent States' business profit from each business activity (wholesale enterprises, retail enterprises, service enterprises and small scale firms) was computed based on State's share of enterprises to the national total number of enterprises.

(d) State's total business profit was calculated by adding up the 10 percent profit margins of sales made on all business activities (whole sale enterprises, retail enterprises, service enterprises and small scale manufacturing) (HoF, 2009:17-19)

(e) A "representative tax rate" of business profit tax was calculated as a ratio of average national revenue from business tax (2005-2007) to total States' 10 percent business profit on national sales. The "representative tax rate" was computed to be 14 percent

(f) Finally, business profit tax "potential" of State<sub>i</sub> was computed as a product of "representative" business profit tax rate (14 percent) and the States' total business profit tax (total 10 percent business profit tax generated from all business enterprises) (HoF; 2009:19, Table 4.15).

### **[III] Agricultural income tax**

"Potential" agricultural income tax of the States was computed:

(a) Agricultural land size categories in hectare by number of land holders in each State were set.

(b) Tax rates by category of land size of the States were examined and the lowest tax rate in the national tax rate schedule per hectare was taken as the standard tax rate.

(c) States' ETY on agricultural income tax was estimated as a product of number of total land holders and the standard tax rate (HoF, 2009:15-16).

**[IV] Land use fee-** Same approach and procedures were applied in the computation of the ETY agricultural income tax (HoF, 2009:16-17).

### **[V] Value Added Tax-**

To estimate the VAT revenue raising capacity of State<sub>i</sub>, actual VAT collection from wholesale enterprises, retail enterprises, service enterprises and small scale firms were added up and then multiplied by the nationally applicable 15 percent rate (HoF, 2009:21-22).

### **[VI] Turn over tax (ToT)-**

Revenue raising capacity of State<sub>i</sub> from TOT was computed by (I), assuming 10 percent profit margin on small scale business activities, and (II) applying the nationally 2 percent tax rate for sales of goods and 10 percent tax rates for sales of service (HoF, 2009:19-21).

**[VII] Medical Supplies and Treatment Fees (MST)** –are collections made from patients on benefit–received principle. Number of patients who visited public health institutions during the last two months of 2004 was considered as the tax base for medical supplies and treatment fees. ‘Representative’ tax rate was computed by dividing total actual revenue collected from health services provided during 2005-2007 to total number of people who received public health service same period. Finally, revenue raising capacity of State, from medical supplies and treatment was calculated by multiplying the tax base to the ‘representative’ tax rate (HoF, 2009:22-23).

#### ***Assessment of the revenue raising capacity***

The 2009 RTS excluded ‘chat’ tax without explanation but included ToT and fees from medical supplies and treatment. There is no official explanation why ‘chat’<sup>224</sup> was disregarded in the 2009 revenue equalization despite it is a significant source of revenue for Oromia, SNNP, and Harari. It will be a potential revenue source for Dire Dawa, Somali, Afar, and Amhara if they properly administer it. The consideration of ToT is justifiable as it is an emerging revenue source to the States.

Comparing Table 8.5 to Table 8.7 above, one may observe that the choice for which revenue source needs to include in or to exclude from the RTS calculation seems to be determined partly on subjective judgment of the Consultant Teams who were involved in designing the 2007 and 2009 fiscal gap equalizations and partly on the result of political bargaining as the availability of robust statistical data are so scant in Ethiopia.

The consideration of medical supplies and treatment fee in the revenue equalization negates the principle of benefit-received principle.

#### ***The Expenditure Need Equalization***

One finds visible similarities with some differences between the lists of the 2007 and 2009 functional categories. Functional categories 1 to 5 are almost the same, with minor differences in functional categories 4.3 and 5. Element of Item 6 of 2009 was quite different from item 6 of 2007 expenditure need category. Item 7 and 8 are new functions.

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<sup>224</sup>Chat tax is imposed on domestic consumption. It is a State tax power but has been administrated by the Federal Government.

**Table 8.8. Expenditure needs equalization of 2009**

S.N	Function	Indicators	Disability factor
1	Agriculture and Natural resource	No of rural households,	Rural number of population
		area of land cultivated, in hectares,	Rural household Population engaged in crop cultivation
		tropical livestock units,	Livestock size
		inverse of population density	
2	Provision of clean water Rural	Rural people target access to water in 2010(15 liters of water per day within 1.5 km ) and maintenance cost	Rural population size, economies of scale, ground/surface water resources potential
3	Rural Road	Proportion of new road construction and maintenance cost of a State.	Geographical terrain, economies of scale
4	Education		
4.1a	Primary education recurrent exp.	No. of students enrolled.	Primary school population age size
4.1b	Primary education capital exp.	Primary school age population (7 to 14), (100 percent target).	Primary school population age size
4.2a	Secondary education. recurrent expenditure	No. of students enrolled.	Secondary school population age size
4.2b	Secondary Education Capital	25% targeted participation rate of	Secondary school population age size

	Expenditure.	the secondary school age population (15 - 18).	
4.3	Text Book Development	No. of languages used in grade 1-4 and total text books (subjects)	Ethnic composition of a state, pupil population size, cost of publishing books
5	Public health		
5.1	Treatment related expenditure need	No. of ill people who visited health institutions, and the ratio of poor people who received treatment	Population size
5.2	Health Extension Program	No. of Health Extension Workers (HEW), and guards, Training cost of HEW,	Population size, economies of scale,
6	Administration and General Service		
6.1a	Expenditure need for hardship allowance	No. of Weredas with degrees of hardship allowance (20%, 30% and 40%), No. of civil servants working in hardship allowance Weredas, and their salaries in 1999.	Climate variation,
6.1b	Expenditure needs for extreme weather conditions	No indicator was applied. *	Climate variation

<b>6.2</b>	Expenditure need for Special Zones and regional level NNP federations	Organs of State level NNP Council, and No. of Constitutional Zones/Special Wereda Administrations	Ethnic composition of states
<b>6.3</b>	Cross-border related expenditures	Ratio of expenditure on cross-border conflict to justice and security in 1999	cross border conflict prone weredas
<b>7</b>	Micro and Small Scale Enterprises Development	No of average urban unemployed people in 2003-2005	Cost of creating job per person, urban population size
<b>8</b>	Urban Works and Development	No. of urban population	Unit cost of Urban population

Source-Organized by the author based on HoF, 2009: 24-40. The Federal Budget Grant Distribution Formula, Addis Ababa

\*The consultant Team accounted for air conditioning and 1000 offices for ventilation for only 10 Regional Bureaus of Afar, Benshangul-Gumuz, Gambela and Dire Dawa. In addition, costs of 20 refrigerators to each hardship Wereda were used.

The expenditure needs of each functional category (sector) of state<sub>i</sub> were added up to get the total expenditure need estimation. In order to account for price differences and remoteness, 60 percent of it was multiplied by the adjusted price index (HoF: 2009:40). The result gives the expenditure need of the state<sub>i</sub>. Then, revenue raising capacity of the state<sub>i</sub> was subtracted from its corresponding expenditure need to arrive the fiscal gap of State<sub>i</sub>. Finally, percentage share of each state from the total resource pool was determined as a ratio of state<sub>i</sub> fiscal- gap to total average population of State<sub>i</sub>.



## Comments on the expenditure need of 2009

[1] ***The Rural water supply expenditure need*** equalized both capital cost and maintenance cost for rural and urban water supply services (HoF, 2009:35). The political choice to equalize the capital expenditure need for the provision of rural water supply is sound partly because the service is strongly associated with primary health, girls' school participation, and women's participation in local decision making process, and partly currently the rural population are not in a position to cover the entire capital investment through benefit-received principle. However, equalization of capital cost and maintenance cost for the urban water supply as well as the cost of maintenance for the rural water supply is not convincing for a couple of reasons: First, the urban beneficiaries pay user fees for the provision of water service based on benefit-received principle, and second, water point beneficiaries in the rural area pay monthly a fixed amount of money designed for the purpose of operational expense and maintenance cost.

[2] ***The rural road expenditure needs-*** equalized rural road construction cost as well as periodic and routine maintenance costs. It considered road density gap as a difference between the State's targeted road density (45.7 km per 1000 Km<sup>2</sup>) and actual road density km per 1000<sup>2</sup> km in 2008 (HoF, 2009:33). The unit road cost per km for construction and maintenances was based on simple average national data, which did not consider variations in geographic terrain among the state. The failure not to consider cost differential underestimates the expenditure need of the mountainous states. Moreover, there is no logic to equalize the rural road periodic and routine maintenance costs as the States receive road fund for that purpose from the Road Fund Office.

[3] ***Primary and secondary education expenditure needs-*** the consideration of States' text books development expenditure need in the 2009 is positive because it not only enhances development skill of the teaching-learning process of primary school students, but is also a vital instrument to maintain and develop own language. Nevertheless, the text books development expenditure need assessment took into account only the existing languages being used as medium of instruction. It failed to consider the states' need to introduce new languages as medium of

instruction. For example, in the SNNP, there are about 56 ethnic groups, but the text book development expenditure needs considered only 13 languages. Without considering the expenditure needs for the development of text book for all languages, how can the SNNP deliver the service then?

**[4] *Health expenditure needs*** failed to take into account capital expenditure needs although there is visible disparity among the States in Health Centre and hospital level health services among the States.

**[5] *Administration and general service expenditure needs***

This function considered various variables. The 2009 RES estimated fixed cost of administrative and general expenses of each State to be Birr 65.2 million. Total variable cost was estimated 24 times State population size of 2000.<sup>225</sup> Thus, total administrative cost of state was computed by adding the fixed cost of administrative (Birr 65.2 million) and total variable cost. General Service expenditure needs consider the following expenses.

**[5.1] *Administration cost of Ethnic-based Zones, Special Weredas and State HoF***

States' executive organs are not uniformly structured across the states. The heterogeneous States have more executive agencies, more legislators and more levels of government than the relatively homogeneous ones. Besides, the SNNP, Gambela and Harari are bicameral legislation bodies. The heterogeneous States need more money to exercise their right to self administration at State, Zone, or Special Wereda or Wereda levels of government. In line with this spirit, the 2009 considered total actual expenditures allocated for running Zone/Special *Wereda*, and NNP Council of the SNNP as benchmark expenditures. Birr 3.5 million running cost per Zone/Special *Wereda* per annum was estimated as fixed administration cost for an ethnic based Zone/Special *Wereda*. Hence, total expenditure needs of a State for running Zone/Special Wereda or Nationality Zone Administrations were computed as a product of the fixed cost and number of Zone /Special

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225The regression based analysis of fixed and variable costs were found to have strong correlation between the administrative and general expenditure needs of the States and their population size,  $R^2 = 0.865$  (HoF, 2009:25).

Wereda or Nationality Administration of a State. In addition, administration and general service expense for running NNP Council (upper house in the multi-ethnic States) was taken into account. Total administrative expense for NNP Council of SNNP was estimated Birr 4.7 million. For the NNP Council of Gambela, half of SNNP (Birr 2.35 million) was assumed (HoF, 2009: 26 and 30).

The consideration of administration cost of ethnic based self government can be seen as a positive measure, as it enables the ethnically diverse States get additional money. However, it has some limitations. First, it is discriminatory. It did not treat the States equally as the assessment benefited the States of SNNP, and Amhara only. There is no rationale to exclude Benshangule-Gumuz, and Gambela which have three ethnic based Zone Administrations. There is no convincing reason to exclude Harari which is a bicameral like the SNNP and Gambela. Second, it takes actual administrative and general expenses of Zone, Special *Wereda* and NNP Council of the SNNP as a benchmark without measuring the workload of each activity. Such a system develops incentive to expand administration expenses of the beneficiary States.

#### ***[5.2] Hardship allowance and extreme weather condition***

Unlike the 2007 RES, the 2009 considered expenditure needs for hardship allowance of the states. All States except Harari and Dire Dawa provide hardship allowance benefits, ranging from 20 percent to 40 percent of gross salary, to their civil servants who work in *Weredas* designated as climatically harsh areas. Thus, hardship allowance expenditure needs is a function of degree of hardship of working area, number of civil servants of a State who work in climatically hardship areas, and gross salary of employees who are paid hardship allowance.

The 2009 RES also considered state's expenditure needs for air conditioner, ventilation and refrigerator in climatic harsh *Weredas*. However, the need assessments were subjectively determined. It was discriminatory, because the need assessments for air conditioner and ventilator were limited to Afar, Benshangul-Gumuz, Gambela and Dire Dawa only (HoF, 2009:29) rather than selecting eligible *weredas* based on objective indicator like temperature level. The expenditure need for refrigerator in harsh climate *Weredas* were not also assessed based on need. Only 20 refrigerators per hardship *weredas* were considered.

### ***[5.3] Cross-border conflict related expenditures***

For reasons of economies of scale and spill over effect, the responsibility of cross border related tasks are reserved to the Federal Government. All the States except Hareri and Dire Dawa have engaged in maintaining peace and order associated with international cross-border conflicts. Because in a situation where identity based mobilization is easy, strong and effective, to sporadic ethnic nature guerrilla warfare calls for active involvement of the concerned State and LG. The States, through their local government agencies, play vital role in maintaining local security and gathering intelligence about the movements of infiltrators. However, these tasks have drained their public money. The burden is heavier in Tigray, Somali, Afar and Oromia.

The cross-border conflict expenditure need was estimated in the following ways: first ratio of cross-border conflict was measured by dividing state<sub>i</sub> reported expenditure for cross-border conflict in 2006/7 to actual expenditure on justice and security for the same year. Then the ratio was adjusted to national average. Finally, the adjusted ratio was multiplied by actual expenditure on justice and security in 2006/7 (HoF, 2009: 26-27).

The computation of cross-border conflict expenditure need creates incentive to manipulate the figure as it was based on the states' reported expenditure on cross border conflict. One may also challenge the wisdom of addressing the cross-border related security expenditure needs of the States in the fiscal equalization formula rather than a specific grant.

### ***[6] Micro and Small Enterprise (MSE) Development***

Since 2005 the States have aggressively engaged in micro and small scale development with the objective to (i) reduce urban/rural poverty, (ii) create employment to the youth and women, and (iii) enhance local economic development. The States/LGs organize unemployed citizens in business associations or PLC on voluntarily basis, provide short-term training, facilitate access to loan for the unemployed nationals from micro financial institutions, and create marketing link with government agencies.

