Fiscal Federalism in the Ethiopian Ethnic-based Federal System

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Solomon Negussie

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ISBN: 978-90-5850-1 89-9
ISBN: 90-5850-1 89-2

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First published in the Netherlands by:
Wolf Legal Publishers (WLP)
Postbus 31051
6503 CB Nijmegen
http://wolflegalpublishers.com,

Verzorging binnenwerk: Gj. Wiarda Instituut, Utrechts Instituut voor Rechtswetenschappelijk onderzoek, Boothstraat, 3512 BW Utrecht

Revised edition
The publication of the revised edition was made possible through the generous grant of the Forum of Federations, an international Network of Federalism; www.forumfed.org
The forum is not responsible for any errors or opinion expressed in the book.

This book is the revised version of the published PhD thesis which was defended on 9 June 2006 at the University of Utrecht, the Netherlands.

Preface

This book deals with the fiscal aspects of Ethiopian federalism, with constitutional analysis at the forefront. It deals with the design of Ethiopia's fiscal constitution – form and scope of distribution of powers, responsibilities, revenue sources, the sharing of revenues and how intergovernmental transfers are structured. It also tries to take into account not only the constitutional form but also the operational realty since the change in government in Ethiopia in 1992. Although the process of fiscal federalism appears to have been implemented with little problems in Ethiopia, it is usually prudent to undertake scholarly researches in view of detecting and correcting any potential pitfalls ahead of time. It is with this background that an attempt has been made in this book to inspect issues of fiscal federalism which involve economic, political and constitutional analysis. By doing so, it is anticipated to study how the federal system envisages a need to keep a balance between the factors promoting a federal institutional model of self-rule with those promoting shared rule.

This book is the outcome of a PhD research that undertook between 2002 and 2005 at the Law Faculty, University of Utrecht, The Netherlands. There are numerous people and institutions who have directly or indirectly contributed for the completion of my research. First, I am tremendously thankful to Professor H.R.B. Kummeling and Professor Leonard F.M. Besselink, for accepting to be my promoter and co-promoter respectively and for their continuous assistance and intellectual guidance throughout the research project. I am further immensely grateful to Leonard Besselink who inspired me in constitutional law, made this study possible and shared the ups and downs during the last four years. I am also indebted to his entire family for extending cordial hospitality to me.

I would like to thank the members of the PhD Council for their constructive suggestions. I am also indebted to all those individuals who provided me all the necessary data and materials for my research and to all the interviewees who volunteered to share their time with me.

Thanks are also due to institutions which contributed for undertaking and completing my PhD research by providing me the necessary funding. These include the ECSC - my home institution - for giving me the study leave to complete my research, and the Institute of Constitutional and Administrative Law and G. J. Wiarda Institute (Institute of Legal Studies) of Utrecht University. The G.J. Wiarda Institute deserves my special appreciation for providing me all forms of assistance and the necessary facilities for the entire research period. My Thanks go especially to Professor Vervalle, Corrie, Frieda, LIoyd, Frans, Willemien, Kloos, Peter Moris, and other staff of the faculty for assisting me in every possible way.

To this list of thanks I would like to add the Summer University of the Institute of Federalism at Fribourg, Switzerland. It gave me an opportunity to meet and discuss issues of federalism in general and fiscal federalism in particular with professor Cheryl Saunders and other research fellows at the institute. The 15th International Conference of Ethiopian Studies which was held in the summer of

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2003 at Hamburg, Germany, was also instrumental in meeting many experts on different issues about Ethiopia. The Third International Conference on Federalism which was held in Brussels, Belgium, in March 2005 also gave me an insight into contemporary political and financial issues of federalism.

My gratitude also goes to those whom I met in the Netherlands for their encouragement and support, and to my colleague and friend Assefa who shared the challenges of life in Utrecht. In addition, I would like to thank my best friends in Ethiopia and abroad for their enthusiasm and moral support for me as well as for my family.

And, I would like to express my profound gratitude to my family. My deep love, respect and appreciation goes to my wife Genet Shibeshi for her continuous encouragement and for shouldering alone many responsibilities. I owe indebtedness to my wife and to my son for my absence at a time when they most needed care and love. Also to my parents, sisters and brother-in-laws who have extended unwavering moral and intellectual support all the way through. I feel honoured when I dedicate this work to them all.

I thank the Forum of Federations, an International Network on Federalism, for its generous grant for printing out the revised edition of this book in Ethiopia.

Finally, none of those people and institutions mentioned here bear any responsibility for the contents of the book.

Solomon Negussie
April 2008

JQ 3756 .S6 E85 2008 c.3

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LIST OF ACRONYMS

ANDM	Amhara National Democratic Movement
Bundesrat	Germany's Upper House
Canton	Name for the twenty six constituent units in Switzerland
Dergue	Amharic term for the committee, referring to the military government in power from 1975 to 1991
EPRDF	Ethiopian Peoples' Revolutionary Democratic Front
FDRE	Federal Democratic Republic of Ethiopia
EFFORT	Endowment Fund for the Rehabilitation of Tigray
ESRDF	Ethiopian Social Rehabilitation and Development Fund
HOPR	House of Peoples' Representatives
HOF	House of Federation
Länder	Name for the sixteen constituent units of the German federation (singular Länd)
MEDAC	Ministry of Economic Development and Cooperation
MOFA	Ministry of Federal Affairs
MOFED	Ministry of Finance and Economic Development
MOR	Ministry of Revenue
NGO	Non-Governmental Organization
OLF	Oromo Liberation Front
OPDO	Oromo Peoples' Democratic Organization
PLC	Private limited company
REST	Relief Society of Tigray
SDPRP	Sustainable Development and Poverty Reduction Program
SEPDC	Southern Ethiopian Peoples' Democratic Coalition
SEPDF	Southern Ethiopian Peoples' Democratic Front
SNNPR	Southern Nations, Nationalities and Peoples' Region
TDA	Tigray Development Association
TGE	Transitional Government of Ethiopia
TPLF	Tigray Peoples' Liberation Front
TOT	Turnover Tax
VAT	Value Added Tax

Map showing the constituent states of Federal Ethiopia



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INTRODUCTION

1. BRIEF INTRODUCTION

The post-1991 period witnessed the introduction of an unprecedented political structure in the modern history of Ethiopia. The federal Constitution, which was adopted in December 1994 and came into force in August 1995, is built on the principle of 'the sovereignty of nations, nationalities and peoples' as a guiding principle of accommodating diversity and the distribution of powers and responsibilities between the central and regional governments. As can be concluded from Articles 8, 39, 46 and 47 of the Constitution the language-based constituent units and the attempt to create territories that match the ethnic groups seem to be the essence of the federal system. These provisions of the Constitution confirmed the new approach towards ethnic diversity by stipulating ethno-linguistic criteria to be the primary basis of the federal structure.

From its inception this federal arrangement appeared to be peculiar not only because it follows ethno-linguistic lines for state formation, but also it explicitly recognizes the right to secession. This utmost emphasis on the rights of ethnic groups[1], and, the subsequent devolution of significant powers, is considered by many as 'ethnic federalism'. This unusual approach was considered by some as innovative, while others saw it as problematic to sustain the federal system. There are still others who take it as a change only in form but not different from its predecessors in substance. The argument of the latter is that the formal federal arrangement is overshadowed by a very powerful centralized ruling party which accumulates powers at the apex of the party structure and undermines the power relationship with the regions. According to this assertion, regional governments remain under the hegemony of the group who controls the centralized party system.

Regardless of these controversies, Ethiopia is constitutionally a federation with nine member states, which have mainly ethno-linguistic boundaries. Although it has only nine states, it is, in principle, a federation of many 'nations, nationalities and peoples' (normally considered ethnic groups) with a possibility of an ever-growing number of states. The country has been plagued by a cycle of conflicts, poverty, high population growth and economic problems, and through the new federal dispensation, it is hoped that the devolution of powers and functions would guarantee more autonomy, a fair distribution of national resources and participation at the level of central government through a genuine and working federal system.

---

[1] The term 'ethnic group' has been defined by different authors in various ways. Some have used it to refer to a group of people considered to be inferior to the dominant group while others used different criteria such as culture, history, language or ancestral relationship. Here, the term ethnic group is applied to describe a group of people identified by language. This is because, although the Constitution ascribes some different elements to it, it is only language that is used to identify the groups. For a recent analysis of ethnic identity, ethnicity, nationalism and ethno-nationalism in Ethiopia, see Merera Gudina, *Ethiopia: Competing Ethnic Nationalism and the Quest for Democracy, 1960-2000* (reprint, Addis Ababa, Chamber Printing press, 2003)

The adoption and operation of a federal system is characterized by the existence of two or more tiers of government that are directly and separately accountable to the people. Each tier of government has to perform distinct functions by means of the respective institutions, or by involving some formal and informal channels of cooperation.

Theoretically, in a federation, each level of government should have financial resources that broadly match its expenditure responsibilities. But the practice hardly fits this assumption. This leads us to the study of the implementation of financial aspects of federalism, in short: *fiscal federalism*, which examines four interrelated issues: first, the distribution of expenditure responsibilities, which depends on the constitutional division of powers and responsibilities, deals with the issue of 'who does what'. The second issue is the division of the revenue raising powers between the federal government and the regions. Third, the fiscal imbalances between the tiers of government and the disparities between them in executing their respective responsibilities. Here, the study focuses on the causes and impact of the two kinds of financial imbalances, referred to as vertical and horizontal fiscal imbalances. Fourth, the process of adjusting the imbalances and establishing a meaningful relationship between the tiers of government, both of which are indispensable for a viable federal system.

In a federal system, there could be some measure of inequality between the regions, i.e. some could be richer than others. In general, the greater the disparities between the regions, the greater the possibility for tensions and conflicts between them. In Ethiopia, however, accusations and objections abound with regard to the fiscal aspects. Some are mere suspicions while others are based on facts, but all pointing to the system of intergovernmental fiscal transfer. The arguments against the Ethiopian fiscal federal arrangement also emanate from the precariousness of an ethnic-based federal system. These issues urge an understanding of the context of constitutional law, the prevailing politics and the financial features of the federation. Therefore, this study examines not only the regime of fiscal federalism proper in Ethiopia but also seeks to indicate the need to avert the perils of the ethnic-based federal system (as shall be discussed in Chapter VIII).

2. THE RESEARCH QUESTIONS

Federalism was introduced as a solution for all internal illnesses of the country: from securing equality between the heterogeneous groups to promoting proportional development and an equitable distribution of the resources between them. The aim was to democratize the political process, to assure equal access to power and resources and, thereby, to reduce any form of interethnic conflict. However, this does not seem to be an easy task in a developing multiethnic polity like Ethiopia.

The primary step towards achieving the above stated objectives is the constitutional distribution of powers and responsibilities between the central and regional governments. Of course, the actual operation of a federal structure is based on the basic proposition that devolving powers and financial responsibilities to the constituent units of the federation can ensure autonomy, equitable distribution of resources and proportional development. However, many factors may interfere with this, and there is also a serious danger that it develops ethnic and regional cleavages. Thus, the problem addressed in this

thesis is how fiscal federalism is implemented in Ethiopia and whether its implementation can be operative to sustain the federal system and its particular objectives.[2]

This study discusses fiscal federalism in the Ethiopian ethnic-based federal system. The discussion focuses on two interconnected issues: first, we explore how the Ethiopian Constitution deals with the primary topics embodied in the concept of fiscal federalism, i.e., the distribution of powers and responsibilities, revenue sources and fiscal transfers, and examines the extent of its implementation. The second focuses on the impact of fiscal matters in the existing federal structure, that is, a system that claims to be symmetric in form but operates under an asymmetric context in reality (for the discussion of symmetry and asymmetry, see chapter 3, 1.6 below). This involves an examination of how best to reorganize the constituent units for a better functioning of the federal system.

This research is based on the analysis of key questions pertaining to the two interrelated issues mentioned above. In this regard, the following core questions will be addressed:

1. Does the constitution provide a clear allocation of expenditure responsibilities and revenue sources? Is the constitution sufficiently clear in the allocation of shared responsibilities and administrative power? What are the emerging trends in the implementation of powers and responsibilities at the regional level?
2. What are the degrees of imbalance in the revenue capacities and the expenditure requirements of each government – between the federal and regional governments and between the regional governments as well? What are the processes of adjustment dealing with the vertical and horizontal imbalances? Is there an appropriate institutional framework for adjusting the fiscal imbalances?
3. What form of intergovernmental relation exists and to what extent does the law regulate it?
4. To what extent does the implementation of fiscal federalism underpin the operation of ethnic-based federalism? The related issue is whether the implementation of fiscal federalism sustains the federal system with its peculiar constitutional features of both to the right to state formation and secession.

3. STRUCTURE OF THE STUDY

The study is organized as follows: The First and the Second Chapters sketch the historical and theoretical backgrounds of the topic under consideration.

- The First Chapter provides a brief description of the development of the history of the Ethiopian state which has culminated in the adoption of a federal arrangement. It does not, however, aim to illustrate all details of the controversies over the interpretation of the Ethiopian history although it argues that the present system has tried to address the historical struggle

[2] See, for instance, Art. 8, 39, 46 and 47 of the Ethiopian Constitution.

between the forces of centralization and decentralization solely from an ethno-linguistic perspective.

- The Second Chapter highlights the meaning and essential characteristics of federalism in general, and the principles of fiscal federalism in particular. The concepts of decentralization, cooperative and competitive federalism are also discussed in this chapter. The reason for the inclusion of these concepts is for a better understanding of the kind of relationship between the levels of government in the operation of fiscal federalism which will be discussed in the later chapters. This chapter also highlights the challenges of diversity in the process of intergovernmental fiscal relationship.

From the Third up to the Seventh Chapter the focus is on the analysis of the mainstream subjects of fiscal federalism, i.e., the division and distribution of expenditure responsibilities, revenue-raising powers, the vertical and horizontal financial imbalances, and the mechanisms for adjusting the imbalances and the disparities.

- Thus, the Third Chapter addresses the division of expenditure responsibilities and the mechanisms for implementing them at the regional levels. With regard to the division of expenditure responsibilities, it addresses the following questions: What is the distribution of expenditure responsibility from the perspective of the constitutional dispensation of powers and responsibilities? How is the executive powe: divided between the centre and regions? What is the competence of each tier of government? Are there areas of cooperation and shared powers which have fiscal implications?
  When there is considerable variation between the constituent units of a federation in terms of economic situation, geographical size, population or social factors, some federations opt for establishing constitutional asymmetry in the distribution of powers and financial resources towards effective implementation of responsibilities. This is to take into account the differences by implementing different degrees of decentralization. This will lead us to other questions: What are the implications of the symmetrical allocation of powers and responsibilities by the Constitution in a *de facto* asymmetrical context? What are the problems we encounter in these respects? Hence, in order to address these issues an attempt is made to discuss the importance of intergovernmental cooperation and the federal performance concerning the relationship between the centre and the regions.
- The Fourth Chapter focuses on the division of revenue raising powers, which is a sequel to the allocation of expenditure responsibility to each order of government. Every federal system should decide on what considerations the division of revenue raising power is to be based. Similarly this chapter raises the following questions: In what manner are the tax powers divided between the federal, regional and local governments? Which are the types of taxes, their sources and the implications for the financial capacity of each level of government? What consequence is envisaged by the Constitution which provides for 'concurrent power of taxation'? What are the limitations on the power to tax, beyond restrictions on the types of taxes that may be imposed?
- Chapter Five demonstrates the extent of vertical and horizontal fiscal imbalances based on an empirical analysis. This chapter links the previous two chapters, as it is largely a consequence of the constitutional assignment of expenditure and revenue raising responsibilities. But it also raises further questions, such as: How are the centre-states and state-state imbalances

measured? What are the factors that have contributed to the high degree of imbalances? What kind of difficulties may emanate from this? Can the imbalances be attributed to the existing socio-demographic asymmetries between the regions? The issues will be analysed in light of the question whether reducing the existing regional socio-demographic disparity can help in creating a more viable constituent units and federal system.

- Chapter Six and Seven discuss the most important but also most controversial aspects of fiscal federalism i.e. intergovernmental fiscal relations. Chapter Six discusses the general principles of intergovernmental revenue transfer. It focuses on revenue sharing arrangements, the types of grants, the methods and institutional mechanisms for the allocations of grants in some federal systems. After this general background has been laid, Chapter Seven thoroughly discusses the processes of intergovernmental transfer system in Ethiopia as they have occurred since the beginning of the devolution process up to the 2003/04 fiscal year. It reviews the revenue transfer arrangements between the federal and regional governments and the recent issues arising from transfers below the state level. Towards solving or reducing the complexities in financial arrangements, this chapter addresses the following questions: In what manner are the financial disparities between the regional and subregional levels of government addressed? To what extent do the region(s) depend on the federal transfer? What is its implication for the regional autonomy? What is the impact of intergovernmental fiscal transfer on the *de facto* asymmetry between the regions (or between the diverse groups)? A related issue is whether the framework for fiscal transfer should be administered by parliament or by an independent and non-partisan agency.

  The chapter deals on the whole with the apparent problems of intergovernmental transfer between the federal and regional governments and accommodating the diverse interest of people in a large and ethnically diverse country. These points will be analysed in light of the importance of asymmetrical federalism and the need for reorganizing the constituent units for a better performance of the federal system.
- Chapter Eight elaborates the idea that the implementation of intergovernmental fiscal relations faces considerable problems from the utmost emphasis given to diversity. The topic looks broad and may involve non fiscal issues, but it focuses on the findings of chapter five regarding the system of revenue transfer and assesses whether the implementation of fiscal federalism sustains the federal system with its peculiar constitutional features of the right to statehood or secession.
- Finally, a general conclusion will be drawn and recommendations will be made.

4. SIGNIFICANCE OF THE RESERACH

The relevance of this research emanates from the dearth of scholarly studies primarily focusing on the operation of fiscal aspects of the Ethiopian federal system.

Theoretically, the study advances the knowledge of and the insight into the legal parameters of the expenditure responsibilities, revenue-raising powers and the

institutions of intergovernmental fiscal relations. In addition, the empirical analysis based on the available data, legal and policy documents and interviews will advance an insight into the relationship between the expenditure responsibilities and revenue capacity of each tier of government with the institutions of intergovernmental fiscal transfers which aim to address the fiscal imbalances. It also studies the limitations of the existing intergovernmental administrative cooperation in addressing the disparities between the constituent units and executing the expenditure responsibilities.

In general, every federation demonstrates in some way the uniqueness of its fiscal aspects although it might show some similarities with others. By the same token, Ethiopia's uniqueness from a constitutional perspective emanates from the ethno-linguistic nature of the federal system and the constitutional guarantee of the right to statehood and secession for every nation, nationality and people. This uniqueness is analysed to show the problems regarding the vertical as well as horizontal financial relationships and how the fiscal issues influence the need to reform the ethnic-based federal arrangement.