The 2009 RES equalized states' expenditure need of MSE development. Three years average urban unemployment rate (2003-2005), urban population size in 2002, and average unit cost of creating

job to an unemployed person were used as proxy indicators. Expenditure need for MSE development of the States was computed by multiplying average cost of creating job per person (Birrr116.00) and size of urban unemployed population in 2000 (HoF, 2009:39).

In a situation where reliable data on unemployed population is hardly available, equalizing MSE development favours the relatively urbanized states and it is easy to manipulate the data<sup>226</sup>. The objective of MSE development would have created more incentives had it been treated through a matching conditional grant rather than equalization.

#### **[7] Urban Works and Development Expenditure Need Assessment-**

The States/LGs engage in construction of condominiums, cobble stones and drainage network to meet couple of objectives: (i) to significantly alleviate housing problem in the urban centres and, (ii) to create job and foster entrepreneurship skill through integrating the housing development program with MSE development. Urban population in 2000 and unit cost of housing and urban facilities were taken into account. States' expenditure need for urban work and development was estimated by multiplying average unit cost of housing and urban facilities per urban person by total urban population 2007/8 (HoF, 2009: 40).

The Urban works and development program is a cost recovery scheme. The States borrow seed money from federally-owned banks to undertake construction of condominiums and then they transfer this debt to those who buy the condominiums. Therefore, the wisdom of considering urban works and development expenditure need in the equalization system is questionable. It creates two problems. One, it develops incentives to raise unit cost of providing housing. Two, it takes the entire urban population in its calculation even those who already own a residential house. The formula favours the relatively urbanized States at the cost of the less urbanized one.

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<sup>226</sup> Large part of unemployed people do not have incentive to visit Labour Offices and register for seeking job for couple of reasons. First there is no unemployment benefit system. Second, employers invite job applicants often through advertizing on news papers or through personal relations.

## 8.4 Conclusion

The intergovernmental transfers are designed to provide minimum standard basic public services across the States, to close vertical fiscal gaps, and to address horizontal fiscal disparities. Transfers to correct inter jurisdictional externality are not respected or wrongly designed. The sources of the Federal subsidy/ fiscal equalization derive from Federal treasury and external sources (loans and assistances).

The intergovernmental transfer system contains various elements. The Federal transfers (unconditional, conditional and Road Fund), wereda block grant and Kebele block grant. The transfer system is dominated by unconditional grant. This has both positive and negative impacts. On the one hand, it gives to the States and LGs budget discretion authority. On the other, it has created disincentive to exert more tax effort. The Federal subsidies which are derived from Federal treasury are stable, predictable and certain (received regularly), but the external sources (loan and assistance) are less predictable and are not paid on time. The Federal conditional grant is channelled through Line Ministries to achieve national goals. Conditional grants are mainly derived from external sources. They are uncertain and unpredictable.

The HoF has introduced a fiscal equalization transfer system that fills up the gap between the revenue raising capacity and expenditure needs of the States. The expenditure needs and fiscal capacity are fully equalized. Such a political choice, however, has inherent disincentive problem.

The Federal subsidy (both the socioeconomic variable formula and the fiscal equalization) is characterized by a highly centralized distribution of transfer. That is, the size of Federal transfer is determined by the HoPR on ad-hoc basis every year. There is no legal framework that guarantees a minimum or floor Federal transfer to the States. Neither the States nor the HoF has any legal right to negotiate with the Federal Government on the size and composition of the Federal transfer. The Federal Government allocates Federal subsidy to the States after it allocates recurrent and capital expenditures for itself. The Federal subsidy pool size depends on internal and external factors such as volume of Federal domestic revenue collection, Federal Government's

Five Year socio-economic development plan, and the availability of external loans and assistances.

The fiscal-gap equalization has been introduced to address the shortcomings of the socio-economic based formula and to enable the States to provide comparable public services at comparable tax efforts. The 2007 and 2009 fiscal equalization arrangements equalized about 80 percent of the revenue sources and the expenditure need. The fiscal equalization system is not immune from technical and conceptual problems, however.

**[A] The fiscal equalization used incorrect expenditure need indicators.**

One might ask the wisdom of equalizing the following expenditure needs:

- (i).the prevention and treatment of malaria in the 2007;
- (ii).the maintenance costs for rural water supply in 2007;
- (iii).the capital cost and maintenance costs for urban water supply in 2009;
- (iv).the routine and periodic road maintenance costs in the 2009 (rural and urban road);
- (v).the cost of cross- border related conflicts;
- (vi).The inclusion of Education and health expenditures of Harari and Dire Dawa in the equalization;
- (vii).the MSE development and;
- (viii).the Urban Work and Development.

The states have received money from the Global Initiative Fund<sup>227</sup> in the form of conditional grant to prevent, control and treatment of malaria. The equalization of the maintenance costs for rural water supply in 2007; as well as the capital cost and maintenance costs for urban water supply in 2009 create inefficient allocation of resources. They should have been financed by users on benefit- received principle basis. One might also criticize the inclusion of routine and periodic rural road maintenance costs in the 2009 RES as the States receive money from the

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<sup>227</sup> Global fund finances malaria and TB eradication, and reduce HIV/AIDS programs.

Road Fund for such purposes based on the length of the rural road they have. The cooperation of the state with the Federal Government in cross border conflict activities could have been treated through conditional grant. The Federal Government and the concerned State could sit together in a round table and separate the tasks and roles of the states/LGs determine budget requirement to carry out the task, revisit periodically the cost elements and reach an agreement on cost reimbursement for the cross-border services rendered by the States.

The equalization of Harari's and Dire Dawa's education and health services contradicts with the well established theory of intergovernmental transfer. The practice develops free riding behaviour. The compensation mechanism should have been born by the beneficiary States of Oromia and Somali rather than correcting the spill over effect through fiscal equalization.

There is no logical argument to treat MSE development as well as urban works and development expenditure categories in the fiscal need equalization system. Matching conditional grants would have been appropriate mechanism to deal with.

## **[B] The fiscal equalization system promotes disincentive**

### ***Re-revenue Raising Capacity equalization***

The introduction of fiscal equalization has avoided the problem of disincentive that had been caused due to the Federal subsidy netting mechanism. This is by no means to say that the new fiscal equalization system encourages tax effort. The 100 percent revenue raising capacity equalizations does not give incentive to exert more tax effort as the system does not estimate potential revenue capacity of the states but actual collections.

In effect, ETY is applied, which means that neither the difference between the potential tax revenue and the effective revenue, nor the difference between the tax bill and the effective payments are taken into consideration. So if State<sub>i</sub> has a potential of 100, but bill only 80 because of its inability to mobilise the total tax base, and then cash only 70 because of mismanagement, then 70 only are considered. Then, the state will gain the total difference between 70 and whatever the national



average could be. Thus the revenue raising capacity equalization does not sanction laziness in matter of taxation. A “lazy” state in any case obtains a revenue equalization that corresponds to the national average.<sup>228</sup>

### ***Re-expenditure Needs Equalization***

The full equalization system has also created incentive to increase public spending. The states establish unnecessary government structures. For example, they establish the same executive structures at Zone and Wereda levels parallel to respective State. Since the average per capita expenditure per function serves as a reference, the states have interest to push as much as possible for higher standards in those functions because: (i) the large part of their budget is paid by federal transfers—so the financial consequences of higher standards are supported by the centre; (ii) what is not covered by own revenue are made up by the equalization system, at least, for all states that are below average. So the incentive to push for a higher standard is real. It develops the common pool problem: it is almost a free lunch since each state has an egoistic rationale to get more than its “fair” share—payment is vertically externalized. These two reasons are structural.

## **[C] Technical problems**

### ***Re-expenditure needs equalization***

The road expenditure need assessment has technical problem because it failed to consider the impact of physical topography difference among the States on the expenditure need for road construction of the States. The rural water supply also does not take into account the cost

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<sup>228</sup> For instance, the system rewards Afar and Somali for their choice not to impose tax on agricultural income and rural land use. It is understandable that rural land use fee is not conducive tax base in the predominantly pastoral States of Afar, Somali, Borena of Oromia and Omotic of the SNNP. Nevertheless, it could be substituted by livestock tax.

differential due to water resources potential (surface and underground) variation of the states.

The IGT system conceals the inter-jurisdictional externality effects. If there is at all, it wrongly addresses through unconditional transfers. Failing to address the externality effect creates disincentive to allocate more budget on the sector.

### **[D] Failure to design hardship fund**

The shift from socio-economic variable based formula to fiscal gap equalization has resulted in winners and losers. The fiscal equalizations have made losers the less populous States in general and Gambela and Benshangul-Gumuz in particular. They receive a lower share of equalization entitlement as compared to the socio-economic variables based formula. It caused them to face severe financial stress to the extent they become unable to finance their recurrent budget needs, let alone to finance the work-in-progress capital projects or to undertake new capital investments.<sup>229</sup> Although the adverse effect of the 2007 fiscal equalization on some states was known, it failed to design a hardship fund for a transition period.

Understanding the severity of the problem, the designers of the 2009 fiscal equalization proposed one percent of Federal subsidy additional payments for the Emerging States. The relatively advanced four States, Harari and Dire Dawa expressed their willingness to give 1 percent of the total Federal Government equalization pool to the Emerging states (HoF, 2009:45). This is something that should be appreciated. It is unique symbol of expressing solidarity. The fund serves as hardship fund to the recipient states, which are severely disadvantaged by the introduction of the new transfer formula; it is akin to horizontal equalization or at least brotherhood<sup>230</sup>.

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229 My discussion with Head of Planning and Programming of the Ethiopia Road Authority revealed that the Authority was ordered by the Prime Minister Office to finance the in-progress intra state rural road projects in Gambela as the State was unable to effect payments to road contractors as per the agreement entered previously.

230 The willingness of the states to give 1 percent from their equalization entitlement can be cited as a unique expression of solidarity. One may argue that it is not made

## **[E] Equity concern: rhetoric or reality?**

As discussed earlier, no State was happy with the variables and weights assigned to the socio-economic based formula. Each State was demanding incorporation of variable(s) that would maximize its Federal subsidy entitlement. The less populous states felt that the higher weight assignment to population distorted the distribution of national cake in favour of the populous states. To address the problem, the HoF has introduced the fiscal-gap equalization. Paradoxically enough, the fiscal-gap equalization system has exhibited less equitable than the socio-economic based formula. The Federal subsidy standard deviations show 8.58 and 10.69 for 1994/5 and 2003/4 respectively. In contrast, it is 11.73 for 2007 and 10.83 for 2009 fiscal gap equalization (see Appendix 7.B), showing worsening inequality of Federal subsidy distribution among the States. Taking into account the solidarity fund of the 2009, the Federal subsidy standard deviation was reduced to 10.59, which is close to the standard deviation of the 2003/4 Federal subsidy. According to the standard deviation values, the 2007 fiscal equalization was found the most unequal Federal subsidy allocation ever seen.

Therefore, shifting from the socio-economic variables to the fiscal equalization without consideration of a solidarity fund, did not bring about better equitable distribution of Federal subsidy as it was intended to achieve. Rather it has made the less populated States fiscally starved than ever before. The 2007 fiscal equalization had resulted in shifting national resource from the less populated and fiscally weak States to the populous States of Oromia, Amhara, and SNNP which have better economic base and institutional capacity to mobilize better revenue than the Emerging States. The equalization system has narrowed the per capita distribution among the states at the cost of the small populous states without scrutinizing the causes of cost differentials among the states.

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between same level of jurisdiction but vertical. But one has to understand that it is the states money voluntarily endorsed to be given to their counterparts which are severely disadvantaged by the introduction of the fiscal equalization.



States/LGs are eager to borrow but reluctant to payback their debt either through raising tax /inventing new tax bases or setting the right user charges. They would rather develop strategic behaviors to pass their debt burden to a higher level of government, to secure bail-out policies or postpone the cost to the future generation. Therefore, borrowing should be evaluated from its impact on macroeconomic stability, inter-generational equity, and efficiency.

The Chapter is organized into three sections. Should borrowing right be limited to finance capital investment only or should it open to finance recurrent budget too? The purpose of borrowing, source of credit, how much to borrow, when to borrow and who should bear the debt burden, etc... are points of debate among public finance economists and decision makers. The first section, therefore, discusses on these issues. Section two examines the legal framework of borrowing and purposes referring to the Federal Constitution and other pertinent proclamations. The natures of balanced budget, and requirement/ rule are also discussed. The last section assesses the practice of borrowing in Ethiopia.

### **9.1 The ‘Revisited golden-rule’**

The ‘revisited golden-rule’ answers, at least, two core standing questions: Should states and LGs have freedom to borrow for financing current expenditure or should borrowing restricted for capital investments only? Should a long-term investment be financed by borrowing (pay-as-you-use) or from current revenues (pay-as-you-go)? Unlike the classic ‘golden rule’, the ‘revisited golden rule’ distinguishes between current and capital budget<sup>231</sup>.’ For the classical golden rule, balanced budget would mean the total equilibrium between public

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231 Current budget refers to spending for public service that are consumed within a budget year (salary, administrative costs, operation expenses including interest, depreciation, etc), whereas a capital budget is public spending on investments that yields service for more than a year.

expenditures (current and capital) and monetary revenues from taxation. It emphasized maintaining a balanced budget for equity and efficiency without differentiation of current and capital budget (Dafflon, 2010). But, with time, considering balancing the budget which contains in block current and investment expenditures on one side against taxation on the other revealed too restrictive in order to undertake capital investment. Thus, the “pay-as-you-use” concept, developed by Musgrave, has challenged the freedom of states/LGs to operate at deficit on current budget and filling the gap through borrowing.

The conventional wisdom and the content of the ‘revisited golden-rule’ prescribe:

- [A] Governments should run at balanced current expenditure,
- [B] Borrowing should be allowed to finance capital expenditure only (Musgrave and Musgrave, 1976; King, 1984, Denison and Hackbart, 2006:316; Dafflon, 2010);
- [C] Interest and amortization expenses are recurrent expenditures and they have to be paid out of current budget (Dafflon, 2010).<sup>232</sup>
- [D] Maintenance costs of the new investment and functional costs must be incorporated in the future current budget (Dafflon, 2010).

The rationales behind the contemporary ‘golden-rule’ revolve around the benefit-received principle, inter-generational equity, efficiency, distribution and macroeconomic consideration (King, 1984; Rosen and Gayer, 2008:472-473; Dafflon, 2010;).

The benefit-received principle implies that consumers of a certain public service have to internalize the cost of the benefits they receive through tax or user charge. The inter-generational equity argument asserts that the burden and benefits of long-term capital investments should be spread out between the present and future generations.

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232 Dafflon (2010) in his article “Local debt: from budget responsibility to fiscal discipline” revisited the ‘golden-rule’ and links the classic ‘golden-rule’ for a balanced budget with Musgrave’s “pay-as-you-use” principle.

Allowing governments to finance their current expenditures from borrowing mean passing debt burden to the future generation without any additional physical asset. It would also imply maximizing current consumption by inheriting polluted environment to the future generation. Financing capital investments by imposing higher taxes or user charge on the current generation only is equally imprudent policy because the future generation will enjoy consuming public service without paying for the benefit. Designing the financing modality of a capital project in a way to be paid by beneficiaries over the life period of the project through taxes or directly user charges is necessary. Thus, spreading out the cost and benefits of capital investments over generations is prudent for the reason of inter-generational equity and the benefit-received principle.

The efficiency argument is associated with matching politicians' decisions with preferences of tax payers and beneficiaries. In other words, granting state/LGs the right to borrow limited to capital expenditure only upholds politicians' accountability for their tax and expenditure policy decisions. The issue of efficiency also implies identifying the most economic modality of financing a capital investment (borrowing vs. tax). According to Rosen and Gayer (2008: 473), financing capital projects from borrowing with small tax rate is more efficient than through taxing. They further argue that when domestic borrowing crowds-out private investment, financing a capital project through tax or user charges is more efficient than borrowing. Also, allocative efficiency is satisfied when at the time of decision for an investment financed through borrowing, [C] and [D] above are taken into consideration and recounted at the moment of decision to guarantee that future current budget can support the new expenditure. This corresponds to inter-temporal accountability of politicians.

Whenever there is an intention to finance public investment through borrowing, analyzing its impact on macroeconomic stability is necessary

too. Governments face serious fiscal stress during economic recession. The problem is more severe in the absence of “rainy day funds”. Injecting public fund through borrowing during economic turn down to stimulate the macroeconomic environment may increase output, income and employment. But it should be noted that timing is very critical because continuing or excessive expansionary fiscal policy “when it is no longer required” will cause unintended consequence such as inflation (Rosen and Gayer, 2008: 473).

**Source of loan**-Governments may borrow to finance long term capital expenditures either from domestic or external financial institutions or from both sources. There is a general understanding among economists that financing government budget deficit from domestic borrowing would ‘crowd-out’ private investment. The private sector will compete with the public sector for the scarce capital resource and will be compelled to bid at a higher interest rate that makes investment more costly. This, in turn, may raise inflation rate.<sup>233</sup>

Experiences on the purpose of borrowing and sources of credit vary among federations. For instance, Canadian Provinces are not required to balance their current budget. LGs borrow from domestic as well as from abroad without the interference of the Federal Government (Krelove, Stotsky, and Vehom, 1997: 221), while Swiss Cantons and Communes have to operate on balanced current budget and can mobilize fund even from external sources but for investment purpose only (Spahn and Fötting, 1997: 334). The states and LGs in the USA are also restricted by law to operate at balanced current budget. They have freedom to borrow from both domestic and abroad to finance long term investments, to subsidize private industries and to meet short-term cash flow needs<sup>234</sup>

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233 The argument will be convincing when the lending institutions face a problem of cash liquidity.

234 Here a word of caution is in order. When states borrow to subsidize private industries, the rule is same. They must meet the requirement of running balanced



(Stotsky and Sunley, 1997; Rosen and Gayer, 2008: 474). Moreover, the Stability and Growth Pact (SGP) of the Maastricht Treaty, considers the 'golden rule' although it is not respected by all EURO-Zone members.

**Debt ceiling (debt limit)**-There is no golden rule how much debt ceiling and public indebtedness of a state/LG should be. In principle, a state/LG must have unlimited freedom to borrow for capital investment "as long as the current budget can support the debt service and amortization" (Dafflon, 2010:8). But, unlimited debt may give incentive to politicians to maximize their political rent seeking behaviors by rolling over loans or putting citizens in a vicious circle of debt. In order to avoid such a risk, governments set debt ceiling rule either on their constitution or statutory, or apply rule of the thumb or exercise informal to control SNGs to behave in budget discipline (Denison and Hackbart, 2006, Dafflon, 2010:11). Thus, the legal rule for debt ceiling would be to require that [C] and [D] (above) future cost be calculated at the moment of deciding the investment and the discounted sum could be supported in the current budget in balance.

Governments may finance their additional investment need  $[\Delta I]$  either by mobilizing additional borrowing  $[\Delta B]$  or from own revenue, or from grant and donations from domestic and/or abroad) what Dafflon (2010) calls [F] or combinations of various source options.

$$\text{i.e., } [\Delta I] = [\Delta B] + F \quad \text{Equation 9-1}$$

According to Dafflon (2010: 6) the general debt ceiling formula for a state/LG can be expressed as:

- and foreign grants-in-aid, donations).
- S net savings on the current account (according to the European System of National and Regional Accounts)
- M maintenance costs in a given year, related to the new asset created by  $\Delta I$
- E current costs in a given year, related to the local public service that  $\Delta I$  allows to offer
- R revenues from the operation of the asset (e.g. user charges, sponsoring);
- O Operating grants received from other government entities for the planned investment programme
- i Interest rate for B (%);
- d Depreciation rate of  $\Delta I$ . It corresponds to the amortisation (instalment) rate of  $\Delta B$  (%), according to the pay-as-you-use principle. If the useful life of the investment is 20 years, then  $d = 0.05$ .

Dafflon (2010:7) links the revisited golden rule with the debt ceiling of a State/LG by considering investment costs (investment and amortization), and operating costs (maintenance cost, M and costs required to provide public costs, E) which should be financed from current revenues.

An additional investment [ $\Delta I$ ] can be initiated as long as the economy is in a position to pay all cost of investment and operating costs. Cost of [ $\Delta B$ ] varies with the amount of [F]. The lower the [F], the higher the need for [ $\Delta B$ ] is. The internal borrowing limit in equation (9-2) is computed on accrual accounting system. That is, it calculates asset and liability terms not in cash terms (Dafflon, 2010:7-8).

Governments and IMF use various ratios to indicate indebtedness level. Burden of debt service, net debt per population, net debt/cash flow ratio, net debt/own revenue ratio, debt/GDP ratio or debt/ export ratio are the common ones. The more the ratios are, the higher the debt burden is.

***Fiscal discipline versus Budget responsibility*** - Governments adopt rules to prevent proactively defaults of states/LGs and they apply administrative and financial sanctions against an act of breaking the rules. For instance, the EU issues laws, directives, and rules that compel all Member States (MS) to run at a balanced budget but in economic

downturn environment they are authorized to operate budget deficit up to 3 percent of individual State's GDP. Violation of the budget deficit limit causes serious administrative and financial sanctions<sup>235</sup> (Vaneecloo, et.al, 2006:67-68). In practice, however, some MS of EU experience budget deficit beyond the limit and no sanction measures have been applied. The EU has hardly power to put into effect the budget deficit limit among the MS or it does not have strong enforcement means to coordinate fiscal policies of the MS when they do not behave appropriately.<sup>236</sup> Thus in effect the administration sanction remains nominal.

Dafflon (2010) argues that *budget discipline is not an effective instrument to maintain a balanced budget* in a decentralized system because with top down rules, states will engage in strategic behavior to avoid the severity of the rules and sanction. Dafflon (2010) further argues that maintaining States' and LGs' budget discipline by defining rules and sanctions is important but not sufficient condition because imposing strict central control over States/LGs may not necessary ensures budget discipline.<sup>237</sup> As an alternative, he suggests a shift from fiscal discipline to budget responsibility. Dafflon (2010) plausibly argues budget responsibility is superior to fiscal discipline for the following reasons:

(i) Budget responsibility relies on self-made rule or continuous self-assessment and it would have a better chance to be accepted and respected through time. It helps States/LGs to "adjust their investment policy to their real fiscal capacity and assess costs and benefits of each capital programmes in advance, in order to avoid excessive debt",

(ii) "It avoids bailout by a higher government" and,

(iii) It is "more proactive thinking" (Dafflon, 2010).

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<sup>235</sup> According to the Growth and Stability Pact, any excessive budget deficit is not allowed. If a MS violates the deficit limit rule, it has to make a non-interest deposit of 0.2 to 0.5 percent of GDP. If the country still fails to manage its budget deficit to the target limit within two years, the deposit is lost and becomes a fine (Robert and Daniel, 1998:18). But the EU applies exceptions.

<sup>236</sup> The recent years high budget deficits in Greece, Portugal, Ireland and Italy are illustrative (See Rossi and Dafflon, 2012).

<sup>237</sup> The failure of the Stability and Growth Pact (SGP) of the EU is a typical example.

The argument for the budget responsibility is not to say that rules from the above are irrelevant or should not be respected, but self-discipline is more effective than rules from above (Dafflon, 2010:12).

## **9.2 The Legal Framework and Purpose of Borrowing**

To explore the existing legal framework and purpose of borrowing in Ethiopia, references were made to the Federal Constitution, National Bank of Ethiopia financial Regulations, Financial Administration Proclamations of the Federal Government and respective states as well as the States' City proclamations.

### ***The Federal Government***

The history of public budgeting in Ethiopia reveals an evolution from a surplus in the early 1950s to a balanced budget up to the mid 1965, a small budget deficit in the late 1965-74 periods and then has grown rapidly since 1975. The conservative fiscal policy of the imperial regime had contributed to the small budget deficit (EEA, 2000/2001:372). Budget deficit began to grow rapidly during the *Dengue* regime and Ethiopia became one of the heavily indebted among the Least developed countries in the 1980 and mid 1990s (World Bank, 2000b) partly due to the then excessive government intervention in the economic activities and partly because of the steep growth of the defense spending to reverse the invasion of Somalia Republic in 1978-79, and it quagmired in the long civil wars. The budget deficit situation continued in post the post 1991 too. Since 2003, the Ethiopian government has been running a budget deficit between five and seven percent of GDP per year (NBE, 2009). The budget deficit is mainly associates with the Federal Government's extensive infrastructural development programs, huge public investment on strategic manufacturing sectors (sugar development, fertilizer plants, engineering plants, etc...), and defense budget (modernizing the defense to adjust with the highly volatile and conflict- prone regional geo-politics). Federal Government deficit has been financed mainly from external loans, domestic borrowing (from banks and issuing bonds), saving and printing money. The share of selling

domestic bond is small because capital market in Ethiopia is very small. Issuing bonds to external lenders has not been yet introduced.

The Federal Government may borrow for short-term and long-term from the Commercial Banks and National Bank of Ethiopia(NBE) through direct loan, and issuing securities such as (Treasury bill, issuing a promissory note and bond) (Federal Proclamation. 591/2002).

### ***Borrowing by the States***

Borrowing right of the states emanates from the Federal Constitution. Art.51 (7) stipulates, "...States can borrow money from internal sources." Terms and conditions of States' borrowing are defined by the Federal Financial Administration Proclamation No 57/1996 and the Federal Proclamation No.591/2008 of National Bank of Ethiopia.

The federal Government grants preferential right to the City Government of Addis Ababa and the Dire Dawa Council Administration to borrow, in addition from domestic sources, directly from external sources by short-term and long-term repayment arrangement or by selling bonds. The Cities are expected to identify international lenders and solicit the Federal Government to borrow on their behalf (Federal Proclamation No. 361/ 2003and Federal Proclamation 416/2004).

According to the Proclamations, the states may use selling bond and direct loan to finance short-term budget deficit and long-term capital investment. State Councils, up on the proposal of respective Executive Committee, may approve short-term for:

(i) redemption of direct advance or security, such sum of money as are required for the payment of any direct advances, or securities that have been called for redemption, and

(ii) General obligations when the Committee believes that consolidated fund is insufficient (see Financial Administration Proclamation of the States).

The States' Financial Administration Proclamations conceive the states would exercise self-restrain when they borrow to finance their short-term budget deficit. States' autonomy to borrow for long-term investment is restricted, however. The states need to get the authorization of the Federal Government to borrow from domestic

sources directly or by way of selling bonds, for long-term investments<sup>238</sup> (Federal Proclamation No.57/1996).

With regard to domestic sources, the laws are silent about who the lenders are (NBE or CBE or DBE or CBB, or private banks or combinations of all); although in practice the CBE and CBB give loan upon the instruction of the Federal Government.

### ***Borrowing by local governments***

All the States and the City Governments recognize borrowing as a means of ULG financing source <sup>239</sup> (see for example Tigray Proclamation N°. 107/1998 and Amhara Regulation No.37/2005).

Borrowing by ULG is subject to the approval of respective State Council. Long-term borrowings to ULGs are taken into account national and regional economic stability as well as debt payment capacity of the requesting ULG. But, the right of the LGs to borrow remains on paper.

### **Box 9.1. Frame Work of ULG borrowing in Ethiopia: the Case of Amhara State**

Like in the other States, borrowing is one sources of finance to the ULG in the Amhara National Regional State. The State guarantees the ULGs access to short and long-term borrowing from internal financial institutions. Short-term loan is allowed to disburse general obligations when the ULG face fall short of revenue. Long-term loan is authorized for capital investment only on infrastructure development, undertaking investment activities, production of fixed assets and repayment of the long-term loan taken previously.

For any loan, ULGs have to submit their request to the Common Financial Board, a body jointly established by the ULGs and the State. The loan application has to provide detail information about total previous outstanding debt, if any, the purpose of the loan, required amount of

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<sup>238</sup> In this context repayment implies payment of interest and principal that are not repaying debt in due time according to rules of economic amortization, thus they may re-borrow to reimburse past debt. It also refers to current payments for interest and principal for long term investments projects.

<sup>239</sup> The States do not explicitly allow borrowing to rural Wereda Government.

loan, and debt repayment schedule, to mention a few. The Board assesses financial stands of the loan requesting LG, whether it has dependable fiscal capacity to repay its debt on due period, and reviews the impact of the loan on macro-economic management, as well as regional and local socio-economic development. The Board submits its recommendation to the BoFED for further assessment and then, in its turn, submits its recommendation to the State Council for final decision.