The research seeks to contribute to the existing studies on the Ethiopian federal experience. By making a practical analysis, we hope to contribute to the understanding of the operation of Ethiopia's federalism by unravelling issues that need to be reconsidered for a better performance of the system. The outcome of the research may also be considered as a lesson for other countries which may intend to introduce an ethnic-based federal system, and may be helpful for those who want to study the Ethiopian system.

5. METHODOLODY

The primary focus of this research is Ethiopia. However, whenever appropriate, there will be a comparative reference to other federations. The comparative approach will be employed in order to elucidate concepts which are not well developed in Ethiopia but are either incorporated in its Constitution or have relevance for a better understanding of the principles under discussion. Thus, its aim is to draw a conceptual comparison. It has no intention to make a full comparison between the Ethiopian system and the other federations.

This research analyses the Ethiopian federal system from a constitutional perspective concerning its fiscal aspects. But the legal analysis of the fiscal aspects of the Constitution may not suffice. The vertical financial relationship between the centre and the regions and the horizontal relationship between the regions inevitably involve economic interests and have economic consequences. And the exercise of powers and intergovernmental fiscal relations function within the prevailing political system. Therefore, the studies on the functioning of the fiscal aspects of a federal system necessitate an exploration of the literature, not only concerning the legal but also the economic and political aspects of federalism.

In general, this research relies on a qualitative analysis of the following sources: academic literature, government documents, reports and data, and interviews. The choice of literature is focused on two areas: literature on the theory and practice concerning the principles embodied in fiscal federalism in general, and literature on Ethiopia in particular. With regard to the first area, a bulk of literature (mostly written by economists) has been found, but when it comes to

Ethiopia, the literature is meagre. This problem has been reduced by insights gained from literature used for comparative analysis.

The sources - documents, reports and data - mainly include governmental and non-governmental reports, publications and legal codes which are important and primary sources for the research. The government reports and publications include government plans, performance evaluations and reports to the parliament. The legal documents explored in detail include the FDRE Constitution, the regional Constitutions of Oromia, SNNPR, Amhara and Tigray, the Transitional Charter, all pertinent tax legislation and other laws focusing on the regionalization process since 1992. Most of the financial data are gathered from the Ministry of Finance and Economic Development, and from the regional finance bureaus. It also refers to the studies of the donor communities and institutions such as the World Bank, though they are less significant in terms of political and legal implications. Some relevant reports of the Central Statistical Authority are also used as background information. The data gathered from the pertinent institutions are examined to study the horizontal fiscal disparities between the constituent units as well as the vertical disparities in relation to the centre.

The analysis of literature, documents and data is corroborated by some interviews held with appropriate personalities on federal and regional matters in order to understand the issues better. Sometimes views on issues that cannot be easily found from governmental sources and those held widely in public opinion are gathered from the media.

The research is designed to depend to a great extent on official data available in government offices. However, some problems were encountered in gathering the data. In general, the system of documentation and collection of archives in many government offices is poor. With respect to financial data there is a lack of consistency in the data available at different offices. This could be due to variations in terminology used at the federal and regional levels, for example, in tax sources. Similarly, the data on public revenue and expenditure available at the federal and regional levels are subject to revisions and evaluations at several stages (from budgeting to execution) before it becomes a final government report. As a result, the proclaimed budget could be revised at a later stage. The process of consolidating the final report usually takes up to three years which makes the analysis of reports of the more recent years somewhat difficult. The other problem is related to the fact that the regional and local governments depend a great deal on the federal grant, but the reporting and consolidating processes are subject to manipulation in which the data sometimes do not reflect facts on the ground. In order to solve data-related problems and to present unbiased reports, the researcher expended a great deal of effort in collecting and analysing official reports. The difficulty of obtaining access to government offices, conducting interviews and collecting data cannot be underestimated.

Finally, there is one caveat: this study is limited in time in as much as it could not take fully into account the consequences of the May 2005 elections. The study also mainly focuses on the financial data and important developments that have occurred until the 2004/05 fiscal year.

FEDERalism

1 Sketching the Background (I): Historical Developments and Federalism in Ethiopia

The change in government in 1991 and the subsequent adoption of a federal Constitution in 1995 have resulted in a complete overhaul of the state structure with a view to accommodate diversity. Constitutionally, Ethiopia is a federation with ethnic-based regional governments as its constituent units. The adoption of a federal system entailed the devolution of legal, administrative and fiscal responsibilities to the regions with considerable political and economic implications. Generally, the success of a new political structure will largely depend on how carefully it is designed and within how long a time it can meaningfully be implemented. In this regard, designing and implementing an efficient and effective system of fiscal federalism is an essential but perhaps arduous task.

Before delving into the study of the mainstream subjects of fiscal federalism, this and the next chapter try to provide background information in general. To do so, the first chapter sketches a general background by discussing historical developments and the present federal arrangement of the country. The second chapter discusses the principles of federalism in general and the financial aspects of federalism in particular.

Chapter one is mainly intended for readers who are unacquainted with Ethiopia's history and the outlines of the present federal system. It is divided into two main sections:

- The first section deals with the historical background of the country. The issues that will be dealt with under this section are decentralizing tendencies and centralizing practices and the evolution of the public finance focusing on the tax system. These indicate the historical legacy with which the present federal system has to cope.
- The second section deals with the federal system as it exists today. It admits that the federal system is essential to achieve the objectives which excessive centralization cannot attain. However, its success is dependent on how the shift in political structure addresses the outstanding issues pertaining to centralism and how the system is designed to limit the problems it may encounter.

1. HISTORICAL BACKGROUND

Ethiopia is one of the oldest countries in the world whose formal history dates back to the *Axumite* kingdom of 1000BC.[1] Many writers have repeatedly praised Ethiopia as having a rich and varied mix of culture, ethnic groups, religion and

[1] According to the *Kibre Nagast,* it even goes back to 1000BC, the time when Queen Sheba (Makda) of Ethiopia visited King Solomon of Jerusalem where she conceived the later Menelik I - with whom the Solomonic dynasty descended to Ethiopia. Margery Perham, *The Government of Ethiopia* (London, Faber and Faber Ltd., 1968), p. 10.

landscape. The country is also characterized by its distinctive features of culture, history, ethnic heterogeneity and geographic diversity. It is also a country glorified with patriotism and independence, and identified as having a crucial place in the history of mankind. Ethiopia is one of the signatories to the UN Charter; it is the epitome of the pan African movement, and the principal founder of the OAU (presently AU). All these facets have contributed to its peculiar identity. Besides this uniqueness, Ethiopia is one of the very few distinct African states recognized as a successor to its indigenous state. However, it is faced with many political, economic and legal problems.

Since 1991, sweeping changes have been introduced in government. The foremost issues in this recent innovation are the question of ethnicity[2] and the introduction of a federal structure in an attempt to resolve the alleged inter-ethnic conflicts. But whether the recently introduced reform has produced a satisfactory solution for Ethiopia remains to be studied thoroughly. In this section, however, an attempt is made to describe briefly the history of the Ethiopian state with a view to a better understanding of the workings of the current federal system.

1.1. Decentralization in a historical perspective[3]

The state history of Ethiopia and its development have an impact on the nature and viability of a decentralized or a federal system. Understanding the inherited problems and political systems is important in finding a solution to the present problems. With this in view, the following section deals with the tendencies of decentralization and the form of relationship that existed between the centre and the administrative regions which historically known as provinces.

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[2] Ethnicity may mean different things to different people. It can be construed on an objective or subjective criteria. For instance, Merera on ethnicity and nationalism says: 'Ethnicity is a political ideological manifestation of an ethnic group which emanates from the feeling of a separate identity and belonging in turn based on shared 'cultural stuff.' Secondly ethnic nationals generally refer to a demand for creation of an independent state and are political and ideological expressions of an ethnic group or national real or imagined. Express in this definition is that ethnicity and nationalism involve the mobilization of groups for collective action to change their situation within or outside a given nation state.' Merera Gudina, *Ethiopia: Competing Ethnic Nationalism and the Quest for Democracy, 1960-2000* (reprint, Addis Ababa, Chamber Printing press, 2003), p.29-30

[3] This section covers the periods that have demonstrated the tendencies of decentralization in Ethiopian history, successful or unsuccessful forms of decentralization that existed before 1991.
Section 1.1.1 refers to the periods known as:
-The Axumites (from 10th century BC to 10th century AD),
-The Zagwes' (from 10th century AD to 1270 AD),
-The Solomonic dynasty (from 1270-1769),
-*Zemene Mesafint* (Era of the Princess) [from 1769-1855],
-The time of emperor Yohannes IV (1868-1889).
Section 1.1.2 refers to the 1952 of Ethiopian federation which attempted to reunite the northern part of the country colonized by Italy (Eritrea) with Ethiopia.
Section 1.1.3 focuses on the failed attempt of decentralization in 1987 by the Dergue.

1.1.1. Decentralization and regionalism

The *Axumite* kingdom was the first in the Ethiopian history to be considered as 'an established power sharing in the commerce and culture of the ancient world'[4] to the extent of claiming control over the Red Sea. As the history of Ethiopia goes back to the Axumite kingdom, so does the issue of decentralization. The Axumites were identified by their vast area of control over the trade routes through their strong hold over the port of *Adulis*, a strategic place for active participation in commerce. But one may wonder whether this helped the Axumites to implement an effective centralized system. In fact, the vastness of the area could be considered as an impediment to uphold a centralized system. The historical evidence, such as 'the inscription of King Ezana', shows that the Axumites established a decentralized system with petty states brought under their domination. In one of his inscriptions the king described how he controlled such a vast area, and the relationship that existed between the central authority and the conquered territories in terms of the payment of tributes by the subjected kingdoms and military protection by the empire.[5]

This coexistence of the central power with the autonomy of regions or kingdoms continued after the power shifted from the Axumites in the north to the Zagwe[6] and Solomonic dynasties[7] at the centre. Thus, the power relationship between the centre and the regions, widely known as the provinces and kingdoms of the south and southeastern part of the country, existed for centuries.[8] The most influential provincial lords were from Gondar, Tigre, Showa and Wollo, at times claiming the throne for themselves. The autonomous kingdoms were Kafa, Wolayta, Harar and Afar until they were fully incorporated in the late 19th century. Observing the existence of provincial autonomy and kingdoms, one of the writers concluded: 'Ethiopia, the oldest continually existing polity in Africa, has almost always been relatively decentralized at many stages in its long history.'[9]

The other period that is worth mentioning is that of Yohannes IV (1868-1889), a successor to Emperor Tewodros. Yohannes was a strong defender of regionalism.[10] He recognized the regional warlords and the administration of their territories so long as they honoured his throne. In other words he retained the

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[4] *Ibid*, p. 18.
[5] See the 'Inscription of Ezana' as quoted in Perham, p. 22 & 25.
[6] The Zagwes' ruled from the 1100 to 1270 A.D.
[7] The Solomonic dynasty was restored in 1270 AD. The Solomonic dynasty claimed a blood relationship with the house of David and ultimately with Christ. With regard to the literary works, *Kibre Nagast* and *Fetha Nagast* are the most widely known great achievements. Kibre Nagast (Glory of the Kings) was written during the 14th century by Yishak, a head priest of Axum. Its central theme is the fabulous story of King Solomon and the Queen of Sheba, which claims the three thousand-years existence of the country. The Fetha Nagast (the law of kings) which appeared in the Geez language during the 15th century contains sections on canon, property, family, and criminal law. See John Markakis, *Ethiopia: Anatomy of Traditional Polity* (Clarendon Press, Oxford, 1974).
[8] For the history of the Medieval period in general, see Tadese Tamirat, *Church and State in Ethiopia:1270-1527*, (Oxford, 1972); and Sergew HabteSelassie, *Ancient and Medieval Ethiopian History to 1270* (Addis Ababa, 1972).
[9] Paul Henz, 'The economic dimensions of federalism in the horn of Africa', in Woodward and Forsyth (eds.) *Conflict and peace in the horn of Africa: Federalism and its alternatives* (Aldershot, Darthmout, 1994), p. 124.
[10] For a detailed analysis see Bahru Zewde, *A History of Modern Ethiopia: 1855-1974* (London, James Curay, 1991).

title *Neguse Negest*, meaning 'king, of kings', for himself and at the same time recognized the title of 'kings' for regional rulers. Unlike his predecessor, Yohannes was successful in avoiding an unnecessary power struggle with regional lords and the church. He was ready to share power with his subordinates, provided that they accepted his superiority. The period of Emperor Yohannes IV notably exhibited the political system which recognized regional autonomy. On the whole, he was described as 'liberal and almost federal in his practices,'[11] but his death marked the end of a strong form of regionalism in Ethiopia.

In general, the time before the introduction of the modern centralized system in Ethiopia had consisted of a 'king of kings' at the centre and several regional governors known locally by the title *Negus* meaning 'king' or *Ras* meaning 'head' who had to demonstrate loyalty and assistance to the 'king of kings'. The relationship of the regional governors to the centre existed in the form of collection and transfer of tribute to the centre and military assistance to the emperor in his mission against local rebellion or foreign aggression. The regional or local governors had considerable autonomy in tax powers and social status with the consent of the emperor.

The above description demonstrates the existence of unity through powers attributed to the emperor and diversity by recognizing provincial/regional autonomy, i.e. a dual power structure. This implies that the monarchy did not seize absolute power until at least the late 19th century. Rather, in practice, it showed that the power at the centre was limited and at times weak. This weakness had several reasons.

One of the chief causes is the absence of a defined and structured succession to the throne. For example, after the restoration of the *Solomonic* dynasty in the 13th century, everyone who belonged to the hereditary line claimed the throne. Sometimes the more powerful provincial rulers were also candidates for the throne.[12] Thus, during the Middle Ages, the seat of the ruler of the empire was frequently shifting from one corner of the country to the other as a result of an intermittent power struggle by provincial lords all laying claim to the title of 'king of kings'. This shows how difficult it was to consolidate power at the centre and for it to play any meaningful economic and administrative roles. The history of decentralization was also marred by the continuous power struggle between the forces of the centre and the forces of the provinces.

An equally, if not stronger, persuasive reason could be natural factors which hindered a permanent relationship between the centre and the regions, such as communication problems due to difficult terrains, and the lack of infrastructure such as roads.[13]

The third reason is an economic factor. The relationship between the 'king of kings' (the emperor) and the provincial governors existed for the reason that the emperors were interested in making sure that the regional lords submitted themselves by paying taxes and tribute to the centre and laying no claim to the throne. But this did not stop the challenges to the central power since some of the provincial kings effectively exercised taxation powers and controlled the trade

[11] *Ibid*, p. 124.
[12] Markakis, op. cit., p. 15.
[13] Perham, op. cit., p. 43.

routes, which sometimes helped them to become economically stronger than the centre.

All these factors have had historical consequences. First, the perennial struggle between the centre and the provinces resulted in the absence of a permanent political seat of government. Initially, it was in *Axum* a place in north *Tigray*. It then moved to *Lasta*, in *Wollo*, followed by *Gondar*, *Tigray* again and finally to *Shoa*.

Second, the power struggle incapacitated central power from the mid-18th to the mid-19th century, a period commonly known as *Zemene Mesafint* (the Era of the Princes, 1769-1855). During this period each warlord was the ruler of his pockets of territories, and whenever it seemed convenient attempted to claim the throne. This period was unique compared to the ones preceding and following it. It was unique in the sense that the period evidenced the collapse of the pre-existing relationship between the emperor and the provincial governors. There are controversies among scholars as to whether during that period the empire succumbed into total disintegration or was reduced into a loose relationship and a type of confederal system.[14] The power of the emperors drastically faded and each province remained under the effective control of the regional warlords. Sometimes they suspended the payment of tribute to the centre because of the power vacuum at the centre.[15] However, they did not cut themselves off from the other provinces. They maintained a relationship with some of the contending provincial lords even by sending troops whenever required to do so. Compared to its predecessors the historically powerful empire fell into pieces. In sum, the peak of decentralization was witnessed during that period.

Perham argues that the political history was not only reflected in the provincial domination, but also in changing the geographical distribution of religion and the population. This is manifested in the geographical expansion of the Oromo to the northeastern part of the country and their participation in the power struggle around Gondar.[16] In the 16th century a Muslim force from the eastern region led by Ibin Ibrahim, commonly known as *Gragn* (left handed) Ahmad, had marched into the Christian highlands, caused the devastation of the monarchy and changed the dynamics of the religious population.[17]

The above factors led to a third consequence, which is the creation of a strong regional/provincial sentiment rather than an ethnic one in most parts of the country. This is because the peoples' migration and their religions allowed them to intermingle in a single province without losing their identities. The historically decentralized period had several self-governing provincial units which were further subdivided into smaller territories. Although contrary views are sometimes heard, this division was not necessarily based on ethnic affinity or religious sentiments, but on regional bases which continue to influence the administrative structure even to the present day.[18]

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[14] Bahru, op. cit., p. 14; He argues that 'the moves of the regional lords were to dominate the centre, not to go away from it.'
[15] *Ibid*, p.11; Bahru mentioned that in around the 1830s the emperor had an estimated annual revenue of 300 Maria Theresa Thaler (the then circulating currency which was the official currency of Austria), whereas one of the regional warlords had 75,000MT.
[16] Perham, op. cit., p. 43; Markakis, op. cit., p. 16-19.
[17] *Ibid*.
[18] For instance, all Amharas were not under the same ruler. Sometimes North Gondar (Amhara) and Tigray were under one and the same ruler.

1.1.2. The 1952 federation of Ethiopia (including Eritrea)

After several intrusions by foreign powers through the Red Sea, the northern coastal area, Eritrea, which was an integral part of Ethiopia and known locally as *Bahr Negash* ('the prince of the sea'), finally became colonized by Italy from 1896-1941.[19] Italy managed to stay in Eritrea after its dream of controlling the whole of Ethiopia was defeated in Adwa in 1896. But later on it attempted again to control Ethiopia from 1935-1941. After Italy was expelled from both Ethiopia and Eritrea in 1941, Ethiopia claimed Eritrea to rejoin with the motherland.[20] After a long diplomatic battle (in the UN) Eritrea rejoined Ethiopia in a federal arrangement.[21] Based on the findings of its Commission of Enquiry in Eritrea, the UN decided that Eritrea should form an 'autonomous unit federated with Ethiopia under the sovereignty of the Ethiopian crown.'[22] On September 11, 1952 the federation of Eritrea with Ethiopia took effect under imperial proclamation No. 124/1952. As per the articles of the proclamation and the UN resolution, the federal government retained jurisdiction over defence, foreign affairs, monetary and fiscal policy, communications, commerce, and the ports. The regional government of Eritrea, on the other hand, retained control in all matters not assigned to the federal government, which were basically taxation (in coherence with the federal fiscal policy), budgeting and policing within the territory.