The Proclamation recognizes the right of residents to submit their comments to respective Council in writing or in person on the loan request before it is approved (Amhara Regulation No.37/2005).

Allowing the ULGs to borrow for repayment of long-term loans likely to develop bailout behaviour and/or make the ULGs to quagmire in debt crisis situation.

It must be noted that there is no legal framework that limits the Federal Government and the states to operate at balanced budget deficit. They can finance their current deficits through supplementary budget for both recurrent and capital budget<sup>240</sup> upon the authorization of respective legislative body. Interestingly, conditions of supplementary budget are not defined by law. It is simply left to the discretion of the Executive Committees of the Federal and the States.

In case of investments financed by net saving and federal transfers all costs are accounted as expenses at the time of completion of the project. Thus amortization and maintenance costs are not recognized. Investments are defined in assets and liabilities, or on modified cash-based accounting system rather than in accrual terms (expenditure and revenue stream over the life of the project). The modified cash system does not allow internalizing cost and benefits of public investments.

**Sources of credit**-The Federal Government can finance its recurrent deficit by borrowing from domestic sources or ratifying supplementary

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<sup>240</sup> For instance, in 2007/8 fiscal year, the HoPR ratified supplementary budget amount to Birr one billion for capital budget and Birr 16,026,300 for recurrent (Federal Proclamation No. 579/2008). Similarly the States often allocate supplementary budget for recurrent and capital purpose.

budget by the HoPR. NBE and CBE are domestic financiers. When the NBE intends to give any loan, maintaining stable price is taken into consideration (Federal Proclamation N° 591/2008), although in practice it poses a question. Multilateral, bilateral donors and Non-Paris club are major external lenders. As can be seen from the above Table 9.1, the Federal Government has chosen the external lenders as it's primarily its source of borrowing, except in the 2007/08 fiscal year. Domestic borrowing sharply declined and the Federal Government has aggressively mobilized external concessional loans<sup>241</sup> and grants from multilateral organizations as well as bilateral agreement loans.

**Table 9.1. Federal Budget deficit and financing 2007/8-2011/12, in million Birr**

Description	2007/8	2008/9	2009/10	2010/11	2011/12
Revenue	29794	40174	53861	69120	102864
Grant	9911	14454	12376	16491	12795
Revenue & grant	39705	54628	66237	85611	115659
Recurrent expenditure	24121	27176	32012	40535	72971
Result of the current account	15'584	27'452	34'225	45'077	42'687
Capital expenditure	22794	30599	39322	53,297	51446
Deficit	-7210	-3146	-5097	-8220	-8758
Financing					
External borrowing(net) <sup>1</sup>	2396	3176	4,131	7798	6,530
Domestic borrowing(net) <sup>2</sup>	6400	107	1,758	111	3,793

Sources: Compiled from NBE Annual Various Reports

<sup>1</sup> External debt refers to: (i) all Federal Government external loans, (ii) Federal Government-guaranteed external loans granted to the public enterprises, and (iii) The non-government guaranteed external loan contracted between public enterprises, mainly the EAL and Ethio-Tele

<sup>2</sup> Domestic borrowing includes all banking (direct loans) and non-banking (bonds and Treasury bills) borrowings.

Note the sums of net external and domestic borrowing are not equal to the public deficit, because loans given to public enterprises such as Ethiopian Air Lines and Ethio-Tele are included. Note also the above Table did not include States' borrowing as there are no data on States/LGs deficit and how they finance.

<sup>241</sup> The external sources can be concessional or non-concessional loan. In the case of the former interest rate is low, with grace period for the first two or three years and long-term maturity period.



The rationale behind the outward borrowing orientation of the EPRDF regime, presumably, is sympathy to the argument for the domestic borrowing not to crowd out with the private sector. However, relying on external source raises concerns of sustainability and high risk of hard currency flight in the form of debt service. It also compromises the sovereignty of the country as getting loans from multilateral (IMF and World Bank) and bilateral agreement loans and grants are often accompanied by some preconditions. In order to minimize the possible political and economic costs of relying on external sources, the current government applies two strategies: (a) diversifying the potential lenders (Multilateral organizations, EU, BRICS,) to widen the possibility of getting loans, at less political cost, and (b) rapidly increase the financial capacity of the country to cover its capital projects through introducing tax reform, and broadening the tax bases as well as mobilizing resources from the public by selling bonds and issuing Treasury bills<sup>242</sup>.

### ***Debt Limit***

#### ***(a) of the Federal Government***

Own-revenue is insufficient to finance the intended development programs. Borrowing from domestic and external sources are major financing means. But how much should the Federal Government borrow to accelerate the economic growth Unless the borrowing is restricted, it will have inevitable consequences on macroeconomic stabilization Does the debt management system enable us to calculate the maximum limit of the Government?

The debt limit for external and domestic sources is treated differently. There is not legal limit for external source. It depends on the

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<sup>242</sup> Because of the water politics over the Nile River, Egypt has aggressively engaged in lobbying potential lenders not to lend to Ethiopia for financing its power plant projects. As a response, the Ethiopian Government has mobilized from its own revenue to finance its power plant projects such as Tekeze, Belesa, and Gibe power plants from its own resources. Moreover, the Government has launched the Great Renaissance power plant, which costs USD 80 billion, to finance from saving and by selling bonds to nationals.

negotiation process between the Government of Ethiopia and the lending institutions. It also depends on the type of borrowing (concessional or non-concessional). In the case of concessional loan, multilateral institutions and bilateral agreements are the major lenders. The loans are development-oriented and are long-term (up to 40 years) at lowest interest rate (not exceeding 1 percent). Non-concessional credits are borrowed by profit making enterprises like Ethiopian telecommunications, Ethiopian Air Lines, Ethiopian Electric Power, Ethiopian Sugar Corporation. The lenders take into account feasibility of the investment project and the repayment capacity of the concerned enterprise. Once the lending institution/country decides to lend, the Legislative body has to ratify the loan agreement on simple majority vote. The body considers the overall impact of the debt on the national economic development.

The NBE has restricted the maximum Federal Government domestic borrowing to be:

(i) direct short-term loan “up to 15 percent of average annual ordinary revenue of the Government for three fiscal years immediately preceding for which accounts are available.” Principal and interest rate for short term loans have to be repaid within the next one year.

(ii) Borrowing by issuing Treasury bill shall “not exceed amount of 25 percent of average annual ordinary of the Government for three immediately preceding fiscal years for which accounts are available”.

(iii) “The total amount of the bonds held by the NBE and other Banks is limited up to 50 percent of the average annual ordinary revenue of the Government for three immediately preceding fiscal years for which accounts are available”

(iv) The Federal Government may issue bonds for financing long-term investment but the maturity period shall not exceed 10 years (Federal Proclamation No.591/2008).

### ***(b) of the States and ULG***

The State’s Executive Committee may determine the limits of the short-run debt size of the states (see Art.39 of the States’ Financial Administration Proclamation), whereas the Federal Government

determines long-term loan demands of the states taking in to account its impact on macro-economic stability and repayment capability of the states.

With respect to LGs, no state sets a rule on debt limit, except the Amhara state, which stipulates a LG may obtain loan for capital expenditure not more than “10 percent of its annual revenue without securing the prior consent of the city residents” (Amhara Proclamation No.43/2000). According to this rule, the debt limit is limitless as long as local residents vote for any amount of loan. Unfortunately this broad autonomy remains on paper.

### **9.3 The practice of borrowing**

Despite the Federal Constitution grants to the states the right to borrow from domestic sources, they enjoy limited borrowing autonomy. There is widely spread perception among top officials that uncontrolled state borrowing schemes will cause macroeconomic instability. As an alternative, the Federal Government designates pragmatic borrowing schemes. LGs also receive state backed short-term and long-term loan schemes. This section deals with the various channels of borrowing are in place.

#### **(i) Federal owned banks as borrowings channels**

The Federal Government initiates and facilitates borrowings for the States from the federally owned banks namely the Commercial Bank of Ethiopia (CBE) and the Construction and Business Bank (CBB). Federal Government initiated borrowings are designed to meet the goals of the series Five Years Development Plans of the Federal Government and the States. For example, in the late 1990s and early 2000s, the Federal Government used to sponsor the states to borrow from CBE for (a) purchasing agricultural inputs mainly, fertilizer, to achieve food security at household and national levels. The peasants were supposed to pay back the principal and interest including interest immediately after next harvest season. The MoFED used to act as an intermediate agency between the borrowing State and the lending Bank by issuing an undertaking letter to the CBE and the concerned States. The states also issued a short term promissory note to the lender. MoFED uses Federal

subsidy entitlement of the states as collateral. If a borrowing State fails to collect from the beneficiaries and repay the debt back within the specified due date, the Ministry used to deduct equal amount of the debt from the State's subsidy entitlement.

(b) Housing development program. The housing development loan is long-term. It requires a tripartite agreement among the MoFED, individual borrowing State and lending bank on the terms and conditions of the borrowing scheme. The MoFED and the States issue undertaking letter and bonds respectively that enable the states to borrow seed money from CBE and CBB to carry out construction of condominiums from CBE and CBB. Here, the States borrow money from the Banks to build condominiums and, upon completion of the project; it transfers to lucky urban dwellers by lottery modality.

The Federal initiative borrowing schemes are designed in a way to close the possibility of bail out problem by transferring all liabilities to the beneficiaries of the programs. For instance, in case of borrowing for purchasing fertilizer, the States transferred all liabilities to the wereda Administration and the latter, in its turn, transferred the liability to individual beneficiary peasant. But the experience of bail out risk was mixed. My discussion with Agricultural extension experts in Tigray in 2009 revealed that repayment rate was recorded more than 95 percent because the Weredas made maximum efforts in compelling the debtors to pay in the next harvesting season at any cost (even by selling whatever assets they have or by arranging another borrowing facility from state-owned MFI to settle previous debt). Any *wereda* which failed to collect the repayment was subject to the merciless deduction of budget from the Wereda block grant. The experience of Oromia was open for bailout problem. Oromia Weredas are found lenient in collecting the fertilizer debt and the state paid Br 400 million Birr for the uncollected debt (Oromia Cooperative Agency Assessment Report, 2002/3 EC budget year).

In case of the housing development scheme, the States borrow seed money for construction of condos. Once the constructions of the condominiums are completed, the States/LGs sell the condominiums to residents through lottery modality. Winners have to pay, at least, 20

percent of the total liability in advance and the remaining liability is transferred to the buyers by linking with the lending bank.

**(ii) MoFED as a borrowing channel of the states**

As mentioned earlier, the Federal Financial Administration Proclamation 57/1996 ensures the right of the States to borrow from the MoFED to settle short-run general obligations of individual states. Such a borrowing aims at filling States' immediate recurrent expenditure needs. Benshangul-Gumuz and Gambela can be cited as illustrative cases. They were unable to pay salary for their civil servants in 2007/8 Fiscal Year as the introduction of the 2007 fiscal equalization system negatively affected their subsidy entitlement. The MoFED used to lend to the states and deduct the same amount of the debt from the next States' subsidy entitlement in the next budget year.

**(iii). Water Resource Development Fund from the MoWRD**

The Office for Water Development Fund has established a revolving fund by mobilizing loans and grants from multilateral, bilateral lending institutions as well as from the Federal Government budgetary allocation (Federal Proclamation No.268/2002).

The Fund is a long-term and earmarked loan for urban water supply and sanitation and for construction of large scale irrigation dams. The States are required to submit a feasible and bankable project proposal which includes information on social and economic impacts of the project, investment cost of the project, State's investment contribution, sustainability of the project and repayment schedule. The Office reserves power to approve or reject any loan request after evaluating the feasibility of a project proposal, although equitable distribution of the Fund among the States is a point of concern (Federal Proclamation NO.268/2002). The Water Supply Projects of Harari and Dire Dawa are points of illustration. The Water Resource Development Fund does not attach borrowing with any collateral binding<sup>243</sup> and thus opens for bailout mentality.

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<sup>243</sup> In order to discourage bail out sentiment, the Office for Water Development Fund included a sancrion clause in the lending agreement that states "In the event of delay in the payment of any sum payable by the debtor, it shall automatically and forthwith, became liable to pay by way of liquidated damages, an amount equivalent to interest at the rate 3 percent will be increased by 2.5 percent per annum calculated on the sum due from the date up to the actual date of payment" (see theLending Agreement

### **(iii) State sponsored borrowing channel from MFI**

With the exception of Afar and Somali for religious reason, all the States and the two City Administrations (Addis Ababa and Dire Dawa) have established micro finance institutions (MFI). Oromia has also established a Cooperative Bank to mobilize saving and investment.

The MFIs function in a business-like manner. They target the lower income group and the rural population who are unable to present collateral asset to borrow from the conventional banks. The States facilitate borrowing to unemployed youth, women who are willing to organize themselves in syndicates (Associations) and to residents who would like to engage in MSE activities from the MFI. The States also facilitate credit facilities for poor farmers for purchase of agricultural modern inputs with the objective to ensure food security. The States guarantee to respective MFI by issuing bonds so that the MFIs receive loans from the Federal owned Banks. The MFIs, in turn, lend to the rural population (for purchasing agricultural inputs, family-focused food security packages, etc) and low income urban dwellers (see Amhara Proclamation No.116/2005).

The Weredas are responsible to collect the repayment of the debt. If they fail to collect the debt, the States deduct the same amount of money from their block grant entitlement. This has made the default rate very low (less than 10 percent with some variation among the States).

### **(v).Federal Government sponsored borrowing channel from abroad**

The Federal Constitution does not allow the States' to borrow from abroad. The prohibition of state's external borrowing might be supported by a couple of economic arguments: First, external debt policy is closely linked to macroeconomic policies such as exchange rate policies and foreign reserve management, which require Federal Government control. Second, as Teresa and Craig (1997: 168-9) note, lenders often "require an explicit central government guarantee for sub national government borrowing." Third, it negatively affects balance of payment of the

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between the Water Resources Development Fund and Dire Dawa Water Supply and Sewerage Authority, June 2012). But the question is what legal enforcement mechanism does the Office have if the debtor fails to pay its debt?

country. Nevertheless, the City Government of Addis Ababa and Dire Dawa enjoy special preferential treatment to get access fund for infrastructural investments from international financial institutions or bilateral loan agreement.<sup>244</sup> The HoPR has to endorse the borrowing after examining the impact assessment report made by the MoFED and the NBE on the relevance of the borrowing and on the macroeconomic management.

Given capital market is very weak in Ethiopia, the private financial sector is not interested to lend the States/LGs. The

Federal owned Banks are also reluctant to lend long-term loan to the states unless they are instructed to do so.

## **9.4 Conclusion**

Operating at balanced budget and restricting borrowing to long term investment project only is justified for benefit-received principle, intergenerational equity, efficiency, redistribution and macroeconomic stabilization reasons. Applying a balanced budget for current expenditures also makes politicians discipline and promotes accountability.

The Federal Constitution of Ethiopia secures the right of the States to borrow from domestic sources. However, the States enjoy little borrowing autonomy. State's borrowing right is subject to the discretion of the Federal Government. So far, borrowings are initiated by the Federal Government. The states can borrow for financing current and capital expenditures. So far, with the exception of Water Development Fund and the housing development program, the borrowing practices are short-term and medium-term. Although borrowing at state/LG level is believed to be a major source of financing long-term investment, it is perceived as a risky business that cause macro economic instability and

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<sup>244</sup> For example, the Federal Government borrowed from the export–import Bank of China for Addis Ababa deep wells water supply project (Phase III) (see Proclamation NO.724/2011). It also secured USD 45 million for financing the Bole Ring road to Meskel Square Road project. Moreover, China has financed the Light railway project of Addis Ababa.

burden on future generation. It is understandable that in the absence of budget responsibility, lenient borrowing policy would bring unintended consequences. But such fears should not preclude the States/LGs from borrowing for long term investment.

There is no law that compels the Federal Government and the States to operate at balanced budget. Budget discipline is less respected. The Federal and State governments often spend more public fund than the initially approved annual budget. No state issues a comprehensive audited financial annual report to respective Council on a timely basis.





assimilation and centralization as instruments of modernization and national unity. The Military regime also pursued a highly centralized system as a state building strategy. Given Ethiopia is characterized by diversities in language, culture, religion, ethnic, etc, the highly centralized state building strategy and the core versus periphery ethnic groups had caused to raise nationality question as a central political issue. Dozens of Nations and Nationalities which believed they were oppressed and marginalized had waged armed struggle against the centre for genuine autonomy. EPRDF, a leftist coalition and adherent to self-determination of NNP, defeated the Dergue regime in May 1991 and has instituted a new state building strategy under the motto of unity-in-diversity as a means of accommodating ethnic diversity, ensuring last peace and guaranteeing democratic order.

The third Chapter briefly explains about the first wave of decentralization that caused the devolution of considerable powers to the Regions. The core objective of the Ethiopian Federal arrangement is to address the century old nationality question and to hold together with free will of the NNP under a democratic Ethiopia.

The Ethiopian Parliament has a dual Chamber structure. The HoF in Ethiopia has, at least, two distinctive features. First, it is a House of NNP because it represents the NNP within the states, not the state per se. Representation in the HoF is a function of the numbers of indigenous ethnic groups within a State, and population size of each ethnic group in a state. Such representation practically gives upper legal ground to the three big States to influence decisions in their favour. Second, the HoF has legal authority on various fiscal issues which include but not limited to: designing distribution of federal subsidy to the States, jointly deciding undesignated tax bases and on concurrent taxations powers, interpreting the Federal Constitution, deciding on issues related to self-determination of NNP, etc(Federal Constitution, 1995, Art.62). The House, however, does not have legislative power as what we see in the conventional bicameral houses. The Lower House ratifies laws without the need for approval of the House of Federation.

The Chapter also deals with making and remaking of the States and LGs. The Federal Constitution recognizes nine states and Addis Ababa City Administration. The States are established on “the basis of

settlement patterns, language, identity and consent of People concerned” (Federal Constitution, 1995 Art. 47). There is no consensus among political parties, academia and ordinary people on the need and outcome of the multinational federal arrangement. Art.39 that guarantees the right of NNP to self determination including secession is the most controversial one. Some perceive the multiethnic federal system as a means of balkanization of Ethiopia, while others believe that the system has uprooted the source of national oppression and has guaranteed self-rule and shared rule.

The debates on individual rights versus collective right have been one of the contested areas among various political elites. All political forces believe that democracy is a necessary condition for the success of the federal system in Ethiopia. The presence of strong and critical opposition parties, independent free press judiciary body competitive electoral system, and good governance are effective instruments for promoting democracy, and respecting human rights. However, there is no consensus among the parties on the meaning and essence of democracy. The ruling party claims to be adherent to ‘democratic’ developmental state, revolutionary democracy, collective rights. In contrast, the ‘multi-nation’ opposition parties are adherent to the neo-liberal politico-economy philosophy and they put individual rights first.

There is a critic that the federal system impedes mobility of labour, capital and trade across the States, although it is not supported by empirical study. It is true that the federal system has contributed to the existing low level of inter-state labour mobility. But it should be noted that in addition to the federal arrangement, economic, political and social factors have contributed to the existing low inter-state mobility of people and capital. The convergence trend in the distribution of public services across the states, strong ethnic identity, social affection to local area, rural land policy, the welfare scheme (PNSP), the language policy and favouritism towards “son-of-the-soil” are factors that pull productive forces from mobility. But labour migration to Addis Ababa is high because there are better job, business and career development opportunities for all sects of population-labourers, entrepreneurs and professionals. Migration to Afar, Gambela, Benshangul-Gumuz and SNNP from the neighbouring states is also evident because these states adopt

Amharic as their working language partly to attract professionals to run the bureaucracy apparatus, and partly to serve as a common language in the ethnically diverse states. Federal mega projects such as construction of dams for power plants, sugar plantation, and fertilizer projects have promoted temporary inter-state movement of labour.

The Ethiopian federal arrangement neither is a product of European colonization as it is the Nigerian federation nor prescribed from outside as it was the Ethio-Eritrea federation of the 1952-1962. It has been developed indigenously by Ethiopians that considered unique political, history, cultural etc circumstances of the country. It is innovatively designed to hold together the NNP through accommodating diversity. The sustainability of the federal system, however, depends on how Ethiopians make work the system. It can be a successful marriage, glue for unity, solidarity, efficient instrument for power sharing, and balanced socio- economic development among the States, if it is used properly. Or, it could be unequal marriage promote ethnic animosity and recipe disintegration, if it is used wrongly.

Chapter four reviews the theories of assignment of responsibilities among different levels of government. There is no consensus among public finance economists whether the competence of macroeconomic stability and interpersonal income redistribution should be confined to the Centre only. The FGTFP prescribes the functions of macroeconomic stabilization should be reserved to the centre only. The logics are: (i) in a decentralized system. SNGs might have different preferences and perceptions on the objectives and means of addressing macroeconomic stabilization, (ii) taking unilateral measures on macroeconomic stability may result in spill over effects, budget deficit and develop free riding behaviour, which discourage SNGs to take counter-cycling measures for national goal, (iii) Central governments have the competence to influence the overall level of aggregate demand and to shift resources for short-term counter-cyclical purposes. This centralist prescription is contested, however. The SGTFP argue that macroeconomic stability is a shared responsibility of the Centre, the states and LGs. According to the SGTFP, if SNGs have fiscal capacity they may take short-term counter-cyclic measures through taxation and public spending. The states may sit

together and negotiate on how they can achieve common goals with respect to macroeconomic and redistribution functions.

The assignment of responsibilities to different levels of government varies from one country to another due to economic, political, historical, and social specificities. Among the economic arguments, economies of scale, spill over effect, and homogeneous preferences are centralizing forces, while heterogeneous preference, and congestion cost are decentralizing forces (Dafflon, 2006).

The process of assignment of responsibilities to different levels of government can be a top-down approach or on subsidiary principle. The latter demands for active participation of core stakeholders in the decision making process of the separation of power.

Chapter five discusses the assignment of responsibilities between the Federal Government and the States as well as between the States and LGs in the Ethiopian federal arrangement. Legally speaking, the Federal Constitution enshrines considerable powers and functions to the States. The assignment of responsibilities between the Federal Government and the States are among the highly decentralized federations. The Federal Constitution envisages strong states. All powers not assigned to the Federal Government are residual power to the States.

Various economic and non-economic variables have been applied in the separation of power between the Federal Government and the States. Subsidiarity principle, economic variables (economies of scale, inter-jurisdictional externality, cost of information and decision making), political preference, macroeconomic stability, interpersonal equity, and minimum national standard public service delivery have been considered.

The Federal Constitution grants symmetric powers and functions to all states (Federal Constitution, Art.52). Despite there are economic arguments (for example economies of scale, externalities and technical capacity issues) that support to pursue asymmetric assignment of responsibilities to the States; it is not politically desirable. Because, treating the NNP unequally has dear political cost.

The Ethiopian states are not in a position to take short-term counter-cyclic measures as their fiscal capacity is too weak to shift their capital budget for short-term stabilization purpose. But the states, coordinate

their economic plans with the Federal development plans, to make influence on the levels of output and employment in the long-term.

LGs' powers and functions are derived from respective State, because by design they are created to be agents of the State. This has enabled the states to restructure the LG (Zones, Special Weredas, and Weredas and Kebeles) in a way to fit with their specific circumstances. As a component of the WLD, the States have devolved some political and administrative powers including preparation of development plans, approval of annual budgets, administration of resources and provision of basic local public services.

In principle, the process of assignment of responsibilities among vertical levels of government should be a product of dialogue and negotiation between stakeholders (local councils, local executives). However, the process of assignment of responsibilities to the Weredas was a desk work of experts (consultants) and decision from above. The framers neither consulted local officials about what competences they would like to carry out effectively nor the considered the nature of production functions of local public services, and factors like institutional, social organization and communities' settlement.

There is widely spread perception that the States have no discretion power local priorities. For example, Pawlos (2007:263) and Young (1999) argue that States' budget autonomy is very limited as decisions are often guided by the Federal Government sector development programs (SDP) and Federal Five Year Development Plans(FYDP). Given the current government inherited the lowest level of primary education, primary health care, rural road, water supply service, etc... by the standard of the SSA countries, one may argue that the preferences for these public services are likely to be uniform across the states.

This may perpetuate till in the coming few years, although with economic progress and increasing citizens' disposable income, difference in preference for public services in quality and quantity across the states inevitable.

Therefore, as long as the States own the Federal Government SDP, it does not imply sacrificing local preference for national objectives. The States' SDP often coincide with the Federal FYDP but not all. Above all, the states determine spending choices between recurrent and capital

budgets as well as among various sectors. They formulate own development plans. But there are cases where the Federal Government dictates the States to take national goals by establishing minimum national standard public service deliver using the conditional grants as instruments.

Chapter six discusses on theory of tax assignment to different levels of government. The FGTFE assigns taxation power on economic principles only. It prescribes that mobile and highly progressive distributive tax bases should be assigned to the centre for macroeconomic and interpersonal equity purposes. The theory limits user charge, real estate property tax and excise taxes to SNGs. For the SGTFE, there is no golden-rule of tax assignment among vertical levels of government. The economic criteria are necessary but not sufficient. Considerations of historical, politic, and specific realities of a country are critical. The SGTFE may apply a decision matrix approach to determine what tax base should be assigned to which level of government. But it should be emphasized that the decision matrix offers paths to solutions but it is not a blue print for practical decentralization taxation policy.

Uncoordinated unilateral taxation decision causes horizontal and vertical externalities. Horizontal externality causes tax competition. There is no consensus among economists on the desirability of tax competition. Some argue that as competitions among business firms increases consumers utility, tax competition among states/LGs enhances government efficiency. Others argue that tax competition causes waste of resources and reduces government revenue which in turn leads to lose of citizens' welfare. To avoid, the disadvantages of tax competition, SNGs may harmonize their tax base (B), deductions ( $D_i$ ) leaving the states to manoeuvre with  $t$  and  $k$  or harmonizing  $B$ ,  $D_i$  and  $t$  by allowing SNGs to compete using  $K$ . The chapter also discusses on financial autonomy and tax autonomy of SNGs from the OECD and Swiss perspectives. The chapter is designed in a way to serve as a theoretical background for the assessment of the Ethiopian taxation assignment between the Federal Government and the States.

Chapter seven examines the vertical tax assignment of Ethiopia from the constitutional context and practical perspectives. The separation of taxation powers are categorized into the Federal Government, the

States, and concurrent between the Federal and the states. Constitutionally speaking, the states have taxation power to determine tax base, to set tax rate and to administer taxes over a range of revenue source. The States have access to various revenue sources including business profit income tax, personal income tax, value added tax, and excise tax. Moreover, considerable elastic tax bases are shared between the Federal Government and the States. The existing lopsided revenue collection in favor of the Federal Government is not because the states have meager taxation powers. Instead this Thesis argues that the separation of taxation power between the Federal Government and the states has been designed in a way to ensure tax sovereignty of the states.

There is a gap between constitutional tax assignment and practice; however. The States do not exercise their tax powers. Tax rates are uniform across the States, except agricultural income tax and land use fees. This practice has diminished tax autonomy of the States.

The States have retained all taxation powers. They have not devolved any tax power to Weredas except municipal revenue sources. The Wereda level decentralization (WLD) is not accompanied by taxation powers to weredas. Weredas collect revenues on behalf of respective State. The states set revenue targets which are not often realistic. The Weredas get what they have collected back in the form of Wereda block grant. If they collect less revenue than the predetermined revenue collection target, they do not receive the difference. But when they collect more revenue than the target, same amount of money is deducted from the Weredas' block grant entitlement. This system may create distinctive to raise more revenue.

Tigray is the only state that has, so far, legally decentralized taxation power to Weredas in the same fashion which the Federal Constitution has applied. Referring to the Proclamation No. 107/1998 of Tigray, taxation powers of ULGs are not limited to benefit taxation and real property tax base. They have power on mobile tax bases such as PIT, BPT, and VAT. Given Tigray is a relatively homogeneous and Tigrians are relatively mobile people, a significant tax rate variation between the ULGs are likely to cause fiscally induced migration of labour and capital within the State.



The tax assignment in Ethiopia does not coincide with the conventional revenue assignment theory of fiscal federalism. Of course, it does not need to match with the theory as specific political preference, and historical circumstance of the country have govern the separation of tax assignments between the Federal Government and the States.