The 1952 federation was different from the present federal system in Ethiopia for several reasons. To mention but a few of them: first, the then federal system had only two constituent units, Eritrea on the one hand and the rest of Ethiopia on the other. Second, the present-day primordial principle of territorial organization, i.e., the ethno-linguistic factor was not the political principle of the implementation of the previous federal system. Third, the UN decided for the implementation of a federal system as a compromise between Eritrea's independence and unconditional union with the motherland.[23] It can be said that the federal system was used as a means for the 'restoration of a historical past with its connotation of a restored or regained [motherland],'[24] and the maintenance of the ideals of a common historical and cultural tradition. However the federation was short-lived; it was dissolved in 1960 and Eritrea became one of the provinces of Ethiopia until 1993.

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[19] Perham, op. cit., p. xxx. She said that Eritrea became an 'artificially created state' annexed by Italy in 1890.

[20] 1941-52 (until the UN decided on a federation) was the period of British occupation Eritrea.

[21] For a detailed account of the diplomatic battle, see Zewde Retta, 'Ye-Eritrea Guday [t Eritrean Affair] 1941-63'(Addis Ababa, 1999).

[22] Art. I of UN resolution 390(V) A of December 2, 1950.

[23] An UN Enquiry Commission Report evaluated the 'unconditional union' requested by Ethio and the 'Unionist' vision in Eritrea, on the one hand, and Italy and the Muslim League in Erit which argued for independence on the other.

[24]It is also considered as one of the reasons for the introduction of a federal system. McWhinney, *Comparative Federalism: State's Rights and National Power* (Toronto, Univ Toronto press, 1965), p. xiv.

1.1.3. The Dergue's introduction of decentralization

In 1987, after the adoption of the third written Constitution of Ethiopia,[25] there was an attempt to introduce decentralization within the unitary system which was inherited from Haile Selassie I. There was administrative and territorial reorganization which resulted in twenty-five administrative provinces and five autonomous regions. It was partly based on the consideration of ethnic factors although no mention was made of it.[26] The government resorted to decentralization when it faced severe pressure from different directions. Some of the challenges were attributed to the fact that provinces were entirely under the control of line ministries at the centre, and political and military confrontations prevailed in many parts of the country. According to the laws, the regional councils (called in Amharic *Shengo* - a kind of parliament) were to be established in order to assume responsibilities for planning and implementing economic development.[27] However, these attempts during its last days did not bring about a meaningful fiscal, administrative or political decentralization. There was no devolution of decision-making power to the local level. Above all, most of the regions fell under a state of emergency because of the prevailing war in those regions. In fact the whole change was in form not in substance.

1.2. Centralization in a historical perspective[28]

In the previous paragraphs we have dealt with the history of Ethiopia which depicts the tendencies of decentralization. But here, we present the history of centralization which also marks the development of the modern history of the country.

1.2.1. Modern history and centralization

The beginning of the modern history of Ethiopia marks the time when Ethiopia became part of the modern world system.[29] This is the time when the Ethiopian empire regained its unity through the efforts of emperor Tewodros (1855-1868) that brought about the demise of the period of the *Zemene-Mesafint*. Despite

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[25] Proc. No. 1/1987. After the 1955 Revised Constitution of Ethiopia was abrogated in 1974 by the Provisional Military Government that seized power on September 12, 1974, Ethiopia had no written Constitution. The 1987 Constitution was 'approved' by a referendum held on February 1/1987. It established a 'People's Democratic Republic' which only lasted for less than four years.

[26] Three of the five autonomous regions (Tigray, Assab and Ogaden) were drawn partly on ethnic lines. See Proclamation for the Establishment of Autonomous and Administrative Regions of the People's Democratic Republic of Ethiopia, No. 14/1987.

[27] Proclamation to define the powers and duties of the organ of power and administration of the autonomous regions of Tigray, Assab, DireDawa, and Ogaden, No. 15/1987.

[28] This Section (1.2) deals with the development of a centralized system in the modern history of Ethiopia in terms of a centralized form of administration and its public finance covering:
- the period of emperor Tewodros (1855-1868) who successfully defeated the period of anarchy and reinstituted a centralized empire.
- the successful attempts of centralization, at times with dire consequences, by emperor Menelik II and emperor Haile Selassie I (1889- 1974)
- the military dictatorship (1974-1991)

[29] Teshale Tibebu, *The Making of Modern Ethiopia 1896-1974* (The Red Sea Press Inc., Lawrenceville, 1995), p. 50.

striving to unify the country, he introduced some innovative ideas for introducing and reorganizing the whole system of administration in the country. He proclaimed several measures, such as introducing salaries for the officials appointed by the emperor, took steps to create a professional state army which received a salary, introduced a legally fixed amount of tax, reduced the amount of land owned by the church and limited its relationship with the government. He clearly mandated the central government to facilitate the maintenance of law and order and protection against foreign aggression by appointing army leaders in the provinces.[30] Many authors opine that Tewodros's centralization policies and his pioneering ideas mark the dawn of the modern Ethiopian empire.

The centralizing policies continued and were significantly improved by Emperor Menelik II,[31] who succeeded to the throne (after Yohannes) in 1886. Though it is Tewodros who took the initiative to maintain central power, it is Menelik II who took serious measures to consolidate the central government. He took several measures besides expanding and consolidating the present-day shape of Ethiopia. He had built a strong army, took several measures for the purpose of modernizing the country by importing technology, introduced the use of currency, abolished slavery, and multiplied state activities. He also introduced a centralized system for imposing and collecting taxes by the centre. All his concerted efforts resulted in the introduction of a new structure of central administration by establishing ministerial offices and a cabinet in 1907. It was conveyed that 'the creation of these posts set in motion forces which led rapidly to the emergence of a nascent secularised, central bureaucracy.'[32]

On the whole, it can be said that the personal efforts of Menelik II, through his effective control and use of successful means, laid the foundation for the emergence of the modern state of Ethiopia as envisaged by him.[33] However, his reign is also the kernel of all the controversies in interpreting the modern history of the country.[34]

1.2.2. Modernization and consolidation of power

The process of the consolidation of a modern centralized state continued and became deep-rooted through the period of Emperor Haile Selassie I. Haile Selassie I, first as Regent[35]to Menelik II's daughter, Empress Zawditu, and later as Emperor, held power with perseverance and continued the centralization and modernization policies initiated by Menelik II for more than half a century. Some

[30] Tewodros's innovations backfired and led to strong resistance from the nobility and the church, which contributed to his power crumbling at an early date. However, the succeeding emperors strengthened some of his initiatives. For a detailed analysis see Bahru Zewde, op. cit.

[31] It is Yohannes who succeeded Tewodros in 1872. Yohannes's centralization policies were directed towards territorial expansion. He was praised in his decentralization policies since he permitted the regional lords to continue to rule over their respective territories so long as they submitted to him and paid taxes.

[32] Edmond Keller, 'Ethiopia: Revolution, Class and the National Question'(African Affairs vol. 80 No. 321, 1981), p. 531.

[33] Even though Menelik II introduced and laid down the foundation for modernization, he died before completing the consolidation process for a modern centralized state.

[34] The two most important controversial issues are Menelik II's treaty with Italy concerning the status of Eritrea and his geographical expansion to the south.

[35] He only had the title of Ras, meaning head, which was below the title of a King. Hierarchically, at the apex of the power ladder lies 'King of Kings,' followed by 'King', and then 'Ras'.

of the major steps taken by the emperor include the expansion and modernization of the army, strengthening and opening up new ministerial offices, reorganization of provinces and provincial administration, and the employment of salaried civil servants by the government. His decisions, in general, brought about the 'further development of secularized, professional bureaucracy, a professional army and an indigenous middle class committed to modernization.'[36]

The period of the reign of Haile Selassie I can be marked, *inter alia*, by three facts: modernization and a centralized system, consolidation of power in his person and the introduction and execution of a serious financial system and fiscal policies.[37] With regard to the consolidation of a modern centralized system, his position was clear from the very beginning when he ascended to the throne. After ascending to the throne the emperor declared, 'Ethiopia must remain united ...subjected to a common rule.'[38] He also mentioned that central ministerial offices were empowered to enforce all laws and decisions passed by the emperor or the parliament. Uniform laws and decisions were supposed to be imposed upon all the 14 administrative regions. In his decree during the signing of the first Constitution, he showed his commitment to the pursuit of a modern system of government and said that 'it is our duty to decree and enforce all the measures necessary for the maintenance of our government, for increasing the well-being of our people and aiding their progress on the road to happiness and the civilization attained by independent and cultured nations'.[39]

The emperor was actually busy centralizing the administration as well as the economic system of the country. He was the head of the executive, the legislature as well as the judiciary, which is the characteristic of an absolute monarchy.[40] The historical title of *king* for the provincial rulers was abolished as one manifestation of concentration of power. He gave his people the first written constitution in 1931, which defined how and who can succeed to the throne in order to restrain any conflict of power in contesting the throne. The constitution was later amended in 1955 and it existed until the demise of the monarchy in 1974.

As the centralization process was vigorously pursued, it also generated the beginning of the civil war for the liberation of Eritrea, the peasant revolt in several parts of the country (in Tigray, Bale and Gojam), famine followed by the popular uprising and the students' movement. The students' movement which began in the 1960s was characterized by the struggle for political rights and was the strongest opposition to the regime. It was known for raising the popular

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[36] Keller, *op. cit.*, p. 531.

[37] For a general account of the emperor's progressive role and the impact of his absolute power, see Bahru Zewde, 'Hayla-Selasse: From Progressive to Reactionary', in Abebe Zegeye and Seigfried Pausewang (eds.), *Ethiopia in Change: Peasantry, Nationalism and Democracy* (London, British Academic Press, 1994), p. 30-44.

[38] *Ibid.*

[39] Paul and Clapham, *Ethiopian Constitutional Development*, Vol. II (H.S.I. University, Oxford Univ. Press, 1972), p. 325.

[40] However, Abera Jembere considers the Emperor's time as 'a period of Monarchy with a limited power'. According to him the period from 1931-1955 was 'a partly limited power' (legislative power being shared with an embryonic parliament), the second part 1955-1974 was a monarchy with limited power, to certain extent. Abera Jembere, 'The Major Constitutional Arrangements of Federation and Decentralization,' in Lidija R. Basta and Jibrin Ibrahim (eds.) *Federalism and Decentralization in Africa: The Multicultural Challenge* (Institut du Federalisme Fribourg, PIFF etudes et colleque, vol. 24, 1999), p. 167-68.

slogan of 'land to the tiller', the acceptance of Marxist ideology and the introduction of the rights of nationalities to self-determination.

The emperor was successful in defeating regionalism and centralizing power in comparison to modernizing the economic, administrative and infrastructural aspects of his governance. Of course, the process of modernization was sustained compared to the periods that preceded him, but it lagged far behind the rest of the world. Scholars did not agree on the causes of the failure of Ethiopian modernization but seemed to agree on the consolidation of power by the emperor. Some argued that his greed for power, coupled with senility, thwarted all the possibilities for a peaceful succession of power and transition into a constitutional monarchy which could have helped to avert some of the perils the country experienced during the *Dergue* regime.

1.2.3. The military dictatorship (1974-1991)

As a result of the 1974 Ethiopian revolution,[41] a military government, widely known as the *Dergue*, grabbed power and pursued a centralization policy but with a different political ideology and vigour. The Dergue echoed the political questions raised by the public, but only tried to address the popular demand of 'land to the tiller'. However, its subsequent economic as well as political measures did not redress the pre-existing national socio-economic problems. The seventeen-year record of the Dergue regime witnessed an indiscriminate reign of terror against any opposition, the failed system of the command economy, prolonged war and famine. In the face of these problems, the military government pursued its persistent denial of political rights coupled with socialist ideology. Throughout the period mentioned, all power remained in the hands of the military. The fiscal policy, with all related financial laws was uniformly applied to all regions through the Ministry of Finance. Administrative, political and economic centralization became deep-rooted, even compared to the former regime. The brief attempt at decentralization (see above 1.1.3) did not change that. In general, the Dergue emerged as one of the most notorious dictatorships in Africa.

The people's dissatisfaction with the persistent economic and political repression led to different forms of struggle against the government, either in the form of armed struggle or in the form of popular anger.[42] The causes of the national struggle as well as the international pressure were the lack of the rule of law and the denial of fundamental rights, of which the Ethiopian people were indiscriminately deprived. In this regard it has been said:

> The more complex reality is that the Dergue undermined itself through its increasing and indiscriminate use of violence, through its resistance to democratization pressures, through its repression of all civic and ethnic organizations and through its failure to deliver social services to the country at

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[41] For the detailed analysis of the Ethiopian Revolution see Andargachew Tiruneh, *The Ethiopian Revolution 1974-1987* (Cambridge University Press, 1993).

[42] The major opposition groups were the Eritrean People's Liberation Front (EPLF), Tigray People's Liberation Front (TPLF), Oromo Liberation Front (OLF), and Ethiopian People's Revolutionary Party (EPRP). The EPLF, which begun its armed struggle in the late 1960s continued its extensive military campaign during the Dergue's seventeen-year period until it succeeded in its mission in 1991. The TPLF began its struggle immediately after the military took power in 1975. Above all, the people of the country, including the Amharas, abhorred the then military government.

large. These elements played themselves out through the agency of regionalized resistance that did eventually overcome the tottering Dergue.[43]

A brief conclusion on the political history

In general, most of the political rhetoric in Ethiopia centres around emperor Menelik II's expansion to southern territories, the student movement, the Italian invasion, the Oromo expansion (some call it migration) and the introduction of Islam. The political elites are not, however, in consensus on their interpretation of the historical process through which the country emerged and on the nature of the conflicts that prevailed in the country. The solutions they recommend also vary according to the characterization of the historical processes and conflicts. Some characterize the history as a colonial experience and recommend independence as a panacea for all problems. This idea was first propounded by the Eritrean liberation movement which started in 1960. Later on, some liberation movements from Oromo elites and Ethiopian Somalis advanced the same idea. The former group traces its argument from the Italian occupation of Eritrea and the dissolution of the federation which lasted from 1952 to 1960, while the latter group refers to the atrocities committed during Menelik II's expansion to the south and southeast in the late 19th century.

There are others who reject the colonial characterisation of the country's history, but vary in the solutions they recommend. They can be grouped into two. According to the first argument there was a national oppression by one against all others; thus it is only ethno-linguistic political characterization that can guarantee the equality of all nations and nationalities within the country. The second group challenges the argument that there was ethnic domination and advance a solution that is free from any ethnic-based politics. Nonetheless, the former group have the opportunity to test their belief, but it is too early to tell where this is heading, though some of its achievements and limitations will be discussed in later chapters.

1.3. The evolution of the tax system

Before we discuss some general features of the system as it developed after 1991 and aspects of the theory of federalism, it is appropriate first to sketch in outline the taxation system as it evolved before 1992. It focuses on centre-region relationship and how the tax system evolved to strengthen the tradition of centralism.

The traditional fiscal system was a corollary of the political decentralization that prevailed up until the mid-19th century. This system operated on two levels of taxation: at the provincial or regional level by the respective rulers and at the centre by the power of the *Neguse Negest* (king of kings). The tax capacity of the emperor was dependent on the levies owed to him by each provincial ruler or directly paid by his subjects. The provincial rulers levied taxes for maintaining their own military and administrative apparatus and for paying tributes to the centre. Thus, the same people were subject to payments to the provincial ruler and to the Neguse Negest (emperor).

[43] Lincoln Joshua, 'The effect of Federalism on Inter-group Relations in Multiethnic States: Evidence from Nigeria and Ethiopia', (UMI services, 2000), p. 63.

However, the mode of payments and the amount collected showed wide variations in the provinces.[44] The variation was attributed to the rate of taxation, the whims and discretions given to the tax administrators, and the absence of fiscal instruments that could ensure uniformity throughout the provinces. The tax power relationship between the emperor and the provincial rulers was dependent on the strength of the emperor's authority. Thus, one can observe the strength of the taxation power of the emperors following the centralization of power after the *Zemene Mesafint* (the Era of the Princes). But it does not necessarily mean that the burden of the taxpayer was lightened at the time of such a loose relationship. What is certain is that it was agriculture and the people who depend on it that were always the primary subjects of taxation.

The system of taxation which existed in ancient and medieval Ethiopia can be explained primarily in terms of the payment of tax in kind to the provincial rulers as well as to the emperors.[45] The people paid tax from their produce or livestock. Thus, the payment was in the form of grain, cattle, sheep, goats, honey, etc. Although agricultural taxes were the major traditional taxes, there were also other taxes imposed on non-agricultural activities such as taxes on minerals such as salt, taxes on handicrafts such as on carpenters, plough-makers, weavers, and tanners, on elephant hunting and transaction taxes and market dues.[46] Such kinds of payments were made at several stages besides those paid to the emperor and the provincial rulers. In principle, the taxpayers were subject to all subordinate rulers in the respective jurisdictions. There were also times when they paid in the form of services to the rulers and the emperor. There were also payments to the church. On the whole, the levying of tax had ruined the lives of the people who were dependent on agriculture.[47]

Taxes pertaining to internal as well as foreign trade and commerce were paid in kind or cash and developed as a source of economic and political strength. Revenues from internal trade and import-export trade were mainly related to the long-distance trade routes in Ethiopia. The long-distance trade route consisted of two main routes: the first running from the southwest to the northern part, and the second linking the western and eastern part of the country.[48] The trade routes served as the source of revenue for the local as well as the national rulers. They fostered the development of local markets, strengthened relations between the lowlands and the highlanders, and promoted commercial links with the outside world.[49] In this regard, Bahru notes, 'the network of trade routes that united north and south was one of the main bases of the process of unification

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[44] Richard Pankhurst, *Economic History of Ethiopia 1800-1935* (Haile Selassie I University, 1968), p. 504.

[45] Taxes were paid in kind and in several forms. It is believed that tax used to be imposed beginning with the Axumite period (100BC) and was collected in Axumite currency. In the middle of the 18th century a currency known as the Maria Theresa Thaler (Austrian origin) was introduced, and although its circulation was limited, its importance continued until the first decade of the 20th century. Another currency, the birr, was introduced by Menelik II. Pankhurst, op. cit., p. 468-78.

[46] Pankhurst, op. cit., p. 504-05; Teshale also mentions grain tax, craft tax, livestock tax, spice tax, mining product tax, wood tax, honey tax and ivory tax as the seven kinds of taxes in kind. Teshale Tibebu, op. cit., p. 85-87.

[47] As Pankhurst observed the onerous taxation system was 'out of proportion to the ability of the people to discharge them'. *Ibid,* p. 505.

[48] The trade routes are also indicative of the items exported from and imported into the country. For instance, salt and other imported items such as cloth and iron were carried from the north to the southeast. In the opposite direction ivory, gold, slaves and musk were taken to the coastal area. Bahru, op. cit, p. 21-2.

[49] *Ibid.*

that took place in the second half of the 19th century.[50] However, foreign and local traders were subject to multiple taxes levied at custom posts installed by every provincial ruler. Initially, it was emperor Tewodros who felt the problem and attempted to install three custom posts only.[51] However, regulating interregional trade and levying related taxes became successful at a later stage, as the emperors continued to centralize power.