On average, so far, states' own revenue size has not exceeded 25 percent of their expenditure needs. This wide fiscal-need gap makes the Federal transfer more critical to provide minimum national standard public services at state level.

Chapter eight examines the practice of intergovernmental transfer system in Ethiopia. The transfer system uses unconditional, conditional, wereda block grant and road fund as policy instruments to correct VFG, to address horizontal fiscal disparity, and to provide minimum national standard of public service.

The unconditional grant gives liberty to the states to allocate on what they think appropriate. It is also equity-oriented, but it creates disincentive to mobilize more own-revenue and develops the common pool problem. In the Ethiopian context, conditional grants also serve as equalization tools for two reasons: (i) eligibility for conditional grants aim at enhancing equitable socio-economic developments across the States, and

(ii) Distribution among the eligible States is not made by the capacity of the States to contribute to a fixed grant pool, but based on the Federal subsidy entitlement percentage share designed by the HoF.

The state own revenue–federal transfer balance has skewed to the transfers implying that the States are heavily dependent on Federal transfers. This is so partly because the states revenue raising capacity is weak and partly because the states are engaged in carrying out national standards. The skewed distribution of concurrent revenues between the Federal Government and the states also favour the former.

The transfer system is dominated by unconditional grant, comprising about 70 percent of the total Federal transfers. In a situation where the distributions of basic public services are at lower level across the states, the lion's share of unconditional grant is expected. Nevertheless, with the per-capita growth of the population, variations of local preferences for public services are expected to be visible. By then

conditional grants will be more effective instruments in gearing the public spending to meet national concerns (World Bank, 2000b). The choice between unconditional and conditional grants depends on what objective(s) the decision makers would like to achieve (such as budget autonomy, narrowing horizontal disparity, efficiency etc). If the Federal Government gives more focus on State's budget autonomy, then unconditional grant is more appropriate instrument. If emphasis is given to efficiency, then conditional grants are good policy tools. Therefore, what mix of unconditional and conditional transfer should a country has to have is a political choice. From technical perspective gradual shifting from the unconditional to conditional grants would bring better efficiency.

At LGs level, recurrent expenditure needs are almost covered by WBG, whereas capital budgets are financed through specific purpose grants. The capital budget allocation to LGs is subject to States' priority and equitable distribution of basic public services across the Weredas.

Over the last two decades, the unconditional grant has gone through modifications and changes. Socio-economic variables formulas were applied from 1994/5 to 2006/7. The variables were more of expenditure needs indicators and, on average, only less than 20 percent weight had been dedicated to revenue raising effort. The subjective selection of the variables and assigning weights to each variable instigated voices from the States. As an effect, the HoF replaced it by fiscal gap equalization in 2007/8 (HoF, 2007).

What should the Ethiopian fiscal equalization equalize? Should it equalize expenditure needs only or revenue capacity only or both? Equalizing the expenditure needs only ignores the existing wide asymmetry in revenue raising capacity among the States. Likewise, considering only revenue capacity equalization understates States' expenditure differences due to expenditure needs and cost differentials among the States. Therefore, in the current Ethiopian context, applying combinations of both expenditure needs and fiscal capacity equalization is a prudent policy to ensure minimum standard provision of public services at comparable tax effort. The fiscal-gap equalization equalizes about 80 percent states' own- revenue sources and more than 90 percent of the expenditure needs of the states

The fiscal-gap equalization has fully equalized both the expenditure need and the revenue raising capacity of the states. The political rationale for the full equalization is to ensure provision of minimum national standard public service at comparable tax effort. However, it has developed incentive to compete for common pool. The revenue raising capacity equalization has also developed disincentive to optimize their revenue potential, because it considers actual revenue collections of the states, not their potential fiscal capacity.

The last chapter discusses the golden-rule of borrowing and the borrowing practice in Ethiopia. Contemporary literatures on public finance prescribe for a balanced recurrent budget. Borrowing should be allowed to finance capital investments only for reasons of macroeconomic stability, inter-generational equity, efficiency, and redistribution.

The Federal Constitution ensures the right of the States to borrow from domestic financial institutions. In practice however, the states enjoy little autonomy to borrow. State borrowings have aimed at financing short-term budget need, except the Water Development Fund and Housing Development program. All the states recognize the right of ULGs to borrow from domestic lenders but no state has implemented. All levels of government do not run on balanced budget. They can finance recurrent expenditure either through borrowing from MoFED or by easily ratifying supplementary budget by respective legislative body. And, thus the 'revisited golden rule' is not respected.

## **10.2 Policy Recommendations**

### **[1] Efficient provision of public services**

The Ethiopian federation is a federation of NNP. Regardless of the population size of the NNP, all are granted the right to self government and self-determination. The formation of Zone/Special weredas along ethnic groups guarantees minority's rights to self rule as well as to develop and maintain communal value (local cultural identity, language, and history). However, some ethnic-based Special *Weredas* and *Wereda*

Governments are too small in population size to efficiently provide some public services like Teachers and Health Colleges, hospital level health services, Zonal level Court service at lower cost because the production function of these public services do not allow them to reap benefit from economies of scale. Policy makers are, therefore, confronted between two conflicting objectives. On the one hand, they want to empower local people by establishing ethnic-based small governments closer to the people. On the other, providing public services at the lowest cost (bottom of U cost curve) demand minimum threshold of population size. Merging forcefully small ethnic-based jurisdictions with the intention to take advantages from economies of scale or centralizing the functions at Zonal level contradicts with the basic principle of the Federal Constitution. The assignment of the above mentioned public services uniformly across the Zone Administration has also technical problem because the public services cannot have identical economies of scale across the Zones. Each public service attains minimum average unit cost at different production function. For instance, TVET and Zonal hospitals cannot have same production function across the states. Moreover, the centralization of the public services at Zone Administration level has made the public services far away from citizens. For example, in many weredas, students are compelled to leave out their local areas for seeking preparatory or technical schools. Patients are referred to next higher layer of health institution, which are located far away from their residence areas. The referral treatment system is not patient-centred<sup>245</sup>.

The Special Weredas or Wereda Governments can efficiently provide the public services without sacrificing their right to self-rule by establishing special purpose functional units for each public service (for example, for polytechnic institutions, Preparatory school, Hospital level health service, taped water supply service etc). Establishments of such special functional units presuppose consultations and negotiations among the concerned LGs as well as coordination of tasks.

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<sup>245</sup> The current practice of health service referral system is confined to health institution within a state: Health Post→ Health Centre→ Zonal hospital→Regional Referral Hospital→ Federal Referral Hospital.

An alternative policy option is to introduce inter-state or intra-*Wereda* compensation agreement for the public services provided to non-state/LG residents. This policy option would be more ideal for health service. It would be cost saver and comfortable to patients to refer them to the nearest hospital, belonging to a neighbouring State/LG rather than referring to a higher level health institution within a State/LG, located far away from the user residence area. For instance, it would be convenient and cost saving to refer patients from *West Gorji Wereda*, Oromia, to Hawasa Referral Hospital, SNNP State, rather than to Adama Referral Hospital of Oromia. Similarly, for Kafta–Humera *Wereda* residents, (Tigray state), Gonder Referral Hospital (in Amhara state) is by far closer and more equipped than Shire Zonal Hospital. Such an arrangement can be introduced by signing a contract agreement between two states or between the service providing institution and beneficiary *Wereda* Government on the admission, quality of the service, language usage and compensation modalities etc.

Provision of tap water supply service has become a serious challenge for many ULGs in all the states partly because the initial investment cost is beyond their financial capacity and partly many urban jurisdictions do not have surface or underground water resource. ULGs may provide dependable water supply service at lower cost by: (i) establishing special territorial function for water supply that would serve for a wider population size, or (ii) Voluntarily amalgamation of vicinity LGs (Rural and urban) located within a defined radius. These policy options may enable LGs to combine their resources (water resources and finance) and to reap benefits from economies of scale. The amalgamation option, however, is not priceless. It makes trade-off between sacrificing autonomy and reaping benefits from economies of scale.

## **[2] Inter-jurisdictional externality/Spill over effect**

The intergovernmental transfer system of Ethiopia does not respect the principle of inter-jurisdictional externality. It neither acknowledges

vertical nor horizontal transfer for inter-jurisdictional externality benefits.<sup>246</sup>

Theories of intergovernmental transfer assert that states/LGs would not have incentive to allocate more public budget on public services that would produce positive spill over effect to other jurisdiction, in the absence of compensation mechanism for the cost of externalities through designing some sort of matching grant (Oates, 1972:75; Boadway and Shah, 2009:326). With regard to this, the so far Ethiopian experience is mixed. Tigrai's public spending on MIT generated positive externality to the national stock of skilled man power. An appropriate Federal compensation mechanism in the form of matching conditional grant would have given incentive to the Tigrai state to spend more public funds on the sector, or to smoothly run the Institution. Unfortunately the absence of such a compensation mechanism has caused the MIT to shut down.<sup>247</sup>

Failing to compensate inter-state externality effects, however, has not precluded the highland jurisdictions from investing on soil and water conservation that produce positive spill over effects to the States/weredas down the hills. How long the highland States/weredas will keep on financing projects/programs that produce positive externalities without any compensation is questionable, however.

If the States are to invest more on public services that would produce positive inter-jurisdictional externality effect, compensation mechanism has to be designed. This may pose who should compensate whom? If the spill over effect is confined to a neighbouring jurisdiction, the beneficiary has to compensate to the positive spill over producing jurisdiction. By the same token, a polluter jurisdiction has to bear the cost of the pollution. If public spending policy of a state produces a positive inter-jurisdictional externality at national level, the Federal Government should design a compensation mechanism in the form of conditional matching.

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<sup>246</sup> Except Harari's and Dire Dawa's public spendings on education and health services.

<sup>247</sup> The State of Tigrai handed over the MIT to the University of Mekele because the MIT budget burden was perceived too heavy to the state.

Addressing inter-jurisdictional externality effects through unconditional grant/equalization, as it has been practicing for Harari and Dire Dawa, is a flawed policy because equalization does not properly measure the costs of the inter-jurisdictional externality effects. Introducing an open-ended conditional matching grant will address the problems of inter-jurisdictional externality effects.

### **[3] Ensuring the tax autonomy of the states and LGs**

As discussed in the previous chapters, the Ethiopian states cover small portion of their total expenditure needs from their own revenue sources. The fiscal position of the states can be strengthened by taking the following measures:

#### **[3-1] Introducing objective financial indicators of business income profit to distribute revenues generated from more than a state-**

As discussed in Chapter seven, location of production/business area does not automatically guarantee a state to control over taxation power or to get share from concurrent revenue sources. The issue of registration of legal entity (HQs) has precluded the states from benefiting revenue sources generated within their jurisdiction, because many of the enterprises have made their HQ in Addis Ababa. It is understandable that prorating the sources of business profit of a company which operates in more than a state is difficult, but it is not impossible. Proceeds derived from business income profit can be distributed between the hosting jurisdiction(s) and the HQ by applying some objective economic and financial indicators like share of capital investment, share of production value, sales volume, insurance premium, share of wages and salaries, or some combinations of the variables

#### **[3-2] Let the states exercise their constitutional taxation powers**

This recommendation includes, but not limited to:

[3-2-1] Allow the states to set their tax rate to maximize their revenue sources.

The fear of racing-to -bottom tax rate to attract investment among the state could be addressed by setting a minimum floor tax rate. A

maximum tax rate may also be set to avoid excessive tax burden on residents and businesses (see [6] below). Undo the act of recentralization of state's taxation powers at the Federal government on excise tax on 'chat' and letting the states to set the rate and administer it.

[3-2-2] Invent new revenue sources such as real property tax, environment tax, road toll tax, etc

[3-2-3] Impose certain percent of tax on the Federal Government profit making enterprises as per art.100 (3) of the Federal Constitution. The Ethiopia Electric Corporation, Ethio-Tele, Ethiopian Sugar Corporation, Commercial Bank of Ethiopia, Ethiopian Insurance Corporation, Ethiopian Mine Development Enterprise, and Ethiopian Aviation Enterprise are most likely candidates to tap revenue. This proposal is justified for couple of reasons: First, these Federal-owned enterprises make profit using the State's resources (land, road, etc) and, second, the States provide public services (education, health, road, security, etc) for the employees of the Federal Government owned business firms. Third, some federal-owned enterprises pollute local environment.

[3-2-4] The states can maximize their revenue capacity by securing 5 percent free equity on the total investment of large scale mining and by buying shares on lucrative mining enterprises in line with the Federal Mining Proclamation No 816/2013.

[3-3] Revise and correct the existing unfair distribution of concurrent revenue sources between the Federal Government and the States, which favour the former. Taking away lion's share from the concurrent revenue pool by the Federal Government and giving it back in the form of federal transfers to the states undermines the tax autonomy of the states. Allocating fairly the concurrent revenue sources between the Federal Government and the states could improve the existing wide VFG and tax autonomy of the states.

The states have not been benefiting from royalty fee as stipulated in the Federal Constitution Art.98. Royalty fees generated from large scale mining are collected by the Ministry of Mine and Energy (MoM&E). So far, the Federal Government takes all royalty fees. The HoF must enforce the MoFED/ MoM&E to transfer royalty fees related to mining operations



to respective states, because interpretation of the Constitution is absolute power of the HoF (Federal Constitution, 1995, Art.83). Any unconstitutional act of the Federal Government is expected to be automatically nullified by the House.

#### **[4] Launching the Third wave of decentralization**

##### **[4-1] Abolish Zonal functional Administrations**

In spite of the fact that the Wereda level decentralization was intended to empower the local government politically and administratively, yet considerable powers and functions remain delegated or deconcentrated to the LGs. Many functions like secondary school, TEVT, hospital level health service, Collector road category (that link centres of Main Access roads to each other) are still retained at functional Zone Administrations.

Functional Zone Administrations were important to coordinate the activities of *Weredas* when skilled manpower was very difficult to find at *Wereda* level in the 1990s. Nowadays labour supply of skilled manpower (university graduates) is not a point of concern. Therefore, abolishing the functional Zonal Administrations by launching the third wave of decentralization that devolves more powers and functions downwards will empower local governments and promote accountability. There is no more need to suppress *weredas* by functional Zonal Administration on the pretext of “supporting and coordinating” *wereda* activities. *Weredas* may coordinate their functions horizontally through establishing LG Associations without the need of Zonal Administration control.

Therefore, if elected politicians are to make responsive to local needs and accountable for their decision choices, first and foremost, the Functional Zonal Administrations should be removed and let the *Weredas* decide what functions/ responsibilities would they like to retain and to pass over. The (de)centralization matrix discussed on chapter 4 may be helpful by adapting it to specific individual *wereda*’s political, institutional, economic and social realities.

##### **[4-2] Devolution of taxation power to LGs**

The second wave of decentralization has not been accompanied by devolution of taxation. The third wave of decentralization has to devolve

adequate taxation powers to the LGs. As far as tax devolution to the LG is concerned, there is a widely spread perception among centristic minded State politicians and bureaucrats. If taxation powers are devolved downward, LGs may not use revenue yields properly and as a consequence provision of public services may deteriorate in quality and quantity. The argument is not persuasive for two reasons. First, despite capacity problems are undeniable; in practice the LGs collect taxes on behalf of respective State. The problems of managerial and institutional capacity are relative concepts and they can be addressed through launching extensive capacity building schemes. Second, by establishing democratic local institutions that would promote grass-root participation in local affairs and strengthening the existing ones would make local politician accountable to their decision choices.

#### **[5] Determine the size of Federal subsidy by law**

In some federations, size of federal transfer/equalization and revenue source(s) of equalization are explicitly stated by law<sup>248</sup>. These make the intergovernmental transfer system more transparent, predictable and stable. In Ethiopia the source(s) and size of federal transfer are not explicitly defined by law. The HoF sets the Federal subsidy/equalization formula. The Federal Government determines the equalization grant pool size on *ad-hoc* method from its general revenue collections (central treasury), external loans and external assistances after it takes for itself. Finally, the HoPR approves the size of the Federal subsidy. No fiscal negotiation/ bargaining takes place between the HoF and the legislative or between the Federal Government and the States on the size of the Federal subsidy. This makes the equalization system less predictable. To avoid this problem, the HoF or the States need to initiate a law that enforces the Federal Government to determine the equalization pool size by law. The determination of federal subsidy by law may also curb the Federal Government from manoeuvring transfers

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<sup>248</sup> For example, in Australia, the national goods and services tax (VAT) is the only source of equalization fund (Spasojevic, 2007:270).

for buying votes by shifting from unconditional grant to conditional ones. A legal framework that compels the Federal Government to dedicate some percent of its total tax revenue to transfer would enable the States to predict the size of the Federal transfer pool and to forecast how much they can receive in the coming years by analyzing the macroeconomic performance of the country.

#### **[6] Setting the “right” degree of tax autonomy**

The choice for the federal system in Ethiopia, among others, is argued to devolve powers and functions as well as to ensure the states to have access to various revenue sources. The Federal Constitution envisages strong states. The states have Constitutional rights to determine  $B$  and  $D_i$  and to set  $t$  and to administer taxes on ranges of revenue sources. But, there is a centralization tendency on the pretext of tax harmonization for ‘achieving fair horizontal equity and /or fearing of tax war among the states. Ensuring high level of tax autonomy of the states and achieving horizontal equity are not mutually inclusive. Therefore it is a political choice to make the right balance between the two conflicting objectives of ensuring higher levels of tax autonomy with wide horizontal socio-economic disparity and relatively better horizontal equity at the cost of tax sovereignty.

Now, the question is: What extent of cost of horizontal inequality is tolerable for what degree of tax autonomy? Or how much tax autonomy should be forgone to achieve horizontal equality? If one advocates for a high degree of tax autonomy of the states, he/she should answer whether there are well developed institutional self-controlling mechanisms that would bear the costs of tax war, or whether tax race-to-the bottom will not exacerbate the existing economic development disparity across the States, and how minimum national standard public service delivery can be achieved at comparable tax rate by pursuing tax competition? Likewise, if one argues for low level of tax autonomy by harmonizing  $B$ ,  $D_i$ , and  $t$  with the objective to narrow horizontal development disparity among the states or to provide minimum national standard public services at uniform tax rate but comparable tax efforts, there are some concerns to worry about. Does uniform tax system

enable the States to provide basic public service to the satisfaction of their residents? Are there mechanisms in which citizens directly decide and control budget implementation? Are there adequate institutions to hold politicians accountable to their constituencies? Would not a uniform taxation system induce states' dependency on the Federal transfer and exacerbate competition for the common pool? Does not the system preclude the States from prioritizing their real choices?

Therefore, the extent of tax autonomy to achieve is a political choice. Nevertheless it should be in harmony with the spirit of the Federal Constitution. There are obvious concerns about the inherent negative effects of horizontal tax competition in exacerbating horizontal economic inequality. Allowing the States to engage on tax war would neither contribute to provide comparable minimum national standard public services at 'uniform' tax rate nor to achieve a balanced socioeconomic development across the States. Similarly, the uniform tax system has precluded the States from exercising their constitutional right. In the Ethiopian context, the horizontal equity/comparable public service delivery and tax autonomy are necessary ingredients for the sustainability of the federal system. Hence, balancing these conflicting objectives by sacrificing some degree of tax autonomy for some degree of horizontal equity seems necessary. A balanced trade-off between autonomy and addressing horizontal disparity can be achieved by allowing the States to exercise their right to set tax rate but refrain them not to go for not tax wars by voluntarily ratifying an Economic Charter where all the States and the two City Governments negotiate, set a binding minimum and maximum tax rate agreement on consensus basis. This policy option is believed to yield multiple advantages. It upholds the States' tax autonomy and allows them to manoeuvre regulated tax competition within a limited range. The minimum tax rate will address the legitimate concern of those who pronounce the adverse effect of tax competition. Setting maximum rate will preclude politicians from imposing excessive tax on tax payers. It also promotes accountability.

The range can be determined in a way to reflect how much the states are willing to trade-off tax autonomy for horizontal equity and provision of comparable public services at comparable tax rate. The HoF or an Association of the States (when they form) may take the initiative and

chair the negotiation process in shaping consensus based Economic Charter in the future.

### [7] Promote Accountability

Accountability can be promoted through setting transparent budgeting process, and citizens' participation in setting budget priority, applying public procurement procedures and ensuring citizens control over performance based budget execution so that voters will have information not only what resources are used but also what outcomes have been achieved at what cost. Competitive electoral system at all levels of government and establishing active democratic institutions will enhance accountability.

Periodic Kebele meetings and people' conference at Kebele and Wereda levels are held annually to discuss on various issues like good governance, annual budget evaluation, performance report, as well as on State policies, strategies and plans. However, these forums play little role in enforcing bottom-up accountability, because by *de facto* officials are primarily accountable to their Party. Elected politicians are dismissed by Party Assessment. Demotion of politicians for their incapacity and corruption by the voters is less common.<sup>249</sup>

In principle, State Council is the highest decision making body at any level of government. The Councils have legal rights to decide on annual budgets, planning, quality and quantity of public services to be delivered. They have power to oversee the performance of the Executive body. But in practice, the Executive body is stronger and vocal than the Legislative. By *de-facto*, real powers rest on the hands of the Executive body, who are among the top ruling regional party and almost all Heads of Bureaus and Wereda Executives are Members of respective Council. Such system has created strong Executive bodies at all levels of government. There is asymmetric of information and competence between the Executives and Legislators. Many of the Councillors at state, Wereda and Kebele levels of government have little academic capacity. They are handicapped with reliable and updated information on technical issues. They lack

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<sup>249</sup> There are few incidents where local officials were demoted for wrong doing or inefficiency because of pressures from bottom.

knowledge of laws of the land, government regulations and bureaucracy procedures. The centralized party channel and strong party discipline (democratic centralism) do permit little room to accommodate different views and alternative options other than the Party and government stands and policies. Moreover, there is no clear red line demarcation between the Party and the government. All these have created strong and vocal Executive bodies at the cost of the legislative and judiciary bodies.

### **[8] Borrowing**

States'/LGs' current expenditures exceed to current own revenues. The gap is financed through transfers. Transfers are not only sufficient to cover all expenditure needs, but also not ideal sources of financing long-term investments. Due to very limited availability of fund, large public works like roads, bridges, water supply service, housing developments, hospital level health services, preparatory and technical educations etc. are either underprovided or not provided. Neither undertaking long-term investment projects on pay-as-you-go base is appropriate from inter-generational equity and efficiency reasons. Therefore, guaranteeing states'/LGs' access to borrowing but restricted to capital investment only enables the States/LGs to adequately provide public services.

True, there is legitimate concern of exercising borrowing rights on the impact of macroeconomic stability and bail out risks. The fear can be checked by limiting borrowing for feasible investment projects only and by setting institutions and rules that promote self-discipline of the borrowers.

At the current situation the supply side of domestic lending institution (capital market) is undeveloped and is very weak in Ethiopia. The existing private commercial banks are not interested to give long-term loans to the States/LGs. The Development Bank opts to provide long-term loans for profit-making enterprises and to enterprises engaged on import substitution or export oriented firms. Therefore, under such weak credit market environment, establishing State Development Banks (SDB) that will operate in

business-like may solve the existing credit market problem. A state/LGs and/or Associations of LGs may take the lead in facilitating the formation of the SDB where the LGs will be major share holders.

**Appendix 5.1. Federal Government and States' public expenditure and own revenues, 1997/8 to 2009/10, in million Birr**

	Fiscal year ending July 7	1998/9	1999/0	2000/1	2001/2	2002/3	2003/4	2004/5	2005/6	2006/7	2007/8	2008/9	2009/10	Average
Federal revenue	Direct tax revenue	1141	1378	1593	1917	1682	1632	1792	2183	2775	3789	5437	8801	2703
	domestic indirect revenue	1005	1168	1136	1248	1432	1834	2173	2534	3156	4226	5964	8824	2742
	Foreign indirect revenue	2301	2694	2821	3293	3564	5276	5746	6587	8189	11693	11814	17685	6447
	Non tax revenue	3561	3188	2303	1972	2366	2087	2299	3829	3293	4598	8708	8719	3812
	Total revenue	8009	8428	7852	8430	9043	10829	12011	15133	17413	24307	31923	44029	15704
States' revenue	Direct tax revenue	876	989	1142	1202	1329	1798	2138	2278	2393	3226	4432	6105	2212
	Domestic indirect taxes	204	274	246	251	236	366	548	577	841	866	1361	1903	608
	Non tax revenue	475	478	435	511	540	924	885	1542	1151	1396	2468	1827	1011
	sub total revenue	1555	1741	1823	1964	2105	3088	3571	4397	4385	5487	8261	9835	3831
	Federal subsidy	4165	3141	4417	4653	6043	5970	6365	7833	9880	14261	17439	20934	8758
	From Federal treasury	3,527	2,475	3,076	3,340	4,556	5,056	5,556	7,056	9,056	13,556	16,556	19,556	7781
	From external loan and Asssistance	638	667	1,341	1,313	1,487	914	809532	777	824	705	883	1,378	978
	Grand States' revenue	5,401	4,550	5,570	5,961	7,405	8,601	9,538	11,842	13,853	19,396	25,259	30,080	12288
	Federal and States total revenue	9,564	10,168	9,674	10,393	11,148	13,917	15,582	19,530	21,797	29,794	40,184	53,864	20468
	share of States own-revenue to national revenue	0.16	0.17	0.19	0.19	0.19	0.22	0.23	0.23	0.20	0.18	0.21	0.18	0.20
	Share of Federal subsidy to total States' revenue	0.77	0.69	0.79	0.78	0.82	0.69	0.67	0.66	0.71	0.74	0.69	0.70	0.73

Source: Author's compilation from MoFED data base

Note that figures are rounded to nearest whole number



**Appendix 5.2. Public spending of Federal Government and States by category, 1997/8-2009/10, in million Birr**

Gov. level	Budget allocation	expenditure category	1998/9	1999/0	2000/1	2001/2	2002/3	2003/4	2004/5	2005/6	2006/7	2007/8	2008/9	2009/10	average
Federal Gov't	Capital budget	ED	592	650	699	699	1170	2057	4478	6048	7208	9724	11028	15319	4973
		SD	223	120	49	233	474	1296	1274	1574	2452	2381	2902	5323	1525
		GD	140	113	193	276	128	129	112	167	505	319	263	350	225
		Total expenditure	955	883	941	1209	1771	3482	5864	7788	10164	12424	14192	20992	6722
	Recurrent budget	Economic service	256	273	367	360	558	378	275	316	373	578	775	812	443
		Social service	414	622	471	806	787	625	695	886	1171	1696	2181	2885	1103
		General service	4811	7444	4953	3450	3260	3326	3934	4133	4248	4941	5704	6589	4733
		Total expenditure	5766	8339	5790	4616	4605	4328	4905	5335	5792	7215	8660	10287	6279
		Total Fed.Exp.	6436	9222	6731	5825	6376	7810	10769	13123	15956	19639	22852	31279	13001
State Gov't	Capital budget	ED	972	687	1033	1048	999	1070	1887	2162	2615	4338	5595	5129	2295
		SD	361	202	448	270	276	360	408	594	640	962	1550	2218	691
		GD	204	146	165	213	196	488	206	241	413	553	1375	2345	545
		total capital exp.	1538	1035	1646	1532	1470	1918	2501	2997	3668	5853	8520	9693	3531
	Recurrent budget	Economic service	545	536	594	694	779	983	1472	1621	1828	2533	3054	3274	1493
		Social service	1504	1480	1933	1995	2396	2628	3144	4110	5027	6966	8068	9702	4079
		General service	905	878	912	1180	1418	1722	1882	2389	2825	4188	5557	6198	2505
		total state rec. exp.	2954	2894	3439	3868	4593	5333	6498	8120	9680	13686	16679	19175	8077
		States' total expenditures	4554	4002	5165	5444	6235	7718	9079	11234	13386	19886	25389	29714	11608
		Grant (national) Expenditure	9390	12116	10170	9693	10969	13143	17267	21243	25636	33325	39531	50454	21078
		Share of Fed.exp.to national exp	0.69	0.76	0.66	0.60	0.58	0.59	0.62	0.62	0.62	0.59	0.58	0.62	0.62
		Fed cap. exp /to capital exp.	0.38	0.46	0.36	0.44	0.55	0.64	0.70	0.72	0.73	0.68	0.62	0.68	0.58