As stated above, the levying of tax in the form of money was uncommon. The payment of tax in cash became effective with the issuance of national currency and the enactment of appropriate tax laws to that effect. It was Menelik II who introduced the legal tender and issued subsequent decrees in order to raise revenue for strengthening the power of his government. Accordingly, tax was imposed on every owner of a parcel of land, on cattle breeders, on traders, and on income and customs.[52] Government expenditure had also grown since the late 19th century to include the provision of social services like schools and hospitals, officials' salaries, and the organization of police force.

The evolution of tax payments in cash had brought about the disappearance of payments in kind.[53] Moreover, the traditional taxation system that existed between the *Neguse Negest* and the regional governors was changed and replaced by uniform taxes and a monopoly of power at the centre. Although the evolution towards a modern centralized system began during the reign of Menelik II, it was Emperor Haile Selassie I who created a strong centralized government, abolished the power of taxation of provincial governors and enacted and implemented uniform tax legislation.[54]

A more centralized taxation system was introduced in the post-1941 period. This could be observed from a series of tax laws enacted by the emperor. These taxes were levied on income, property, customs, and business. Specific tax laws on excise taxes, customs and export duties, turnover tax and tax on construction with varied rates were levied. The levying of charges and fees for licences and documents were introduced, and special purpose taxes (education and health taxes) were also imposed. Most of these laws, together with their amendment, existed for a long time or influenced the subsequent tax legislation. For instance, income tax law, which was first enacted in 1942 and then replaced in 1961 (proc. No. 173/1961), together with its amendments, was applicable until it was completely repealed in 2002.

The emperor's reign resulted in a strong centralized administrative as well as political system. This was also true of the fiscal system as a reflection of this centralized system. All decisions related to revenue and expenditure were made at the centre. The Ministry of Finance, through its branches extending to the regions, designed and implemented all policies pertaining to revenue and

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[50] *Ibid*, p. 21.
[51] Pankhurst, op. cit., p. 523-24. He said that similar actions were taken by others to address the same problems which hindered free trade. The most important are the treaties signed by some Ethiopian influential provincial rulers and kings with British, Italian and French delegations. Some of the treaties mentioned by Pankhurst were the 1841 Anglo-Shoan (a province) agreement, the 1849 British agreement with Ras Ali of Gondar, the 1883 Italian treaty with Emperor Menelik II, and the 1902 Franco-Ethiopian agreement.
[52] *Ibid*, p. 484.
[53] *Id*.
[54] For a detailed account of laws enacted before 1936 concerning the levying of income, excise and consumption taxes, see Pankhurst, *op. cit.*, p. 529-33.

expenditure.[55] Issues pertaining to the type[illegible]s and distribution of expenditure, the overall economic policies, the functional [illegible]classification between the levels of administration, and the structure of revenue [illegible]and expenditure were decided at the centre. All these as well as other financi[illegible]al decisions in connection with the fourteen administrative provinces demonst[illegible]rated the existence of a centralized fiscal system.[56]

After the Dergue took power and declared[illegible] the adoption of a socialist ideology, several changes were reflected in the tax[illegible]tion system. Some tax laws became obsolete and were replaced by new ones – Others were amended and new tax laws were also introduced. Thus, land tax, tax on income from renting land and buildings were abrogated as an immediate consequence of the nationalization of rural land, urban land and extra houses.[57] Health and education taxes were also immediately rescinded.

The socialist influence called for the amendment of some o[illegible]x laws of the time. The immediate effect was on laws that had an impact on the accumulation of capital. Accordingly, the rate of taxes on income was made exorbitant, so that it had a negative impact on the private accumulation of capital. Income tax was also amended to include other sources of income such as dividends, royalties, the rental of property and winning from games of chance. Agricultural income tax and a fee for rural land use were proclaimed. The regime was notorious for its surtax law superimposed on payroll and business profit taxes. Some fiscal measures were also taken later on during the regime. A law was enacted for the payment of tax on income from petroleum operations, and new sales and excise taxes were imposed. In general, the tax and spending system continued in its strongly centralized form.

The liberalized market policy which was declared as a result of a change in government in 1991 was followed by a reform in the tax regime. The primary change was introduced by reducing the rate of taxation on income structure. It was followed by several tax laws; some of them amended the previous laws while others became operational for the first time. The laws governing sales and excise taxes and customs duties were replaced by new proclamations. The taxation of capital gains was introduced for the first time. Agricultural income tax and fees for rural land use were assigned to the regional governments as a sequel to the new devolution process.

The evolution of the taxation system in Ethiopia culminated in the adoption of a federal system. Accordingly, the taxation system displays a federal feature where tax powers are divided between the central and regional governments. The later chapters of this thesis analyse the taxation system and its operation on the basis of the Constitution of the Federal Democratic Republic of Ethiopia (FDRE).

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[55] Eshetu Chole, 'Issues of Vertical Imbalance in Ethiopia's Emerging System of Fiscal Decentralization', in Eshetu Chole (ed) *Fiscal Decentralization in Ethiopia* (Addis Ababa, AAU printing press, 1994), p. 167. Eshetu states 'fiscal autonomy for the regions was the education and health taxes, earmarked for financing primary education and health in the same regions. But this was more of form than substance.'

[56] For a historical analysis of the fiscal system during 1942-1989, see Wegene Yirko, 'History of Post-War Ethiopian Fiscal System,' in Eshetu Chole (ed.) *Fiscal Decentralization in Ethiopia* (AAU printing press, 1994), p. 19-50; see also Shiferaw Jammo, 'An overview of the economy, 1941-74,'in Shiferaw Bekele (ed.) *An Economic History of Ethiopia*, vol. I (CODESRIA book series, 1995), p. 1-71.

[57] Proclamation No. 31/1975, for the public ownership of rural lands; and Proc. No. 47/1975 for the government ownership of urban lands and extra houses.

2. AN OVERVIEW OF FEDERALISM IN ETHIOPIA

2.1 The transitional government and the decentralization process

A conference was convened immediately after the demise of the military government on May 28, 1991 which led to the formation of the Transitional Government of Ethiopia (TGE). The TGE officially stayed in power from July 1991 to August 1, 1995.[58] The conference adopted[59] a novel approach since it recognized the rights of each ethnic group (frequently referred to as nations, nationalities and peoples[60]) to administer itself and even to secede from the union, and also agreed that the secession of Eritrea had to be decided by a referendum.[61]

The TGE had begun its task by reviewing the political, administrative and economic systems of the country, which had existed for the previous century. Accordingly, it took several steps to implement the decentralization objectives enunciated in the Charter, which it had adopted as a provisional constitutional instrument. With this in mind the primary step taken by the TGE was the formation of a three-tiered[62] administrative system and the corresponding decentralization of administrative and fiscal authorities. It established fourteen regions and defined the powers of the central, regional and local (wereda) levels of administration.[63]

The devolution of administrative power had been put into effect by a statutory division of legislative, executive and judicial powers between the centre and the newly formed regional governments. To exercise rights guaranteed by the Charter[64] and by the subsequent proclamations, regional governments had established several administrative organs. The establishment of these institutions at the local level was assumed to provide a good forum for public participation and to ensure local accountability. Despite these assumptions, however, many

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[58] This is the period between the conference and the time when the Constitution officially came into effect. The federal Constitution, although adopted in December 1994, came into force on August 1, 1995 by proclamation No.1/1995. Even though the TGE was only mandated for six months, it remained in power for four years. Its primary tasks were drafting a constitution, conducting a free and fair election and transferring power to the winner. The present Prime Minister, Ato Meles Zenawi was the president and Ato Tamirat Laynie, who is now serving a prison term for being convicted of corruption, was the prime minister. The Transitional Council had 87 seats.

[59] A dozen political 'parties' with ethnic characterization participated in the conference.

[60] The use of this terminology - rights of nations, nationalities and peoples - is known as a Marxist-Leninist ideology and for the first time was raised as a political solution in Ethiopia in 1970 by Walelign, who was active in the student movement of the time against the monarchy.

[61] This was peculiar since Ethiopia was an exception to voluntarily cede its part through a referendum, while its citizens did not participate in it. It was a unique occasion in the recent history of the UN.

[62] The three tiers were the 'Central Government, Regional Self-Government, and the Wereda Administration.'

[63] Initially 14 regions were formed. But later on, six of them were combined together into one region called the Southern Nations Nationalities and Peoples Regional Government (hereafter SNNPR).

[64] The Transitional Charter was a kind of 'Constitution' for the transitional period. It was a concise law which emphasised the rights of nations, nationalities and peoples' including and up to secession, and on the recognition of international human rights conventions as part of domestic law. See the Transitional Charter, Proc. No. 1/1991.

argue that it had no practical significance since the regions were constrained by a lack of capacity and a lack of political will to decentralize powers to the wereda levels.[65] The problem of a lack of skilled manpower had eventually affected revenue-generating capacity and the ultimate performance of the regions.[66]

The establishment of TGE marked a departure from the then traditional roles of the central government in economic establishments at least in two ways. the introduction of a market economy and fiscal decentralization. The former was introduced and highlighted in the economic policy of the TGE and successive government policies and legislation. The principles of fiscal decentralization as enunciated by the Charter and further elaborated under proclamation Nos. 7/1992 and 33/1992[67] provided for the division of expenditure and revenue-raising responsibilities between the centre and the regions. Proclamation No. 33/1992 also provided the principles that govern all forms of intergovernmental financial relations.

Even though the TGE inherited a highly centralized system coupled with its grave shortage of skilled manpower and infrastructure problems, it instantly set up a highly decentralized system of government. Its structure was considered to have a 'federal'-like structure.[68] The period did not serve for conducting a debate as to whether a federal system should be introduced and in what form. Federalism as it appeared in the constitution was considered as the sole option to hold Ethiopia together. The devolution of administrative, economic and political powers, and their institutional and legal organization laid down the foundations for ethnic-based federalism.

When a federal system is introduced by devolution, several precautions must be taken such as identifying appropriate measures to balance centrifugal and centripetal forces, determining the available resources and analysing the additional costs that could be incurred. Normally, a transition period may have a different nature in different federal systems, but can be considered as a formative stage of federalism. This can be observed from the historically strong unitary systems such as Belgium and Spain which passed through several stages before introducing a federal arrangement.[69] The post-colonial federal systems implemented in Nigeria and India had passed through a formative stage introduced by the colonizers in one way or another.[70] Both India and Nigeria pursued federalism as a means of maintaining their independence and unity through a system already implemented before attaining independence in 1947

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[65] Befekadu Degfe, 'The Legal Framework for Fiscal Decentralization in Ethiopia during the Transitional Period', in Eshetu Chole (ed.) op. cit., p. 63.
[66] For a detailed analysis of expenditure and revenue generation see infra Chapters III and IV.
[67] See the Proclamation for the establishment of national regional self-government, No.7/1992; and the proclamation for the definition of the sharing of revenue between the central and regional governments, No. 33/1992.
[68] To be considered as a fully-fledged federal system, there should be at least a supreme written constitution, a formal constitutional distribution of legislative and executive authority, and an umpiring institution for constitutional disputes.
[69] Watts, op. cit., p. 29. Belgium has established a formal federation with a unique feature, which combined both territorial jurisdictions and personal jurisdictions after passing through four stages of devolution in 1970, 1980, 1988 and 1993. Spain also began the process of decentralization as part of democratisation and as a means of balancing powerful regional interests fostered by Basque and Catalonian nationalism
[70] For the historical background in India and Nigeria, see R. D. Dikshit, *The Political Geography of Federalism* (Macmillan, New Delhi, 1975). Many Nigerian authors argue that the federal system was initially imposed by Britain during the Colonial era.

and 1960 respectively. In both countries colonial conquest had altered the historical organization and the relationship of the provinces.

We have just seen that since the late nineteenth century, the prevailing system in Ethiopia was towards maintaining a highly centralized system. It was under this condition that a system of complete decentralization was introduced in 1991. The federal system can neither trace its roots from the recent history of the country nor is it based on the traditional form of decentralization.[71] It has been reiterated, 'in the construction of federated states, it is important to consider that the particular historical context can weigh heavily upon the success or failure of such a strategy.'[72] The abrupt introduction of federalism coupled with a novel undertaking of ethnicising its form was considered by many as a risky venture. The novelty of the system also casts a shadow of doubt over whether the principal actors of the system adequately comprehended it. It is a mistake not to pass through transitory steps like a decentralized unitary system while at the same time laying the foundation for a federal system.

2.2. The federal Constitution of Ethiopia

The 1995 constitution officially declared the 'Federal Democratic Republic of Ethiopia (FDRE)'. The FDRE, as per the Constitution, comprises of nine states, also called regions or national regional self-governments[73] and a federal capital. The Constitution emphatically posits the importance of ethnicity as the major criterion for the establishment of the Federal Democratic Republic of Ethiopia (FDRE) and for the workings of the federal system as a whole. One can observe its importance from the preamble to the Constitution which states 'we, the Nations, Nationalities and Peoples of Ethiopia...have adopted the Constitution.'[74] This Constitution binds the citizens of Ethiopia who should be first identified and categorized in one of the language groups – indicated with the identified and interchangeable categories of 'nations, nationalities and peoples' - before entering into the social contract. The people's common destiny in their choice to build a political community and administrative territories has to be determined from the perspective of ethnic groups. That is why many argue that Ethiopia follows 'ethnic federalism'. Although the Constitution implies 'the coming together of the nations, nationalities and peoples' the federation is established by devolution from a formerly unitary state.'[75]

The Constitution is the supreme law of the land. Hence, 'any law, customary practices, or a decision of an organ which contravenes the Constitution shall have

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[71] Some scholars discussed federalism as a solution to the armed struggle for Eritrea's independence before 1993. See Heinrich Scholler, 'The Ethiopian Federation of 1952: an Obsolete Model or a Guide to the future?' in Murray Forsyth and Peter Woodward (eds.) *Conflict and Peace in the Horn of Africa* (Dartmouth Pub. 1994), p. 10-18.

[72] Edmond J. Keller and Barbara Thomas-Wooley, 'Majority Rule and Minority Rights: American Federalism and African Experience'(Journal of Modern African Studies 32, no. 3, 1994), p. 425.

[73] Unless otherwise provided, hereafter state, region and regional government are used alternatively.

[74] Art. 39 (5) of the FDRE Constitution provides, 'A 'Nation, Nationality or People' for the purpose of this Constitution, is a group of people who have or share a large measure of a 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.'

[75] See below the discussion of federations by aggregation and by devolution, Chapter II (Sec. 1.2.)

no effect.'[76] It cannot be subject to unilateral amendment by either level of government, but it provides a rigid procedure at the central and regional levels.[77] It deals with a federal structure which comprises of the federal government and the member states where each has equal powers and rights as laid down in the Constitution.[78] It guarantees the division of powers between the federal government and the states in which the centre has powers specifically laid down while the regions have residual powers in addition to those specifically stated. However, unlike many other federal constitutions, the Ethiopian Constitution does not provide a clear statement declaring the supremacy of the federal law over the state law.[79] Furthermore, it does not expressly mention concurrent legislative power, except the sharing of revenue generated from some tax sources labelled as 'concurrent taxes'.

The Constitution provides for the independence of the judiciary. It also decentralizes the judiciary in line with the federal system in place. It establishes a three-level court system: supreme, high and first instance courts, at the federal and regional levels. The highest and final judicial power resides in the federal Supreme Court. The state Supreme Court also has similar power over state matters. Unlike the USA and many federal systems, the federal Supreme Court is not a final interpreter of the Constitution. It has no power to hear appeals from state Supreme Courts.[80] The final authority to interpret the Constitution is given to the House of Federation (HOF) - the Upper House.

It also provides for the protection of group rights, cultures and languages. Although the adoption of several official languages is a thorny issue, the Constitution provides recognition for all languages but defines Amharic as the only working language of the federal government. The Constitution contains provisions for the separation of the state and religion, and a prohibition on one interfering with the other. More than one-third of the total provisions of the Constitution are devoted to the recognition and protection of human rights - civil, political, economic and social rights. Many have praised the recognition of equality between the sexes and the mechanisms to address the historical violations of the rights of women. Government accountability is another dimension of the Constitution in order to make any activity by public officials open and transparent to the public. Although the Constitution is praised with all its limitations, it is debated among Ethiopians whether the government itself abides by its own commitments and keeps its promises to protect human rights.[81]

Despite the fact that the federal Constitution embodies the federal principles enshrined in other federations, it also has its own distinct features. The first and most controversial issue is the constitutional recognition of the right to

[76] Art. 9 (a) of the FDRE Constitution.
[77] See Art. 105 of the FDRE Constitution.
[78] Art. 47 (4) of the FDRE Constitution.
[79] However, the states' Constitutions recognize the supremacy of federal laws. The law that provides for the establishment of federal courts also mentions the supremacy of federal laws.
[80] However, the federal Supreme Court has the power of cassation over any final court decision containing a basic error of law. See Art. 80 (3, a) of the FDRE Constitution.
[81] See http://www.EHRC.net/ on the reports of the Ethiopian Human Rights Council and the accusations reiterated by many opposition political parties. Still, many accuse the government of violating the Constitution by arbitrary arrests, harassment of opposition parties and inefficient bureaucracy. But the EPRDF led government is also praised for its commitment for the establishment of human right commission and ombudsman, recognizing diversities and a possibility of a multi party system although the process is in its infancy.

secession.[82] The Constitution in principle grants this right to all 'nations, nationalities and peoples' of Ethiopia.

The composition and the powers of the Federal Houses is another difference. The FDRE has two houses, the House of Peoples Representatives (HOPR) and the House of Federation (HOF), a sort of Lower and Upper House respectively. But the Constitution provides for a unicameral legislative body. It is only the HOPR that has a legislative function. In many federations the states participate in the exercise of powers at the centre through their representation in the Upper House. However, the HOF which is primarily a *majoritarian* Upper House based on population size is given non-legislative power, most of which concerns intergovernmental relations.[83] A potential political controversy surrounding the issue of group rights versus individual rights could also be a marked difference with other constitutions.

2.3. Territorial organization of the constituent units of the federation

The delimitation of interregional and subregional boundaries has significance in the concept of fiscal federalism. Sometimes territories are used as the basic measuring units for the distribution of public goods and services.[84] It may also become a source of conflict,[85] particularly when it becomes linked to a source of finance, as in the case of the discovery of natural resources.

In the modern history of Ethiopia, territorial reorganization has taken place on several occasions.[86] Its recent history (post-1991), however, is so exceptional that it changed our concept of territory. The change in the concepts of boundary and territory in Ethiopia appeared after the adoption of the transitional Charter and the subsequent promulgation of Proclamation no. 7/1992. Article 46(2) of the FDRE Constitution affirms that 'states shall be delimited on the basis of the settlement patterns, language, identity, and consent of the people.' Practically, the regional and subregional territories are organized mainly along ethnic lines (see also Art. 8, 39, 46 and 47). In this regard, Clapham concludes, 'Whereas subnational units within Ethiopia had hitherto been defined primarily in terms of territory, and all comprised peoples of several different ethnic groups, they [are] now defined in terms of nationality.'[87]

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[82] Art. 39 of the FDRE Constitution.

[83] See Arts. 53-62 of the FDRE Constitution. Although each 'nation, nationality or people' shall be represented in the HOF by at least one member, the total number of representatives at the House is determined by population size. And, hence, the composition of the House and its decision is characterized by the rule of the majority.

[84] It is one of the factors used to determine the amount of fiscal transfer to the regions. This will be discussed in the later chapters.

[85] Markakis states that the source of all conflicts in the Horn of Africa pertains to resource allocation and territories, Markakis, op. cit.; Jon Abbink also argues that the conflict between some ethnic groups in the south is the claim for resources and territory. Jon Abbink, 'Ethnic conflict in the 'tribal Zone': the Durzi and Suri in Southern Ethiopia,'(Journal of Modern African Studies 31. No.4, 1993), p. 675-682.

[86] It is, however, incomparable with Nigeria which has conducted six major territorial reorganizations within four decades and has increased the number of states from three to thirty-six.

[87] Clapham, 'Boundary and Territory,'245, as quoted by Joshua, op. cit., p. 147; one geography expert in Ethiopia, however, says that the difference between the post-1991 and the previous territorial arrangements 'does not lie in the basic criteria [ethnic factor] used but rather in the political aims and motives used in creating the divisions and in the administrative modalities employed', Daniel Gemechu, 'A nation in perpetual transition: The politics of change

Article 47 of the Constitution enumerates nine member states of the federation. The states (mostly referred to as regions in the Ethiopian case) are organized with the state governments at the top, followed in some states by zones, and in all by weredas and kebeles. Kebeles are the lowest unit of administration, but the weredas remain as the basic unit of hierarchy of administration in all regions with respect to budgeting and spending decisions. In most regions (except Harari) Zones[88] are introduced as a level of government between the weredas and the regional government. A Zone serves as an instrument to adjust boundaries within a region based on language, such as Gurage, Sidama, and Kambata in the SNNPR region, or Wag Himra, and Awi in the Amhara region. It can also be said that zones in big regions serve to create further subdivisions and manageable sizes in order to enhance administrative convenience. However, neither proclamation no. 7/1992 on the establishment of national regional self-government nor the federal Constitution explicitly provides for the establishment of zones.[89] Zones are established by states' Constitutions.

What consequences do we observe following the post-1991 boundary and territorial organization? One can easily conclude that it has brought about fundamental differences between the constituent units of the federation. To mention some of the disparities as observed from the 1994 census (see also Table 1:1 below), Oromia being the largest state counts 18.7 million people, Harari has 131,400 (Oromia accounts for 35 percent whereas Harari less than 0.3 percent of the total population of the country). The population of Gambela is less than some of the weredas in Oromia and Amhara. The size of Oromia accounts for one third of the size of the country while Harar is only 0.03 percent. While Oromia includes within its boundary the country's three largest cities and economic centres, Addis Ababa, Harar and Dire Dawa, Benishangul has a few small towns and fewer infrastructures. Somali and Afar are pastoralists and are dependent on livestock whereas Amhara and Oromia regions are mainly agrarian. There is also inconsistency in the use of criteria in forming regions. Two neighbouring cities, Harar and Dire Dawa, are inhabited by heterogeneous groups and with comparable social and economic factors, but are treated differently; the former is a state and the latter is a federal administrative council with a lesser legal autonomy.[90]

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in administrative divisions and subdivisions in Ethiopia', in Harold Marcus (ed.), *New trends in Ethiopian studies: proceedings of the 12th international conference of Ethiopian studies* (Michigan State University, 1994), p. 83-113.

[88] Zones reflect the boundaries of the administrative regions introduced in 1987 by the former government. For instance, we find East Shoa, West Welega or Bale in the Oromia region, and we can find North Gondar or East Gojam in the Amhara region. Following the post-2001 massive state reforms regions focus on decentralizing more powers to the weredas but the role of zones have not yet been well defined.

[89] Art. 50 (4) of the Federal Constitution provides, '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.'

[90] See Table 1:1; Dire Dawa, being a federal administrative council receives grants from the federal government, has its own administration and a council elected by the inhabitants, but it is accountable to the prime minister. However, towns with similar heterogeneous factors do not have a status like that of Dire Dawa.

Table 1: 1[91] The 1994 Census; Population, area, number of zones, weredas, towns and kebeles

Region	Population*	Population in %	Area in 000 m^2	No. of Zones	No. of weredas	No. of Kebeles	No. of Towns
Tigray	3,136,267	5.9	50,078.64	4	35	140	74
Afar	1,106,383	2.07	+	5	29	32	28
Amhara	13,834,297	25.86	159,173.66	10	102	337	208
Oromia	18,732,525	35.01	353,006.81	12	180	564	375
Somali	3,439,860	6.43	+	9	44	136	67
Bshangul Gumuz	460,459	0.86	49,289.46	3	13	14	13
SNNPR	10,372,028	19.34	112,343.19	9	82/5 sp.	213	149
Gambela	181,862	0.34	25,802.01	4	8	8	7
Harari	129,000	0.24	311.25	2	1	19	1
A. Ababa	2,112,737	3.95	530.14	6	28	305	1
D. Dawa	251,864	0.47	1,213.20	2	1	24	1
Total	53505418	100		66	523	1792	920

* The population figure shows everyone residing in the region irrespective of his or her ethnic background
- Source: Central Statistical Authority, Statistical Report, April 1996, Addis Ababa
\+ No official data on the territorial size of these two regions are available.

Table 1:2 Ethnic composition of the population, 1994 census

	Oromo	Amh-ara	Tigre	Som-ali	Gurage	Sid-ama	Wol-aita	Afar	others	Total
Pop. million	17.1	16.0	3.3	3.2	2.3	1.8	1.3	1.1	7.4	53.5
In %	32.2	30.1	6.2	6.0	4.3	3.4	2.5	2.0	13.3	100

Source: Central Statistics Authority, and The Ethiopian Economic Association, Annual Report on the Ethiopian Economy, Vol. I 1999/2000, p. 69

Territorial reorganization in Ethiopia has been strongly seen by its architects as a means for liberation from and protection against the domination of a single ethnic group. But whether this territorial reorganization can help to address the other issues of development and the equitable distribution of public goods and services shall be unravelled. However, it could be prudent to take note of the remarks made by one of the authors that 'ethnicity-based territorial reorganization tends to reinforce the distinction everywhere between ethnic indigenes and 'outsiders' and to create classes of individuals on the basis of territorial identity.'[92] As a result, it can hinder the movement of capital, labour, and investment opportunities between the states.

Federalism has been repeatedly praised for serving as an optimum utilization of resources and as an effective system for the distribution of functions between the levels of government. Fiscal and financial arrangements in a federal system, however, work properly on condition that there is an opportunity for an effective use of the resources, labour, capital and land of the country. If this condition is

[91] The number of zones and weredas has changed since 2001. For example, Tigray has focused on weredas for administrative autonomy, SNNPR has established new zones and weredas, Oromia and Amhara have reduced the number of weredas, and Addis Ababa has undergone a different structural reorganization by decreasing the number of kebeles and introducing ten sub-city administrative zones.
[92] Joshua, op. cit., p. 177.

not fulfilled, it can hamper the development effort of the country. In this regard, it would be wise to consider the general principle enunciated by the Indian government when it was engaged in territorial reorganization in 1953 which tried to accommodate both the local and national interests.
It states:

> The language and culture of an area have an undoubted importance as they represent a pattern of living which is common in that area. In considering a reorganization of the states, however, there are other important factors which have also to be borne in mind. The first essential consideration is the preservation and strengthening of the unity and security of India. Financial, economic and administrative considerations are almost equally important, not only from the point of view of each state, but for the whole nation.[93]

In sum, many authors have advanced their arguments as to whether the Ethiopian federalism, with its primordial principles of 'the rights of nations, nationalities and peoples...self-determination up to and including secession,' has been legally and politically justifiable and whether it can address the problems of the Ethiopian people. Some, particularly the ruling party and its allies, have praised Ethiopian federalism, with all its unprecedented ideas, as addressing the historical wrongs committed by predecessors, as a solution to ethnic discrimination and particularly against the dominance of the (*Shoan*) Amhara elite.[94] Accordingly, the proponents of an ethnic-based federal system consider it as an effective mechanism not only to embrace ethnic diversities but also to avoid any form of suppression of ethnic and other diversities. Others have welcomed the federal idea but repudiated the *ethnicisation* of all principles of a federal system, and have opted for a system that emphasizes the individual liberty and the territoriality principles of federalism.[95] This is because they see the ethnic-based federal system as a dangerous political ploy. Some others simply mentioned that it is utilized as a means to monopolize powers in the hands of the powerful regional elites.[96] Some have accepted the federal system with cautious reservation as to the magnitude of decentralization which the government has pursued. In this regard, John Cohen enunciated the danger posed by the administrative and economic devolution of power to the regions. According to him the danger emanates, on the one hand, from the incompatibility of the capacity constraints of most of the newly formed regions and, on the other, from the threat of the ethnic factors in the federal system.[97] Amongst all the challenges, however, the arrangement of fiscal powers and the equitable distribution of financial resources will be one of the most pressing issues. This being the case and before we can address this issue in the Ethiopian context we first have to gain a more general insight in the theory of federalism in general and the principles of fiscal federalism in particular.

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[93] Asok Chanda, *Federalism in India: A Study of Union –State Relations* (George Allen ltd, 1965), p. 49.
[94] The leaders of many ethnic-based 'political parties' have repeatedly reiterated this statement. However, the notion of 'Amhara dominance' is in itself controversial for at least two reasons: The Amhara nation as such has never achieved it, be it politically or economically, and government officials have had various ethnic backgrounds through the centuries.
[95] Minase Haile strongly argued along these lines in his article against ethnic federalism. Minase Haile, 'The New Ethiopian Constitution: Its Impact upon Human Rights and Development,' (20 Suffolk Transnat'l L. Rev.1, 1996), p. 1-84; for a different opinion, see Twibell, T. S., 'Ethiopian Constitutional Law: The Structure of Ethiopian Government and the New Constitution's Ability to Overcome Ethiopia's Problems,' (21 *Loy. L. A. International Comparative Law Journal,* 1999): 399-426.
[96] See Mesfin W/Mariam, *The Horn of Africa: Conflict and Poverty* (Addis Ababa, Chamber Printing press, 1999).
[97] Cohen, *op. cit.*, p. 176.

2 Sketching the Background (II): The Theory of Federalism and the Principles of Fiscal Federalism

The present chapter, by way of introduction, deals with the nature and meaning of federalism in general, and introduces some general concepts of fiscal federalism as the basis of the studies in the subsequent chapters. It contains two main sections:

- The first section of this chapter discusses the meanings of federalism, and is mainly intended for readers who may be unacquainted with the various concepts associated with federalism. To clarify the concepts of federalism, various definitions given by different authors will be described and analysed. It also tries to understand the concept from the process of adopting a federal system, and from the perspective of the form of intergovernmental relationships. The objectives of federalism and the relationship between federalism and decentralization will also be discussed.
- The second section scrutinizes the major theoretical principles embodied in fiscal federalism before embarking on the study of its implementation in Ethiopia. It will also highlight some of the challenges of diversity upon the implementation of intergovernmental fiscal relationship.

In general, the second chapter clarifies concepts that will be used in the subsequent chapters. It also sketches the fiscal challenges which could be faced in a highly asymmetrical federal arrangement.

1. THE THEORY OF FEDERALISM

1.1. The meaning of federalism

The study of the modern federal system begins with American federalism in 1789, but some argue that the study of federalism is as ancient as the history of association between human beings.[98] But if we restrict ourselves to the study of federalism since the late 18th century, we can observe an emphasis on how different parts come together to form a union and at the same time a constitutional safeguard is provided to the component units. Consequently, the theoreticians have emphasized the constitutional contractual agreement between the units to form a general cooperative authority, in contradistinction with a unitary system. The theory of federalism can be illustrated by some definitions and the descriptions of the questions addressed by these definitions.

[98] Kriek says 'the term 'federal' was coined in 1685 by a group of theologians...they derived the term from a Latin word 'foedus'. The word foedus means covenant, pact or trust, implying free and mutual agreement. For the historical development of federalism see D. J. Kriek, 'Historical Development and Federalism', in D. J. Kriek (ed.), *Federalism: The Solution?* (Pretoria, HSRC Pub. South Africa, 1992), p. 1-10.

To begin with, let us see the strictly legal definition,

> Federalism can be identified with a federal government, i.e. a federal state as a type of governmental organization within which both central and component governments operate directly upon the people, each being independent within respective, constitutionally laid down spheres of allocated powers, and in a coordinating relationship with one another, whereby the residuary powers lie with the authorities of component units.[99]

This definition emphasizes the method of dividing power between the centre and the constituent units, and the place of residual power. It is somewhat elaborate but is derived from the definition of a 'federal principle' as provided by K.C. Wheare. In his study of the American Constitution, K.C. Wheare defined the federal principle as 'a method of dividing powers so that the general [central] and the regional governments are each, within a sphere, coordinate and independent.'[100] The emphasis is on the division of functions and powers between the central and regional governments so that powers are divided between independent but coordinate authorities, and both levels of government operate directly with regard to the people. However, Wheare's definition was challenged by many due to the difficulty to find some of the powers of each tier of government perfectly independent with the other while others perfectly coordinate.

Nonetheless, Wheare discussed institutions like the constitutional delimitation and supremacy clause, bicameral legislation and the election of its constituents and the independence of the judiciary as important features in relation to the (elements of a) 'federal character'.[101] According to him, if the federal character is predominantly found in a given constitution, he considers it a 'federal constitution'. But a country with a federal constitution is not necessarily a 'federal government'. It is not only the constitution, but also 'the working of the system' that determine the existence of a federal government.[102] In furtherance of the definition put forward by Wheare, W. Riker argues and emphasizes the authority of the dual governments upon the same land and people.[103] This is an important factor which distinguishes federal from confederal system of government. In a confederation the central government does not directly reach the people of the constituent units unless the states unanimously accept that it does so. It is only through the respective sovereign member states that the central government can reach the people.

Federalism, on the other hand, is seen as more than the division of power between the centre and the regions. According to sociologists, the formal division of power between the centre and the regions is merely a transitory step towards this and cannot be considered as the adoption of a federal system. In this regard, Livingston went further by arguing that 'the essence of federalism lies not in the

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[99] Thomas Fleiner and Lidija R. Basta, 'Federalism, Federal States and Decentralization,' in Basta and Fleiner, (ed.), *Federalism and Multiethnic States: The case of Switzerland, 2nd ed.*, (Fribourg, PIFF vol. 16, Helbing &Lichtenhahn, 1996), p. 1.

[100] K. C. Wheare, *Federal Government 4th ed.*, (London,, Oxford university, 1963), p. 11.

[101] *Ibid*, p. 10-15.

[102] *Id.*, p. 22 & 33. If the federal principle is to be found but is not predominant in the constitution, then it is quasi-federal; and a country where the practice of the constitution is not predominant has a quasi-federal government. For him the 'practice of the constitution is more important almost than the law of the constitution'. That is why he identifies Canada with a quasi-federal constitution, but considers it to be a federal government.

[103] William Riker, *Federalism: Origin, Operation, Significance*, (Boston, Little Brown & co., 1964), p. 11.

constitutional or institutional structure but in the society itself.'[104] However, this idea blurs the distinction between federal and decentralized unitary systems. It also seems to restrict the relevance of federalism to only heterogeneous societies.

Friedrich approaches federalism as:

> a process by which a number of separate political units, be they states or any other kind of association, enter into arrangements for governing themselves jointly regarding joint needs and interests. Or reversely, the process through which a hitherto unitary political organization becomes federalized to the point where separate and distinct political communities arise and become politically organized.[105]

According to the above definition the process shows a two way of establishing a federal system, i.e., either independent units can be organized to form a federal system or a formerly unitary state may devolve into a federal structure.[106]

Other authors have also considered the importance of the social phenomenon for the adoption of a federal system. For instance, the late Daniel Elazar advocates the conceptualization of federalism as a social phenomenon in two ways. In the first, federalism is seen as a cohesive factor for, 'the proper relationships among people as individuals, or in families and groups, as well as in their capacity as citizens, whereby they relate to each other federally, that is, as partners respectful of each other's integrity while cooperating for the common good in every aspect of life, not just in the political realm.'[107] The second recognizes the existence of essential groups such as cultural, religious, ethnic or social groups. Any organization of a political system, according to him, should address the diverse interests of these groups. This can be done either by formally recognizing them in any polity in practice or by formally structuring the federal system around these groups. Federalism is viewed from its political significance in addressing the problems of citizens by creating proper political relations. In this regard, Elazar argues that federalism is a mode of political activity that requires certain kinds of cooperative relationships while preserving the diversities. He defines federalism and expresses it in short, as 'self-rule plus shared-rule.'[108] Elazar also emphasizes that a 'territorial division' of power should be enshrined in a constitution.[109]

Federalism must be seen *vis-à-vis* the dangers posed by the concentration of power at the centre in a unitary system. Unlike a unitary system, federalism recognizes the political reality of the existence of various groups and interests, and also tries to accommodate their diversity through constitutionally established subunits. Such accommodation of diversity and at the same time maintaining the unity of the federation may take place through two basic relationships: the relationship between the states and the federal government, on the one hand, and preserving or strengthening the bond between the states themselves, on the other.

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[104] Livingston, *Federalism and Constitutional Change* (Oxford Univ. press, 1956), p. 1-2.
[105] Carl J. Friedrich, 'Origin and development of the concept of federalism in the united states'(1960), p. 29.
[106] C. Friedrich, *Trends of Federalism in Theory and Practice* (New York, Preager, 1968), p. 7.
[107] Daniel Elazar, *Exploring Federalism* (Alabama university press, Tuscaloosa, 1987), p. 70-71.
[108] *Ibid*, p. 12.
[109] *Ibid*, p. 157-168.

If, however, the emphasis is on achieving horizontal balance by establishing states for every social grouping, several issues arise. To begin with, it is very difficult to generalize the categories of different groups and the facts defining those groups and their membership. The fact that people speak the same language may not necessarily prove that cohesion exists amongst the members. Other factors, such as religion or geographical factors may prevail over the language issue and create cohesion between the social groups. The other problem could be related to the absence of a genuine political motive behind defining a group and its membership. The political elites may categorize groups in order 'to gain political and economic advantage for their groups as well as for themselves.'[110] On the other hand, even if the groups and societies are defined, it is very difficult to bring about a quantifiable balance between the groups. There should be a mechanism for all groups to take part in the political process and to strive to maintain some kind of solidarity between them. The fiscal aspect of a constitution and the system of its implementation is one of the factors that can determine the nature of unity between the diverse groups that exist at several tiers of government. As regards the Ethiopian situation, we shall explore this in chapters VII and VIII.