Source: Author's compilation from MoFED data base. Note total Federal and State expenditures do not include expenditures from external loans and assistances. ED = Economic Development; SD= Social Development; GD= General development

### Appendix 7.1. Concurrent tax transferred to the States in Birr

	2006/07			2007/08			2008/09		
States	Concurrent Revenue	withholding	total	Concurrent Revenue	withhold tax	total	Concurrent Revenue	Withhold tax	total
Tigrai	54,550,000	224,591	54,774,591	71,824,381	389,836	72,214,217	82,125,530	593,543	82,719,073
Afar	1,410,000	10,995	1,420,995	4,162,207*	9,314	4,171,521	3,233,667*	21,420	3,255,087
Amhara	37,300,000	402,691	37,702,691	39,395,378	779,130	40,174,508	48,237,749	1,248,500	49,486,249
Oromia	96,700,000	572,255	97,272,255	181,981,158	670,331	182,651,489	119,014,867	2,018,779	121,033,646
Somali	190,000	11,700	201,700	516,869*	10,804	527,673	606,886*	14,483	621,369
B-G	230,000	59,023	289,023	4,130*	76,892	81,022	587,445*	66,962	654,407
SNNP	16,580,000	18,622,855	35,202,855	29,120,865	552,150	29,673,015	55,186,321	898,751	56,085,072
Gambela	670,000	5,400	675,400	1,608,590*	11,425	1,620,015	1,221,157*	28,763	1,249,920
Harari	1,070,000	17,331	1,087,331	3,301,059	23,078	3,324,137	2,052,976	46,868	2,099,844
AA	177,500,000	276,330	177,776,330	274,231,745*	23,244,874	297,476,619	73,295,965*	38,029,677	111,325,642
DD	4,890,000	329,261	5,219,261	7,535,878	143,999	7,679,877	4,899,471	297,039	5,196,510
total	391,090,000	20,532,432	411,622,432	613,718,261	25,911,833	639,630,094	390,462,034	43,264,786	433,726,820

Source: Federal Revenue and Custom Authority

Note: Concurrent revenue includes business income profit, dividend, excise tax and VAT

\*include only VAT

**Appendix 8.1 Federal subsidy utilization rate, allocation and actual transfers of external sources among the States1998/9-2002/03, in '000 Birr**

States	Description	1998/99(1991EC)		1999/00 (1992EC)		2000/01(1993)		2001/02(1994)		2002/03(1995)		1998/9-2002/03		
		Federal treasury	External source	Federal treasury	External source	Federal treasury	External source	Federal treasury	External source	Federal treasury	External source	Federal treasury	External source	share of ext. source
<b>Tigrai</b>	allocation	255,655	37,521	248,168	62,857	182,310	30,100	232,349	59,590	377,650	59,900	1,296,132	299,498	23
	actual	262,020	7,387	236,921	6,321	188,873	23,065	299,001	23,065	383,850	38,259	1,370,665	92,396	6.7
	ratio	1.02	19.7	0.95	10.01	1.03	0.77	1.28	38.7	1.02	0.65	1.05	30.8	
	allocation	225,794	11,694	237,809	16,047	175,970	17,920	183,323	23,620	248,980	39,500	1,071,876	128,951	12
<b>Afar</b>	actual	178,211	5,790	219,092	740	165,490	2,589	205,007	2,663	245,190	12,365	1,012,990	27,833	2.7
	ratio	0.79	49.5	0.92	4.61	0.94	0.14	1.12	11.3	0.98	0.31	95	22	
	allocation	725,046	49,002	786,719	63,151	536,530	84,210	662,092	153,000	974,930	154,500	3,685,317	612,573	16.6
<b>Amhara</b>	actual	695,286	17,531	694,576	46,730	498,606	28,854	790,007	44,390	973,270	37,525	3,651,745	196,476	5.4
	ratio	0.96	35.8	0.88	74	0.93	0.34	1.19	29	0.99	0.24	99	32	
	allocation	826,191	83,101	910,180	81,603	612,550	111,790	909,713	154,510	1,274,080	201,900	4,532,714	744,324	16.4
<b>Oromia</b>	actual	839,202	57,317	823,180	25,609	598,107	29,288	1,048,740	30,952	1,278,480	1,000	4,587,709	196,878	4.3
	ratio	1.02	68.9	0.9	31.4	0.98	0.26	1.15	20	1	0	101	26	
	allocation	282,213	44,537	304,875	56,322	234,400	46,830	268,803	50,790	370,100	58,700	1,460,391	275,459	18.9
<b>Somali</b>	actual	203,854	24,423	198,774	18,528	206,410	20,126	305,158	20,126	371,704	13,066	1,285,900	76,443	5.9
	ratio	0.72	54.8	0.65	32.9	0.88	0.43	1.14	39.6	1	0.22	88	28	
	allocation	161,115	11,002	164,418	20,568	120,380	12,950	137,053	14,630	187,700	29,700	770,666	106,090	13.8
<b>BG</b>	actual	151,213	5,661	149,110	3,569	108,712	11,877	151,015	12,458	185,146	25,103	745,196	48,791	6.5
	ratio	0.94	51.5	0.91	17.4	0.9	0.92	1.1	85.2	0.99	0.85	97	46	ratio

<b>SNNP</b>	allocation	554,145	88,701	629,064	74315	440,000	93,660	497,628	132420	818,620	129,700	2939457	616,036	21
	actual	558,784	11,422	570,151	51,847	447,739	42,247	591,216	43,689	834,225	9,472	3,002,115	154,530	5.1
	ratio	1.01	12.9	0.91	69.3	1.02	0.45	1.19	33	1.02	0.08	102	25	
<b>Gambe la</b>	allocation	126,090	6,019	130,570	12,614	97,580	10,570	109,044	11,500	144,064	22,800	607,344	73,763	12.1
	actual	74,162	6,983	133,616	1,810	94,583	1,215	115,653	1,442	136,797	3,304	554,811	22,944	4.1
	ratio	0.59	16	1.02	14.3	0.97	0.11	1.06	12.5	0.95	0.14	91	31	
<b>Hareri</b>	allocation	77,012	3,347	80,311	6,342	58,600	6,580	50,996	6,730	70,350	11,100	337269	39,779	11.8
	actual	67,648	1,310	52,854	101	54,646	658	59,051	658	69,751	10,125	303,950	17,194	5.7
	ratio	0.88	39.1	0.66	1.6	0.93	0.1	0.98	9.8	0.99	0.91	90	43	
<b>Addis Ababa</b>	allocation	0	55,019	0	38,569	0	38,000	0	55,800	0	36,300			
	actual	2,223	24,584	1,012	0	0	23,500	1,056	24,411	760	0	77,146	48,844	63.3
	ratio		44.7		0		0.62		43.7					
<b>Dire Dawa</b>	allocation	32,000	3461	43,960	975030	16,640	3,010	70,000	4450	89,440	14,200	252,040	1,008,761	400
	actual	31,934	932	32,921	1,162	16,007	7,212	34,007	7,212	88,286	205	203,155	12,961	6.4
	ratio	1	26.9	0.75	0.11	0.96	2.4	0.48	1.62	0.99	0.01	81	1.3	
<b>Total</b>	allocation	3,265,262	393,403	3,536	1408857	2474960	455,620	3121400	660,01	4555900	758,300	16953522	4149460	24.5
	actual	3,064,537	163,341	2,771	156,050	2379172	11,674	2551171	32,113	4507458	150,425	15273338	765,623	5
	ratio	0.94	41.5	0.78	11.1	0.96	0.03	0.82	4.9	0.99	0.20	90	18.5	

Sources: Federal Subsidy allocation and actual transfers were collected from MoFED data base and rations are own calculation

## Appendix 8.2 Revenue and expenditures of the Federal and the States, 1993/4- 2009/10, in '000 Birr

	Federal Revenue	total Federal expenditure	State revenue	States recurrent Exp.	States Capital expenditure	Total States expenditure	National revenue	National expenditure (3+7)	Share of 4 to 5	Share of 4 to 7	Share of 4 to 8	Share of 6 to 9
1	2	3	4	5	6	7=5+6	8=2+4	9=3+7	10	11	12	13
1995/6	5,836,800	5,657,750	1,129,290	2,470,550	1,326,490	3,797,040	6,966,090	9,454,790	0.46	0.30	0.16	0.16
1996/7	8,977,870	6,105,990	1,360,650	2,511,470	1,811,970	4,323,440	10,338,520	10,429,430	0.54	0.31	0.13	0.18
1997/8	8,807,687	6,740,180	1,593,410	2,807,530	1,826,340	4,633,870	10,480,570	11,374,050	0.57	0.34	0.15	0.16
1998/9	11,917,300	10,479,730	1,539,670	3,014,640	1,749,290	4,763,930	13,456,970	15,243,660	0.51	0.32	0.11	0.13
1999/00	10,894,330	13,893,280	1,874,700	3,017,840	1,496,660	4,514,500	12,769,030	18,407,780	0.62	0.42	0.15	0.16
2000/01	14,587,690	15,324,464	1,876,210	3,624,540	1,886,000	5,510,540	16,463,900	20,835,004	0.52	0.34	0.11	0.17
2001/02	14,671,470	12,238,550	2,032,380	4,181,080	1,760,520	5,941,600	16,703,850	18,180,150	0.49	0.34	0.12	0.18
2002/03	14,,127,540	7,367,971	2,871,070	5,122,340	1,810,280	6,932,620	16,998,610	14,300,591	0.56	0.41	0.17	0.31
2003/04	17,828,730	9,088,236	3,449,620	5,535,810	2,280,290	7,816,100	21,278,350	16,904,336	0.62	0.44	0.16	0.26
2004/05	19,345,550	12,756,100	3,220,890	6,313,850	11,002,660	17,316,510	22,566,440	30,072,610	0.51	0.19	0.14	0.18
2005/06	13,970,010	14,785,200	4,385,800	8,399,550	12,846,000	21,245,550	18,353,810	36,030,750	0.52	0.21	0.24	0.23
2006/07	17,412,700	15,957,000	4,384,700	9,680,000	13,668,000	23,348,000	21,798,000	39,305,000	0.45	0.19	0.20	0.25
2007/08	15,826,770	25,455,400	5,487,420	9,717,910	15,311,850	25,029,760	21,314,190	50,485,160	0.56	0.22	0.26	1.06
2008/09	24,306,700	21,185,000	8,250,000	14,027,820	20,087,290	34,115,110	32,556,700	55,300,110	0.59	0.24	0.25	0.06
2009/10	31,922,800	24,499,000	9,835,000	16,868,700	13,038,900	29,907,600	41,757,800	54,406,600	0.58	0.33	0.24	0.18
Average	15,362,263	13,435,590	3,552,721	6,486,242	6,793,503	13,279,745	18,920,189	26,715,335	0.54	0.31	0.17	0.24

Source: Columns 2 to 9, MoFED data base [www.MoFED.org.et](http://www.MoFED.org.et) visited April 2009,

\*pre-actual data Column 10 -12 and own calculation Bir4385, 5487, and 8261

### Appendix 8.3 Comparison of Federal Subsidy Entitlement percentage share to the States, 1994/5-2011/12

States	1994/5 <sup>a</sup>		1995/6-1996/7 <sup>a</sup>		1997/8-1999/00 <sup>a</sup>		2000/01-2002/3 <sup>b</sup>		2003/4-2006/7 <sup>c</sup>		2007/8-2008/9 <sup>d</sup>		2009/0-2011/2 <sup>e</sup>		Ave. Pop. share (2005-2207)
	Federal subsidy share	Population Share	Federal subsidy share	Population share	Federal subsidy share	Population share	Federal subsidy share	Population share	Federal subsidy share	Population share	Federal subsidy share	Ave. Pop Share (2002-2006)	Federal subsidy Entitlement		
													Excludsol idarity fund	Including solidarity fund	
Tigray	9.0	5.91	8.3	6.0	7.7	5.83	8.29	6.04	7.18	6.0	6.38	6.04	7.11	7.04	6.1
Afar	3.9	1.97	3.6	2.1	5.0	1.94	5.47	1.97	3.75	2.0	2.51	1.96	3.18	3.34	2.0
Amhara	20.2	25.85	20.7	26.5	19.2	25.74	21.40	26.65	23.65	26.7	26.49	26.59	23.57	23.33	24.2
Oromia	28.3	35.06	27.5	35.8	25.3	35.14	27.96	36.70	33.28	36.7	33.72	36.76	32.86	32.53	38.2
Somali	4.5	5.94	4.2	3.5	7.6	5.86	8.12	6.04	7.27	6.0	6.68	6.02	8.09	8.43	6.2
B-G	2.9	0.86	2.6	0.90	3.6	0.85	4.12	0.88	2.00	0.9	1.42	0.87	1.68	1.96	0.9
SNNP	16.6	19.44	16.6	19.9	15.9	19.62	17.97	20.58	18.61	20.6	20.72	20.62	20.10	19.90	21.2
Gambela	2.5	0.33	2.2	0.4	2.8	0.33	3.16	0.34	1.45	0.3	0.92	0.34	1.47	1.57	0.4
Harari	1.1	0.24	1.0	0.3	1.8	0.25	1.54	0.26	1.12	0.3	0.50	0.26	0.90	0.89	0.3
Dire Dawa	1.0	0.47	0.9	0.5	3.8	0.4	1.96	0.53	1.69	0.5	0.05	0.54	1.02	1.0	0.5
Addis Ababa	10.1		12.3	4.2	7.3	-	-	-	-	-					--
Mean	9.1		9.1		10		10		10		10		10	10	
Variance	73.54		74.29				76.06		114.19		137.50		117.3	112.16	
SD	8.58		8.62		8.88		8.72		10.69		11.73		10.83	10.59	

Sources: a-c =Ministry of Economic Development and Cooperation, 2000 The Federal Budget Grant Formula in Ethiopia (unpublished)

d =MoFED 2004, A New Approach to the Distribution of Federal Budget Grant to the Regional States, AA, Unpublished

e=HoF, 2007, The New Federal Budget Grant Distribution Formula, Addis Ababa, Ethiopia

f =HoF, 2009, The Federal Budget Grant Distribution Formula to Regional States, Addis Ababa,

Variance and Standard deviation are own computation

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