The difficulty in defining a concept which is applied in many different situations also exists in the study of federalism and federations. Many have dealt with the conceptual distinction between them. Some have dealt with the distinction by laying down general federal principles,[111] while others have dealt with them synonymously.[112] However, many have either implicitly indicated the distinction or dealt with the issue in detail.[113] Here we are not going to repeat the discussions of these concepts by several schools of thoughts. The purpose is to provide remarks about the conceptual distinction between the two.

Federalism is considered as an ideology or philosophy for accommodating unity in diversity and for understanding the federation.[114] King expounds that '... 'federalism' is employed where the interest is primarily ideological (whether in the weak or strong sense), while 'federation' is applied to designate a more descriptive, institutional arrangements of fact...'[115] Accordingly, federation is defined as 'a constitutional system which instances a division between central and regional governments and where special or entrenched representation is accorded to the regions in the decision-making procedures of the central government.'[116] The relation between federation and federalism is expressed in the existence of a form of government, where the federation, as a political institution, emanates from the political ideology of federalism. Accordingly, for a federation to exist there must necessarily be some kind of federalism.

[110] Paul Brass, *Ethnicity and Nationalism* (London, Sage Publication, 1991), p. 8-9.
[111] For example, K. C. Wheare emphasizes the place of a federal principle in the constitution to identify whether an institution is federal or less federal. Wheare, *op. cit.*, p. 21-22.
[112] Douglas V. Verney, 'Federalism, Federative Systems, and Federations in the United States, Canada, and India', (Publius, the Journal of Federalism, Vol. 25 No. 2, 1995), p. 81-98.
[113] See Preston King, *Federalism and Federation*, (Croom Helm, London, 1982); Michael Burgess, *Federalism and Federation in Western Europe*, (Croom Helm, London, 1986); and Verney op. cit.
[114] Michael Burgess, op. cit., p. 20. He argues that it is not only an ideological or philosophical concept: 'It can also be viewed as empirical fact to the extent that it recognizes diversity - broadly conceived in its social, economic and political contexts - as a living reality, something which exists independent of ideological and philosophical perception.'
[115] King, *op. cit.*, p. 74-75.
[116] King, *op. cit.*, p. 140-141; See also Burgess, *op. cit*, p. 17.

1.2. Federalism by aggregation and by devolution

Federations do not exist by themselves. They are political systems that are intentionally introduced to serve tangible purposes. In other words, they are meant to solve the problems of a particular political constituency with a specific constitutional set-up. Different federations share similar characteristics, i.e., the need to contain the interest of diversity with that of unity. The problems they solve, however, are not necessarily similar. Neither does federalism serve as a panacea for all social problems. So, if a federal system has to solve the particular problems of a particular country, it has to address the following question: what are the problems which the federal system can adequately solve? The answer is related to the origin of a federation.

The process of adopting a federal system can be either of the following two ways: First, there is a model, which can be described as federation by aggregation ('coming together')[117], where a number of independent autonomous units agree to merge in order to form a single autonomous unit, while, at the same time, maintaining their regional autonomy. They agree to surrender some of their independent powers to the newly formed central government, and to retain their independent regional government on matters they reserve for themselves. The desire to unite and form a union varies from case to case, depending on the problem each faces and the time at which they decide to enter into the union. The Swiss confederation, for instance, emanated from the need for military security and common defence; and the desire for economic advantage by seeking a greater union.[118] On the other hand, the impact of the legacy of the colonial era was the reason in the case of the USA and Canada. William Riker stresses that all federations originate from a need for defence when faced with any common foreign aggression.[119] King further elaborates how federations originate from fear. He suggests that a federation can be created not only from a fear of external threat, but also from inside when some members fear other members of the same state, or when there is an actual or potential threat from inside or outside.[120] T.M. Frank lays down various reasons for the creation of a federation, but emphasizes the 'ideological commitment' on the part of the leaders. According to him, such factors as territorial expansion, achieving larger markets, containing social conflicts, and securing military defence, could lead to a federation so long as the politicians are fully committed and manage to convince their citizens.[121] In general, whatever the reason for adopting the federation, it requires a commitment to maintain the union, within the diversities.

Second, a devolutionary or 'holding together' federation may also be born by disaggregating a single unitary government, and creating new regions, and correspondingly devolving power to them. In this case, a unitary system will be changed into a federal one mainly in order to address the centrifugal forces of

[117] For the discussion of 'coming together' versus 'holding together' federalism, see Alfred Stepan, 'Federalism and Democracy: Beyond the US Model', (Journal of democracy, vol.10 No. 4, 1999), p. 19-33.
[118] Quoted in R. Dikshit, *The Political Geography of Federalism: An Inquiry into its Origins and Stability* (Delhi. Macmillan, 1975) p.29-30; B.M. Sharma and L.P. Choudhry, *Federal Polity* (London, Asia Publishing House. 1967), p. 40.
[119] William Riker, *op. cit.*
[120] King, *op. ct.*, p. 79-80.
[121] T.M. Frank, *et al*, *Why Federations Fail: An Enquiry into the Requisites for Successful Federalism* (New York, New York University Press, 1968), p. 182.

political, cultural, social, or economic factors. It should be emphasized that when a federation is created by devolution, a complex of heterogeneous factors necessitating federalism should be thoroughly studied to maintain a balance between unity and the diverse interests of the groups. This devolution of power with a view to adopting a federal system has recently been utilized in countries such as Belgium, Spain and Ethiopia.[122]

Federalism, whether adopted through aggregation or devolution, should result in the division of legislative, executive and judicial matters between the central and regional governments. In principle, matters that have a direct bearing and importance upon the local people should be left to the regional governments,[123] whereas those matters that affect the interest of the whole nation have to be reserved for the central government. Thus, although only one sovereign federal country exists, there will be, at least, two levels of government autonomously exercising powers reserved for each of them respectively. The regional governments should not be subordinate to the federal government, and vice versa. The viability of one level of government should not depend on the other. In other words, while the regions cannot easily walk away and threaten the union, the centre should not unilaterally abolish the autonomy of the regions.[124] Both levels of government should deal with the people within the ambit of their autonomy. However, they can determine the form and manner of cooperation, but for practical reasons they should enter into vertical as well as horizontal relationships for a better performance of powers and responsibilities.

1.3. Territorial and non-territorial expression of federalism

Federalism has also been conceived as a means of addressing either territorially defined or non-territorial units of heterogeneous groups. In the former, it is the territorial communities that are considered to be essential units of the federation. These are described as regions/states/ provinces/ communes/cantons. These major territorial units can further be divided into local governments depending on the specific context of the federation. It is through the recognition and participation of the territorial subunits that federalism aspires to accommodate the diverse interests. Its aspiration is to establish institutions and to enact appropriate legislation that can help to secure the diverse interests existing in a society. In this kind of federalism the demands of heterogeneous groups, such as ethnic, linguistic or religious groups, are preserved through the participation of the territorially defined constituent units, not by necessarily establishing territorial units for each heterogeneous group. After all, 'federalism is not a means to implement the notion of 'one ethnic group one state'.'[125] Rather it is a means of balancing centralizing and decentralizing forces in a country, i.e. the basis for maintaining both unity and diversity.

The territoriality principle, however, is also argued in a different way. Some authors, like Livingston, have contended that territorial federalism is considered as appropriate, if one believes in a one-to-one correspondence between each

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[122] Nigeria and India have a mix of the devolution and aggregation mentioned above because of the colonial legacy that led to the adoption of the federal system.
[123] The constitutional division of power is discussed in the next chapter, section 1.
[124] The Indian Constitution is an exception by giving significant power to the president to suspend the status of states and to bring them under the authority of the central government.
[125] Lincoln Joshua, 'The effect of Federalism on Inter-group Relations in Multiethnic States: Evidence from Nigeria and Ethiopia', (UMI services, 2000), p. 4-5.

ethnic group and territorial recognition. Thus, each ethnic, religious or linguistic group forms a territorial unit of a federation. In other words, any attempt to accommodate the diversity of each group through the territories which are formed due to historical facts, social, cultural and economic significance, and the need to preserve the union obviates the very purpose of the territories. If each group is not territorially represented, 'a society can not be said to be federalism. It becomes functionalism, pluralism, or some form of corporatism'.[126]

However, because of the difficulty in giving territories to each ethnic or religious group, the concept of federalism can also be conceived as recognition to non-territorial units.[127] It was provided as a means to protect each heterogeneous group that is not confined to a particular territory, but dispersed throughout a country. The non-territorial federal system considers the dispersed group as constituting units in a federation. In order to democratically address the cultural rights of multiethnic societies, says Smith, 'the solutions lay in securing the cultural rights of geographically scattered ethnic groups by providing non-territorial based institutional supports in a combination with a non-territorial form of political representation.'[128] Smith's argument can be acknowledged as a means of creating unity in diversity by constitutionally recognizing groups which are not territorially defined.[129]

The federal non-territorial recognition of ethno-linguistic or cultural groups is differentiated from other unitary systems since the units have to be constitutionally recognized. So, the non-territorial (personal) federalism is sometimes combined with the territorial units of a federation, like in the case of Belgium. In Belgium, there are three territorially recognized subnational governments in addition to the non-territorial language communities recognized in the federal system. It will be difficult to present the nature of personal federalism in Belgium as a model for relatively large heterogeneous groups. It is implemented in order to address the needs of the two main groups, the Flemish and the Walloons, with regard to matters mainly concerning education and culture. The formal relationship between the centre and the regions is accommodated through the territorially defined federated units.[130]

Federalism as a system of governance in multiethnic societies such as Ethiopia may witness serious repercussions. One of the reasons could be the utmost emphasis given to state formation based on the ethnic factor. Other reasons can be related to the protection of minorities in a state, the conflict between

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[126] Livingston, *op. cit.*, p. 2.
[127] The existence of non-territorial political organizations recently considered as consociational arrangements (formulated by Arend Lijphart) as in the case of the Netherlands and Belgium. However, Elazar argues that a consociational power-sharing system has a limited life-span because it lacks the constitutional roots of territorial federalism. Elazar (1987), *op. cit.*, p. 70-71.
[128] G. Smith, 'Mapping the Federal Condition: Ideology, Political Practice and Social Justice,' in G. Smith (ed.) *Federalism: the Multiethnic Challenge* (London, Longman, 1995), p. 6.
[129] King argues that a federation contains the following important features: representation is preponderantly territorial; territorial representation is characteristically secured on at least two subnational levels, referred to as local and regional; the regional units are incorporated electorally, or perhaps otherwise, into the decision-making procedure of the national centre; incorporation into the decision-making procedure of the centre can only be altered by extraordinary constitutional measures. Preston King, 'Federation and Representation,' in Michael Burgess and Alain Gagnon (eds.) *Comparative Federalism and Federation: Comparing Traditions and Future Traditions* (Toronto, Univ. of Toronto press, 1993), p. 94.
[130] Robert Senelle, *Federal Belgium* (offprint from *Federalism and regionalism in Europe* (Editoriale Scientifica, Napoli 1998), p. 30.

individual and group rights, the relationship between the centre and the constituent units, the horizontal relations among the regions and their competition for a better utilization of scarce resources, and financial relations between the centre and the regions. However, of all the problems mentioned, the financial relations between the federal and the regional governments are one of the most challenging tasks.[131] We will discuss the problems of ethnicity and fiscal federalism in Chapter VIII below.

1.4. Competitive and cooperative federalism

K.C. Wheare, whom we mentioned already, defines federalism as a system with two levels of government, each of which is independent of the other level in relation to the matters over which it has jurisdiction.[132] A literal interpretation of this definition would mean that a government authority (legislative, executive, financial, judiciary) should be divided between the two levels of government so that each of them operates independently of the other. In this regard, R. Watts contends,

> A strict application of this principle would also imply a completely dual polity. Each government should have its own legislative and executive institutions completely unfettered in performing its own functions, its own civil service to administer its responsibilities, and its own courts to interpret its laws.[133]

If we pursue the same line of argument, it would lead us to the strict application of the theory of 'competitive federalism'. The assumption, which emphasizes the powers of the two mutually independent governments, is an ideal approach to create a watertight separation between the two levels of government destined to implement their respective responsibilities without any practical interdependence between them. This is referred to as the concept of 'competitive federalism' which mainly denotes a spirit of competition and rivalry between the centre and the regions.[134] The proponents of competitive federalism argue that cooperation undermines the autonomy of the regions and monopolizes power at the centre.

Some scholars criticize Wheare's strict separation of the two orders of government.[135] Others emphasize the importance of the coordination aspect of Wheare's definition, but disregard the independence of the two tiers of government. This is because although one of the essential features of federalism is the constitutional demarcation of powers between the centre and the states, in practice the various levels of government in federations have been found to have frequent interrelations in political, legal, financial and administrative matters. In this regard, Saunders remarks that although the older federations of the United States (1789), Switzerland (1848), Australia (1901) and Canada (1867) initially took competition as a working principle, they later on developed different types

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[131] R. Watts, *New Federations: Experiment in the Common Wealth* (Oxford, Clarendon, 1966), p. 192

[132] Wheare, *op. cit.*, p. 2.

[133] Watts (1966), *op. cit.*, p. 225.

[134] M. P. Jain, *Indian Constitutional Law*, 4th ed., (Reprint, Wadhwa and Co. Law Pub., India), p. 379.

[135] For instance, see Riker, op. cit.

of cooperation between the levels of government.[136] One of the most widely observed form of cooperation is intergovernmental financial relations.[137]

There are several issues in relation to the constitutional distribution of powers that may show the inevitability of the need for intergovernmental interactions and cooperation. Some of the issues are: Does the constitutional distribution of powers and responsibilities promote the competitive approach only? Is there a clear separation of powers between the centre and the regions so that it inhibits any form of interdependence between the two? Are there powers and functions concurrently exercised by the two levels of government? Does any form of asymmetry exist between the constituent units of a federation? Are the levels of government self-sufficient in their financial capacity in order to discharge their responsibilities?

The answers to all these questions can be evidence of how difficult it is to avoid the overlap of powers and interactions between the levels of government. It is difficult to envisage a complete separation of authority between them. For instance, studies carried out in the USA[138] and in Canada[139] have shown that administrative and political interdependencies between the levels of government have been in the nature of the federal systems, despite the fact that the constitutions mainly feature a duality structure. In practice no purely competitive federal system exists in a country.[140]

Intergovernmental relations may take place either vertically or horizontally, and can be carried out formally or informally between the representatives of each level of government. A prevalent form of informal relation involves the representatives of governments sharing information, discussing common problems, considering coordinated action whenever appropriate.[141] They engage in formal relationships as a result of several things: as a consequence of the constitutional allocation of responsibilities, through intergovernmental institutions established by a constitution or by a formal agreement between the authorities of the levels of government, or due to practices and conventions.[142] These forms of intergovernmental relations may cover all forms of vertical or horizontal relations involving several branches of government. Amongst these, a well-known feature is 'executive federalism', which is widely practised in parliamentary federal systems such as Germany, Switzerland, India and Canada.[143] It is a relation dominated by the executives of both levels of

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[136] Cheryl Saunders, 'Constitutional Arrangements of Federal Systems' (Publius: The Journal of Federalism, Vol. 25 No. 2, 1995), p. 71-72.
[137] Saunders, Cheryl, 'Collaborative Federalism'(Australian Journal of Public Administration, IPAA, vol. 61 No.2, 2002), p. 69-77
[138] See Elazar, Daniel J, *American Federalism: A View from the States* (New York, Thomas Y. Crowell Co., 1966).
[139] See Garth Stevenson (ed.) *Federalism in Canada*, (Ontario, The Canadian publishers, 1989).
[140] See for instance, Elazar (1966), op. cit.; Joseph F. Zimmerman, 'Nation-State Relations: Cooperative Federalism in the twentieth Century', (Publius: The Journal Federalism, Vol. 21 No. 2, 2001); Watts (2003)*loc. cit.*).
[141] R. Watts, 'Intergovernmental Councils in Federations.'In: *Constructive and Cooperative Federalism?* Queen's University, IRPP, Montreal, 2003. http://www.iigr.ca/browse_publications.php?section=39, accessed on February 15, 2004.; Meekison, Peter J., 'Council of Federation: An Idea Whose Time has Come,'in Constructive and Co-operative Federalism? (IIGR, Queen's University, IRPP, Montreal, 2003)
[142] R. Watts, *Comparing Federal Systems*, 2nd ed., (McGill-Queen's university, Kingston, 1999a), p.58-59; see also Saunders (1995), op. cit.,
[143] *Ibid.*

government. Hence, the term executive federalism refers to 'the relations between elected and appointed officials of federal and provincial governments and relations between elected and appointed officials of provincial governments'.[144]

Cooperation that results from a constitutional division of powers refers to the manner in which the administrative responsibility is assigned. This refers to an extensive intergovernmental cooperation which developed as a result of the division of powers where most of the federal legislation is implemented through state organs, as is the case in Germany.[145] Article 83 of the German Basic Law provides, 'the states shall execute federal laws in their own right in so far as the Basic Law does not otherwise provide or permit.' Consequently, except in those areas where the Basic Law (see Articles 87-90) expressly provides for direct federal administration, the states largely remain responsible for the administration of federal laws.[146]

Executive federalism in Switzerland also refers to the administration of federal laws by the states, but with a lesser degree of emphasis compared to the German Basic Law. The Swiss Constitution, besides its explicit order where the cantons have to execute federal laws, it provides 'the confederation shall leave the cantons as large a space of action as possible, and shall take their particularities into account.'[147] Although the principle is not stated as comprehensive as is the case with the German basic Law, the Indian Constitution also shows some similarity to the German and Swiss federations. The state's executive power can extend to matters in which both the Union and the states have legislative power and when the Union delegates its executive power to the states by legislation.[148] Intergovernmental cooperation can also be facilitated by institutions established by a constitution[149] or institutions established by a formal agreement entered into by the levels of government.[150] Cooperation can also be necessitated by practice in the process of discharging expenditure responsibilities through negotiations, cooperation, or the resolution of disputes between governments.

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[144] Cathy L. Brock, 'The end of Executive Federalism?'in Francoise Rocher (ed.), *New Trends in Canadian Federalism*, (Bradview press, Canada, 1995), p. 92.

[145] See also Chapter III, Sec. 1.3, concerning the division of executive powers.

[146] According to R. Watts, executive federalism in Germany is reinforced by two factors. 'The first is the constitutional division of legislative and executive authority between the Bund and the Länder, in many areas requiring close intergovernmental coordination. The second is the unique institution of the Bundesrat which gives direct representation within the national Parliament to the governments of the Länder.The Bundesrat which is composed of representatives of the Lander government is responsible not only for making laws together with the Lower House but also plays a crucial role as an intergovernmental institution facilitating cooperation between the Länder and the federal government. R. Watts, 'German Federalism in Comparative Perspective', in Charlie Jeffrey, *Recasting German Federalism: The Legacies of Unification*, (Biddles Ltd., UK), p. 274.

[147] See Arts. 37, 74 (30 and 80(3) of the Swiss Constitution. See Nicolas Schmitt, Federalism: The Swiss Experience (Pretoria, HSRC Publishers, 1996), p.4.

[148] See Arts. 258, 257, 256 and also 73 (1,b) and 154 (2,b) of the Indian Constitution. For an analysis of the executive power of the Union and the states, see B. M. Sharma, *The Republic of India: Constitution and Government* (Bombay, Asia Pub. House, 1966), p. 419; Asok Chanda, *Federalism in India: A study of Union-State Relations* (London, George Allen &Unwin Ltd., 1965), p. 102-105.

[149] For instance, the Australian Grants Commission, the Indian Fiscal and Planning Commissions, the Nigerian Fiscal Commission and the German Bundesrat are the most important intergovernmental institutions established by constitutions.

[150] For instance, the 1992 Intergovernmental Councils of the Australian Government and the 2003 Intergovernmental Councils of Canada are established by formal agreements.

Intergovernmental cooperation has been facilitated by several factors. Saunders mentions some of them: a constitutional interpretation of federal power that gives broader power to the centre, explicit intergovernmental cooperation, and referrals of powers between executives or legislatures.[151] R. Watts emphasizes that economic factors are necessary for cooperation in developing federations. He refers to the difficulty in raising sufficient revenue and covering all governmental activities, the shortage of skilled manpower and the need to avoid unnecessary duplication of governmental agencies as the major reasons for enhancing collaboration between governments.[152] The most distinguished formal cooperation exists concerning the financial relations between the central and regional governments. (The need to redress the financial problems of the subnational governments usually necessitates intergovernmental cooperation which involves the transfer of grants.)

Although intergovernmental cooperation is both an inevitable and a desirable feature of all federations, it should be noted that in most federations the competitive nature of federalism cannot fade away and be wholly replaced by cooperative aspects. The interdependence between the levels of government hinges on the manner in which the federation is formed, the prevailing socio-economic conditions and the political history of the country. With regard to those powers and functions, which by their very nature are explicitly reserved for the centre or for the regions, cooperative arrangements of various kinds may not be necessary. For instance, federal power usually extends to defence, foreign affairs, immigration and some core economic aspects such as national banking and controlling currency. That is why Watts concludes that competitive federalism should be blended with cooperative federalism, as this is inevitable in a federation.[153] Adamovich and Hosp stress the importance of the supplementary coexistence of competitive and cooperative federalism. They say, while only competitive federalism may lead to a complete crumbling of the federation, the other extreme, i.e., only cooperative federalism, will bring in a complete centralization of power. Thus, cooperative federalism would be an empty term without the existence of competitive powers, and vice versa.[154]

1.5. Federalism and decentralization

This section discusses the nature of decentralization and its relation to federalism. The discussion is deemed important to describe the different concepts of decentralization that will be applied in the subsequent chapters. Moreover, it tries to demonstrate the difference between a federal system and a merely decentralized unitary system.

In the study of the operation of federal systems, there are various characteristics demonstrated by each federation. One of these characteristics is the degree of

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[151] Saunders (1995), op. cit., p. 70-71; M.P. Jain, in his study of the Indian Constitution, considers some immanent and external factors which promote cooperation between governments. These are 'exigencies of war and natural calamities, the advancement of technology which fosters fast and effective communication between governments, and the need to coordinate certain activities to meet the huge financial needs.' Jain, op. cit., p. 379.

[152] Watts (1966), op. cit., p. 225.

[153] Watts (1999a), op. cit., p. 61.

[154] Adamovich, Ivan Baron and Gerald Hosp, 'Fiscal Federalism for Emerging Economies: Lessons from Switzerland?' (Publius: The Journal of Federalism, vol. 33, No. 1, 2003), p. 20.

decentralization and its variables in involving lower levels of government when carrying out certain powers and responsibilities. With respect to some of these variables a country, compared to others, may be more decentralized and in other respects less decentralized. For example, in terms of the distribution of financial resources a country may become less decentralized, while in a wide range of other legislative areas it may adopt a more decentralized approach. Thus, countries with a federal arrangement may not demonstrate the same degree of decentralization for the reason that the measuring instruments are dependent upon country-specific factors.

Initially, the concept of decentralization was used to describe various reforms aimed to increase the role of local governments.[155] Recently, an interest in the study of decentralization has become pervasive. And the concepts of decentralization are also closely related to the study of federalism. Thus, some of the studies do not make a sharp distinction between decentralization and federalism, but consider it only a matter of degree. In this regard, Wallace Oates concludes that the concept of federalism as used by economists is considerably wider than the one used by political scientists[156]. He says:

> For an economist, constitutional and political structures are of less importance: what's crucial for him is simply that different levels of decision making do exist, each of which determines levels of provision of particular public services in response largely to the interests of its geographical constituency. By this definition, practically any fiscal system is federal or at least possesses federal elements.[157]

However, if it is not synonymous with federalism then what does it actually refer to? Are there different types of decentralization? Several scholars have explained the concept of decentralization in different ways, some in a narrower while others in a broader sense. Elazar and Watts argue that, strictly speaking, decentralization is different from federalism. They explain the difference between decentralization and federalism by pointing to a difference between the concepts of decentralization and non-centralization. Decentralization is not the same as non-centralization. In the case of non-centralization the dispersion of power is constitutionally determined and any attempt to centralize it would be countervailing the constitutional set-up. But decentralization implies the existence of hierarchy of power where power decentralizes from the top, i.e., the degree to which the lower levels of government play a role as the central government desires.[158]

The study of decentralization in its wider sense begins with the pioneering analysis by Rondinneli, some two decades ago. Its discussion, as is proposed by

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[155] Andrew N. Parker, 'Decentralization: The way Forward for Rural Development?'(World Bank, Policy Research Working Paper no. 1475, June 1995), p. 18.
[156] See Samuel H. Beer, 'A Political Scientist's View of Fiscal Federalism', in Ronald Watts (ed.) *the Political Economy of Fiscal Federalism* (Toronto, Lexington Brooks, 1977): 21-46.

[157] Wallas Oates, *Fiscal federalism* (Harcourt, Brace Jovanovich, 1972), p. xv-xvi.
[158] Watts (1999a) op. cit., p. 71; Elazar submits that non-centralization is intertwined with a political system that guarantees the autonomy of local governments in developing and implementing their own policies. Therefore he mention it 'as a requisite of a federal system that it ensures any consensual participation by one of the levels of government in the discharge of responsibilities by the other. Furthermore non-centralization can be strengthened if the constituent units are represented at the federal legislature and by giving them a guaranteed role in the federal political process.'Elazar (1987), *op cit.*, p. 173.

Rondinneli, encompasses four different categories: deconcentration, delegation, devolution, and privatization.[159]

Deconcentration refers to a situation where the central government disperses responsibilities for certain services to its regional branch offices. This does not involve any transfer of authority to lower levels of government. The process of 'decentralization' remains within the same authority and it is not interested in the presence (or absence) of independent local governments. The level of autonomy enjoyed by the branch offices and the extent (nature) of accountability remain the concern of the central government. Deconcentration can be implemented by a unitary as well as federal system. But it mainly exists in the unitary systems for the reason that efficient and effective provision of public goods and services at the lower level is also the concern of the central authority. Deconcentration is usually criticized because of the lack of transfer of authority to the local level. It is said to be 'an incomplete strategy for decentralization'[160] and is 'unlikely to lead to the potential benefits or pitfalls of decentralization.'[161]

Delegation refers to 'a situation in which the central government transfers responsibility for decision making and administration of public functions to local governments or semi-autonomous organizations that are not wholly controlled by the central government but are ultimately accountable to it.'[162] This definition makes clear that it is different from the internal delegation of power within the same (level of) authority, or a deconcentration of power within the same hierarchy of authority. Obviously, the power and function that is delegated to the lower level must originally lie within the exclusive authority of the delegating government. The power of delegation follows the division of power between the tiers of government. The delegated power does not normally fall within the territory of power of the delegated authority. The relationship between the two authorities involves some kind of agent-principal relationship, with the delegating authority as a principal and the delegated as the agent. However, there are divergent views as to who has ultimate responsibility on the delegated power. It is strongly argued, 'in constitutional law the recipient of a delegated power is seen as autonomous in the exercise of that function.'[163] The delegating authority generally retains the power to revoke this delegation at any time. The delegated authority, on the other hand, is ultimately accountable to the delegating authority, but retains a great deal of discretion in decision making. Delegation also raises further issues as to whether it refers to delegation of legislative, administrative or judicial power, and in a federal system, whether the states can delegate their powers to the federal government.[164] These issues can be observed in the Indian and Ethiopian Constitutions.[165]

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[159] Denis A. Rondinneli, R. Nellis, G. Cheema, 'Decentralization in Developing Countries: A Review of Recent Experience', (Washington D.C., World Bank, staff working paper No.581, 1984), p. 9-15.
[160] Parker, op. cit., p. 20.
[161] Jennie Litvak, J. Ahmad and R. Bird, 'Rethinking Decentralization in Developing Countries'(Sector studies series, the World Bank, 1998), p. 4.
[162] *Ibid*, p. 4 & 6.
[163] As Burkens, Kummeling, Vermeulen & Widdershoven quoted in Jaap De Visser, *Developmental Local Government: A Case Study of South Africa* (Intersentia, Antwerpen-Oxford, 2005), p. 14.
[164] In a federal system, further issues can be raised. For instance, whether delegation of power changes the constitutionally guaranteed division of power, and whether a constitution addresses the financial implications of administering a delegated power.
[165] See Arts. 258(1) and 154 of Indian Constitution, and Art. 50(9) of the Ethiopian Constitution.

Devolution is a more extensive form of decentralization which refers to a situation in which the central government transfers authority for decision-making, finance, and management to quasi-autonomous units of regional or local government.[166] Devolution is common in federal systems since it transfers decision-making responsibilities to regional and local governments that elect their own governmental councils and authorities. Also in developed decentralized unitary systems devolution takes place when local governments have a legally recognized scope for power and autonomy. Therefore, in order to make devolution meaningful and to address the demands of the local people the powers and resources should be legally defined. That is why experts in the field argue that 'devolution may include elements of both deconcentration and delegation, but it goes beyond these decentralization strategies by recognizing the important role that political and fiscal control plays in better satisfying the demands of the beneficiaries.'[167]

Privatization.[168] Many countries in transition have been involved in the provision of certain goods and services to the public which could have been efficiently provided by the private sector. Thus, these countries are engaged in the process of decentralizing power to the private sector partly for the reason that governments are inefficient as regards the provision of certain goods and services. Rondinneli considers this transfer of power where the private sector is involved in service provision that was previously managed by the public sector to be a manifestation of decentralization. In a similar fashion, Ronald Watts suggests that the scope and extent of decentralization to non-governmental agencies also helps to evaluate the nature of centralization or non-centralization in a political system.[169]

The term **decentralization** is widely used in its broader sense to describe the character of a federation. Ronald Watts considers the use of this wider (ordinary) meaning of decentralization in his analysis of the factors used to measure the degree of decentralization in a federal system. According to him, the extent of decentralization and the diffusion of the responsibilities between the tiers of government can be underpinned through the study of legislative, financial, administrative jurisdictions and the overall decentralized decision making at the federal level.[170]

Accordingly, *legislative decentralization* refers to the decentralization of jurisdiction with respect to the formal constitutional division of legislative power between the tiers of government. It should be noted that the scope, extent, and manner of exercising these constitutionally assigned powers vary significantly among countries. This therefore suggests the study of the exclusive, concurrent or shared, and the residual powers laid down in the constitution. *Administrative decentralization* is concerned with how the institutions within the tiers of government carry out the responsibilities assigned to each tier of government by the constitution. Normally, administrative responsibilities follow the legislative jurisdiction of each government. However, this may not always hold true. There are situations where the centre mainly exercises legislative power leaving the

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[166] *Ibid*, p. 6.
[167] Parker, op. cit., p. 22.
[168] *Ibid*, p. 22; Rondinelli *et al*, op. cit. However, some do not mention privatization as being part of the concept of decentralization.
[169] Watts (1999a) op. cit., p. 74.
[170] *Ibid*, p. 71.

administration of laws to the regions.[171] It should be noted that in the assessment of the autonomy of the administration other characteristics such as deconcentration, delegation, and intergovernmental relations have to be taken into consideration.

If power is decentralized to several tiers of government, there is a need for *fiscal decentralization* in order to carry out the responsibilities distributed to them. Each level of government will need an appropriate level of financial resource to cover the costs of providing goods and services to the public.[172] However, some countries opt for a centralized system of revenue raising while distributing the financial resources among the decentralized bodies. In a federal system the degree of fiscal decentralization is measured in terms of the allocation of revenue sources to each level of government in relation to the percentage of expenditure responsibility assigned to each of them. It is also measured in the light of the applicable system of revenue sharing, the allocation of grants and borrowing mechanisms.

In general, in the study of federalism a wider definition of decentralization that encompasses a constitutionally recognized devolution and delegation of power is included. However, in order to have meaningful decentralization there should be, on the one hand, a political will to devolve power from the centre to the local government, and, on the other, the devolved power can only be translated into actual powers if subnational governments have the financial, political, and administrative capacity to manage this responsibility.[173]

2. FISCAL FEDERALISM: A GENERAL DESCRIPTION

The design and implementation of an effective system of fiscal federalism is vital to the success of a federal system. Of course, in a federal system, when several layers of government are established to exercise their powers and functions in the same territory, there is logically a question concerning the allocation among them of public tasks and their financing. This requires a constitutional distribution of tasks (expenditure responsibilities) and revenue sources. But the constitutional distribution of revenue sources normally results in a different financial capacity between the regions. In short, some regions could be richer than others. However, federalism should not function towards making rich regions richer and poor regions poorer. Therefore, it should provide a mechanism that can adjust the fiscal imbalances between the individual regional governments and between the federal and regional governments. On the whole, the distribution of tasks and revenue sources between the central and regional governments with the concomitant financial adjustment through revenue transfers is the major concern of fiscal federalism. In brief, the literature on fiscal federalism encompasses:

> Principles of fiscal relations between central and subnational levels of government that is the command over resources by the various levels of government and the direction and size of intergovernmental fiscal flows. This

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[171] See, for instance, Art. 83 of the German Basic Law. For further discussion on the division of power in German Federalism, see Uwe Leonardy, 'The Working Relationship between Bund and Lander in the Federal Republic of Germany', in Charlie Jeffery and Peter Savigear (eds.), German Federalism Today (New York, St. Martin's Press, 1991), p. 40-59.

[172] See Dethier, Jean Jacques, 'Some Remarks of Fiscal Decentralization and Governance,' http://www.imf.org/external/pubs/ft/seminar/2000/fiscal/Dethier.pdf, as accessed on 10/11/2004

[173] Litvak, *et al*, *op. cit.*, p. 6.

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[172] See Dethier, Jean Jacques, 'Some Remarks of Fiscal Decentralization and Governance,' http://www.imf.org/external/pubs/ft/seminar/2000/fiscal/Dethier.pdf, as accessed on 10/11/2004

[173] Litvak, *et al*, *op. cit.*, p. 6.

includes the division of tax powers and the means through which resources are adjusted to match expenditure responsibilities for central and subnational levels of government.[174]

Generally, the study of fiscal federalism focuses on the allocation of expenditure responsibilities, the revenue raising powers and adjusting vertical and horizontal imbalances through intergovernmental fiscal transfers.[175]

The first one, allocation of expenditure responsibilities, deals with the issue as to which functions should be carried out by which level of government. From the economic point of view, several economists strongly argued for fiscal decentralization on the ground of efficiency, manageability, autonomy and accountability but Wallace Oate's 'decentralization theorem' seems to have set a standard. According to this theorem, 'each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize the benefits and costs of such provision.' Those public services that provide benefits over a wide area, e.g. national defence and international affairs, should be the responsibilities of the national government, while those that provide very localized benefits, e.g. schools, waste disposal, fire protection, road maintenance to be provided by local governments.[176] Some others have also recently strengthened this theorem by other principles such as the principle of *subsidiarity* which requires public tasks to be given to the level of government most suitable for their implementation.[177] According to the 'principle of fiscal equivalence' advanced by Olson, a political jurisdiction should be equated with benefit area to ensure the optimal provision of public services where the marginal benefit equals the marginal cost of production.[178] With regard to jurisdictional design, Stigler submits two principles – 'a representative government works best the closer it is to the people, and the people should have the right to vote for the kind and amount of public service they want.'[179] In any case, the expenditure requirement of each level of government is dependent on which responsibilities are devolved. Legally speaking, this can be determined by the constitutional structures which deal with the legislative and administrative jurisdictions of each order of government. The analysis of expenditure responsibilities may go beyond the economic considerations and focus on political, social and historical factors that are intertwined with the manifestation of diversities in a federation. This analysis focuses, on the one hand, on how the allocation of expenditure responsibility secures regional autonomy, and on the other hand, on how it ensures the freer movement of goods, labour and services between the regions.[180] The extent of intergovernmental collaboration and the administration of federal laws in the states, if there are any, are also its concern.

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[174] Kibre Moges, 'The Conceptual Framework for Fiscal Decentralization', in Eshetu Chole (ed), *Fiscal Decentralization in Ethiopia*, (Addis Ababa, AAU Printing press, 1994), p. 2.
[175] For a general discussion, see Roy Blough, 'Fiscal Aspects of Federalism', in H. Bakvis and William Chandler (eds.), *Federalism and the Role of the States* (Toronto, Univ. of Toronto Press, 1987), p. 384-405.
[176] Wallace Oates, *Fiscal Federalism*, (Harcourt, Brace Jovanovich, 1972), p. 35-36.
[177] See the discussion of subsidiarity in Chapter III (Sec. 2.2.5.).
[178] Mancur Olson, 'The Principle of Fiscal Equivalence: The Division of Responsibilities among Different Levels of Government', *American Economic Review* (vol. 59 No.2, 1969) 479-487
[179] George Stigler as quoted in A. Shah, 'Introduction: Principle of Fiscal Federalism', in A. Shah (ed.), The Practice of Fiscal Federalism: Comparative Perspectives (Forum of Federations, 2007) 7-8
[180] R. Watts, 'The Dynamics of Decentralization,' in R. Bird and T. Stauffer (eds.) *Intergovernmental Fiscal Relations in Fragmented Societies* (PIFF, vol. 33, Bâle, Helbing & Lichtenhahn, 2001), p. 12-34.

The second issue is the allocation of revenue raising power which is concomitant with the basis for desiring devolved expenditure responsibilities. As Ronald Watts repeatedly contends, it is the allocation of these financial sources that enables or constrains governments in the exercise of their constitutionally assigned legislative and expenditure responsibilities.[181] As with the case of distribution of expenditure responsibilities, there is also a need for serious consideration of the reasons for which revenue sources be retained by the centre and which should be assigned to the states. Thus, there are a number of considerations for arguing for centralizing or decentralizing revenue sources by considering criteria of economic efficiency, equity, need and administrative feasibility. However, as a result of the distribution of revenue raising powers federations reveal, with varying degrees, vertical and horizontal fiscal imbalances which in turn call for correcting mechanisms.

Thus, the third important issue is the process of intergovernmental revenue transfer that embraces financial flows between the federal and regional governments as a whole (vertical transfer) and the horizontal distribution as between the regions. The instruments used to correct the imbalances should in general have the objective of increasing the financial capacity of the regions to match their expenditure needs and to narrow down the disparity in the revenue capacities of the subnational governments. The magnitude and direction of the revenue transfer depend on the method of measuring the financial disparity between the regions, the mechanism to address different interests in different regions and the institutions to deal with conflicts between the relatively rich and poor regions.[182]

Through the division of expenditure and revenue-raising responsibilities, and the fiscal transfer mechanisms, fiscal federalism addresses two kinds of conflicts between territorially recognized units: the conflict of interest between the central and the regional governments, and the rivalry amongst the regions themselves.[183] However, several authors note that the implementation of the fiscal arrangement per country is widely influenced by the individual political and economic system, financial resources, levels of economic development, and the constitutional and legal framework. Countries may face various problems which require various policy remedies. But the processes and dynamics of adjusting the fiscal imbalances should be analysed *vis-à-vis* the political stability of the federation. Accordingly, the study of the Ethiopian fiscal federalism aims to analyse the legal and political implications of the fiscal aspects of the federation.

2.1 The objectives of distribution of powers and responsibilities

According to the studies conducted by some international financial institutions over the last couple of decades, there is a clear tendency to decentralize responsibilities (expenditure as well as revenue) to the lower levels of government, to the states and even to third levels such as local or municipal

[181] Watts (1999a), op. cit., p. 43.
[182] However, when there are considerable differences between the states, the process of equalizing the revenue capacity of the states may not be an easy job. For the analysis of the problem of allocating financial resources in Germany after unification, see Exler, Urlich, 'Financing German Federalism: Problems of Financial Equalization in the Unification Process,'in Charley Jeffery and Roland Sturm (eds.), *Federalism, Unification and European Integration* (London, Cass pub. 1993): 22-37
[183] Smith, op. cit., p. 8-10.

governments.[184] This trend is apparently observed not only in federal but also in many unitary countries demonstrating decentralizing tendencies. However, there are enormous variations between federations as to the scope of decentralization, the main reasons which forced them to adopt decentralization, and the type of goods and services assigned to the lower levels of government. Whatever the driving force behind adopting such systems may be, there are certain goals aimed to be achieved when decentralization is implemented. This section therefore mentions the main objectives of distributing powers and responsibilities to different levels of government by briefly addressing the factors that can influence the outcome.

Promoting diversity in unity

When a particular country opts for a federal system it is mainly for the reason that it possesses an advantage for maintaining unity and diversity.[185] This can become a practicable solution, *inter alia*, through the constitutional allocation of powers and functions to the regions and the federal government. Diversities are recognized by providing mechanisms for the constituent units or communities existing in a federation to decide on certain matters on their own. A federal system possesses the advantages of promoting diversity by recognizing certain regional autonomies and distributing some powers and functions to the constituent units of the federation. The distribution of these powers and functions between the centre and the constituent units could be a reflection of the recognition of political rights or could be for better economic performance. Politically, 'it permits the expression of regional claims, which, if resisted, might provoke harsh resentments representing a greater threat to national unity, provides some safeguard to regional groups in the protection of their own special interests, and reduces the risk of the monopoly of power by an autocracy or a bureaucracy.'[186]

The distribution of powers and functions helps the constituent units to preserve their social, cultural, economic and political diversities. This diversity reflects the difference in needs, demands, preferences, and attitudes within the units comprising the federation.

The diverse interests of communities and constituent units can be preserved by decentralizing powers and functions to a jurisdiction which can satisfy its residents' preferences more satisfactorily than the centre. If the provision of goods and services are dependent upon local tastes and preferences, the variations can efficiently be addressed by allocating power to the local governments. This creates an opportunity for everyone to make his or her own choice. It is argued that a tendency to uniformly provide such kinds of goods by the centre may have some adverse consequences: entailing higher costs for goods and services, or compelling those who have a different preference to accept the one provided by the centre. The rule of preserving diversities

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[184] This can be observed from the country reports and staff working papers on the World Bank WebPages, www.worldbank.org/wbiep/decentralization, accessed in June 2003

[185] For the characteristics of federalism as maintaining unity and diversity, see Daniel J. Elazar, *Exploring Federalism* (the University of Alabama press, Tuscaloosa, 1987); Thomas Stauffer and Nicole Tapperwien, *Balancing self-rule and* shared, in Lidija B. Fleiner and Thomas Fleiner (ed.), *Federalism and Multiethnic states: the Case of Switzerland*, 2nd rev. ed., (Institute of Federalism, Friburg 2002) p. 41-74.

[186] Watts (1966), op. cit., p. 97.

therefore helps to achieve the objectives of an efficient allocation of resources and addressing various local preferences at the same time.[187]

On the other hand, the allocation of certain goods and services to the local level may not preserve the diversity of the constituent units because of at least two reasons. It is either because of the nature of the services that all citizens have similar preferences and benefits regardless of the place where they reside, or it could be extremely difficult to bear the financial costs and effectively discharge the responsibility at a local level (for example, defence, regulating financial institutions, foreign relations). The importance of assigning the roles to the centre for a uniform application of laws and the provision of services is therefore another objective of the distribution of responsibility between the levels of government. Institutions belonging to the central government are therefore appropriate in those cases where transaction costs are high and decentralized decision-making could not be conducive to the production or provision of such goods and services.[188] In this particular situation, promoting unity is required.

Public participation

One of the justifications for distributing powers and responsibilities to several layers of government is to promote popular participation in the decision-making process.

Public participation, as propounded by an economist,

> calls for the involvement of significant numbers of persons in situations or activities which enhance their well-being. Participation of the people in the social, political, and economic spheres can take many different forms and could be at different levels: in economic life as producers, consumers, entrepreneurs, or employees; in social life as members of families, or of community organizations or of ethnic groups; and in political life as voters, or as members of political parties or of pressure groups. All these roles overlap and interact, forming patterns of participation that interconnect with and often reinforce each other.[189]

The distribution of powers enables the public to administer themselves and to take the initiative in the development planning and administration aspects of their lives. It determines the extent to which the public can participate in the government by deciding on who will hold power, for how long, and how to dismiss the authorities when they fail to respond to public needs. Thus, the distribution of powers strengthens public participation by bringing the government closer to the people and also by bringing the public closer to the government.

The other justification is that, by establishing state and local governments, effective communication can be established with the public in order to mobilize the local force.[190] This can bring an input by several experts and can increase the quality of decision making at each level of government. It is when the public participation is fostered that it is possible to better utilize the local knowledge and to contribute to development. That is what led to the positive conclusion that

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[187] Thomas Stauffer and Nicole Tapperwien, *Balancing self-rule and shared rule*, In Lidija B. Fleiner and Thomas Fleiner (eds.) op. cit., p. 49-50.
[188] Oates (1972), *op. cit.*, p. 31.
[189] Bulti Terfassa, The role of fiscal decentralization in promoting participatory development in Ethiopia, In Eshetu Chole (ed.) *Fiscal Decentralization in Ethiopia* (AAU printing press, Addis Ababa, 1994) p. 149.
[190] Denis A. Rondinneli, R. Nellis, G. Cheema, 'Decentralization in developing countries: A review of recent experience' (Washington D.C., World Bank, staff working paper No.581, 1984), p. 9-15.

public participation can increase the quality of the provision of public goods and services.[191]

In general, devolving power to the local level creates greater proximity to the people and thereby helps the subnational governments to be more responsive to the residents' preferences. It is through democratic participation that decentralization can create an effective mechanism for citizens to express their needs and preferences, to influence a decision on local and national development planning, and to participate and be represented in the political process.[192] The participation of a local population is, in general, expected to create a favourable environment for a nascent democracy to flourish. And also for the citizens to take an active part in the development process of a nation, thereby paving the way for a better performance in the economic sphere.

Efficiency

The assumption that public participation brings the government closer to the people is also for the benefit of the efficient provision of public goods and services. It is argued that 'the greater the opportunity for collective choice, the greater the opportunity and the potential to supply diverse levels and kinds of government services. This is because, in such situations, there will be reduction of administrative congestion and overall, quick response to local demands, and more effective and efficient provision of public goods.'[193]

Administratively, central governments will be relieved from being involved in many local issues. The authorities will be free from onerous and tedious tasks so that the administration plays a leading role by focusing on effectively discharging its primary tasks. Conyers also argues that as the devolution of power increases, popular participation within the process increases the speed and flexibility of decision making, generates additional resources and encourages a more efficient use of existing resources.[194]

It is submitted that the distribution of powers and responsibilities to different levels of government is to create choices for individuals according to their preferences and circumstances. And also by creating competition between the local and regional governments it promotes the efficient and effective provision of public service.[195] But for the efficient provision of services and the utilisation of resources, the responsibility should be allocated to the appropriate level of government. In this regard, Wallace Oates advocated a 'correspondence principle'. According to this principle, if the level of government that can execute the responsibility is appropriately determined, it allows an approximate

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[191] *Ibid.*
[192] David Slater, 'Territorial Power and the Peripheral State: the issue of decentralization,' in Development and Change 20, 1989, p. 501-531.
[193] Abrar Suleyman, 'Fiscal decentralization: Experiences of Selected Countries,' In Eshetu Chole (ed.) *Fiscal Decentralization in Ethiopia* (AAU printing press, Addis Ababa, 1994), p. 98.
[194] D. Conyers, 'Decentralization and development planning: a comparative perspective', In Valk P. de and Wekwet (ed.), *Decentralizing for Participatory planning* (Newcastle, Athenaeum1 press ltd. 1990), p. 15-33.
[195] Jürgen von Hagen, 'Fiscal Federalism and Political Decision Structures,' In Blindenbacher, Raoul and Arnold Koller (eds.), *Federalism in a Changing World – Learning from Each Other: Scientific Background, Proceedings and Plenary Speeches of the International Conference on Federalism 2002* (Montreal & Kingston, McGill-Queen's University, 2003), p. 471.

correspondence between those who benefit from their provision, those who have to pay, and those who decide on the amount provided.[196]

In sum, with regard to the form of distribution and execution of power and functions federations demonstrate several differences. This can partly be related to various factors influencing the attainment of objectives. Some of the factors are corruption, the challenge of equitable distribution of resources, lack of political commitment and insufficient legal, financial and administrative institutions.[197] As a general remark, we may allude to the words of Prud'Homme that "decentralization measures are like some potent medicines: they must be taken at the right time, in the right dose, and for the right illness to have the desired salutary effect. Taken improperly, they can harm rather than heal."[198]

2.2 The essence of intergovernmental fiscal transfers and the challenges of diversity

The form which the process and institutions established for dealing with intergovernmental fiscal transfers depend on the allocation of expenditure responsibilities and revenue sources to different levels of government, and the size and nature of vertical and horizontal financial imbalances. The essence of intergovernmental transfer is to address these imbalances that exist between the territorially defined levels of government which assume the expenditure and revenue raising responsibilities. Although this process of adjusting the imbalances is widely recognized, there must always be reasons for some of the states to be entitled to some of the federal revenues generated from businesses or individuals in other regions.

Intergovernmental transfer aims to equalize the financial capacity between the subnational governments. But there is an important step of measuring the financial capacity before the transfer is made.[199] What should be measured to reveal the disparity between the regions is the crucial issue. Measuring the fiscal capacity of the regions is important for fiscal relations at the federal level between the federation and the states. Similarly, if fiscal relations exist at the state level between the state and local governments, it will require measuring at the local level, as well.

The process of measuring financial capacity is important for purposes of intergovernmental transfer programs. It focuses on the objective of reducing the fiscal disparity between the regions, enabling the regions perform their tasks, and promoting balanced development. However, this is not an easy task as it may face considerable challenges from the regions. The regions may not agree

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[196] Oates (1972), op. cit., p. 33-34; Richard Bird *et al*, 'Assignment of Responsibilities and Fiscal Federalism,' In Blindenbacher, Raoul and Arnold Koller (eds.), *op cit.*, p.415.
[197] See Prud'Homme, Remy, "On the Dangers of Decentralization," (World Bank Research Observer Vol.10 No.2, 1995); Vito Tanzi, Tanzi, Vito, 'On Fiscal Federalism: Issues to Worry About,'
http://www.imf.org/external/pubs/ft/seminar/2000/fiscal/tanzi.pdf, accessed on 15/08/2002; Bulti Terfassa, 'The Role of Fiscal Decentralization in Promoting Participatory Development in Ethiopia', in Eshetu Chole (ed.), *Fiscal Decentralization in Ethiopia* (Addis Ababa, AAU Printing Press, 1994): 141-166.
[198] Prud'Homme, *op. cit.*, p. 1.
[199] See Douglas H. Clark, 'Assessing Provincial Revenue-raising Capacity for Transfers,' in Ehtisham Ahmad (ed.) *Financing Decentralized Expenditures: An International Comparison of Grants* (Edward Elgar, Uk. 1997), p. 18-42.

on the number of principles and the variables that can be used to determine the formula for the allocation of federal transfers. A serious challenge may come from a region which feels able to stand on its own if it were to break away from the federation. It may even reject the idea of federal revenue transfer but for complete control of revenue gathered from the sources found in its territory. Thus, in a country where there exists considerable economic disparity between regions, the process of fiscal transfer faces problems of convincing the relatively better-off regions to share some of their resources with those less developed regions. This implies that there is a tension in a general approach that all regions should be treated equally since de facto asymmetry exists between the regions.

Explaining the problems of the process of intergovernmental fiscal transfer, R. Watts argue:

> The process and dynamics for adjusting federal financial relations are affected by the degree and kinds of social fragmentation and diversity and the particular form of the political institutions with which they interact: for instance, the degree and kinds of social diversity (linguistic, ethnic, religious, cultural and historical), how this diversity is territorially distributed, and whether this diversity is cumulatively reinforced or cross-cutting will have a significant influence.[200]

The disparity can also be expressed in the form of poor and rich, big and small or strong and weak. It can also be expressed in the form of settlement pattern, historical factors or economic patters. As mentioned above, a significant aspect of the problem of financial relations is not only in case where there is a great variation among the states in their capacity to raise revenue, but also in the extent of addressing regional asymmetries.

These problems can become further complicated in the case of ethnic-based federalism. This is because fiscal federalism primarily examines and deals with imbalances between national and regional governments, and among regional governments. But the sovereign ethnic groups[201] can claim the implementation of an equitable allocation of financial resources not only between the regions but also as between themselves in general. That is, there will be a competition not only between the regions but also between ethnic groups within the same region or with those that exist in other regions. The problem also concerns the role of the centre in creating a horizontal balance between all the heterogeneous groups.[202] This in the end requires the role of the federal government to allocate finance equitably and horizontally among all the ethnic groups existing within the federation. In a country where several heterogeneous groups exist, this tension between ethnic federalism and the principles of fiscal federalism may lead us to a

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[200] R. Watts, 'Processes for Adjusting Federal Financial Relations: Examples from Australia and Canada', in Paul Boothe (ed.) *Fiscal Relations in Federal Countries: Four Essays* (Ottawa, Canada, Forum of Federations, 2003), p. 18.

[201] For instance, see Art. 8, 39 & 47 of the Ethiopian Constitution. .

[202] Lidija B. Fleiner argues that 'The crucial paradox of federalism as a conflict-management device for multiethnic societies lies in 'hidden potentials' of the relationship between territory on one side, and ethnic-driven constitutional solutions in a given multiethnic federation, on the other. The major challenge that any ethnic federalism has to face, moreover the 'trap' with sometimes-fatal consequences for inner piece, remains as to how to avoid that - due to constitutional foundations and established decision-making process at a federal level - every constitutional conflict turns into ethnic conflict.' Lidija B. Fleiner, 'Can Ethnic Federalism Work?' A paper presented at the conference on 'Facing Ethnic Conflicts,' (Centre for Economic Development, Bonn, 14-20 December 2000, Germany), p. 9.

complex 'ethnic arithmetic' concerning the distribution of benefits and the sharing of burdens. In its wider sense, ethnic arithmetic means:

> The assigning of an ethnic label for everything from a piece of territory to a particular office or job, from a functional area of private enterprise to an admission spot in a university. Ethnic arithmetic also includes the controversial 'counting of groups'; the quantitative formulation that seeps into all aspects of life, and the endless discussion or partisan bickering over the rationale and merits of particular policies. It tends to reinforce existing stereotypes and even foster new ones.[203]

Looking at the major issues above, it is worth asking: How should the tension pertaining to the process of intergovernmental transfer towards addressing the imbalances between the diverse groups be reduced? Several authors argue that there should be a political commitment between the regions or the diverse groups to work together through a federal principle accepted by them. This is because federalism with its system of fiscal transfer does not aim to address all forms of diversity and make the citizens equal in every aspect of their life. There must be some sense of solidarity between the diverse groups. This solidarity can be expressed in various forms. For instance, R. Bird recommends adopting asymmetrical fiscal policies manifested in 'differential direct central spending patterns, in differential central taxes, in differential subnational functional or revenue responsibilities, or in differential transfers.'[204] Which region or group will have an asymmetrical relationship with the federal government has to be defined. And the asymmetrical approach should be well accepted by the differentially treated communities. Thus, there must be a search for 'equilibrium' between the financial disparities that can be addressed by instruments of intergovernmental transfer.[205] This requires political bargaining to accommodate conflicts between the centre and the regions, between the rich and poor regions and conflicts between different interests in different regions.[206] The process of bargaining cannot achieve a perfect balance, but leads to reconciling interests of diverse groups. That means tolerance of some of the imbalances between the constituent units.

In a situation where there are considerable diversity and asymmetry between the regions, the bargaining process may face at least two challenges:
First, the problem of realizing a certain level of horizontal balance because of the difficulty to convince a multitude of groups. This is a case when, as Graham Smith argues, 'the aggrieved are invariably those ethno-regions - developed or less developed - which feel that they are not benefiting from association.'[207]
Second, to reduce the regional disparities there may be a need for a great deal of involvement of the central government through conditional transfers or direct federal spending. But a greater degree of involvement by the centre may, on the one hand, threaten the regional autonomy and independent responsibility. And

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[203] Joshua, op. cit., p. 330-331.
[204] R. Bird 'Rationales and Forms of Decentralization' in R. Bird and T. Stauffer (eds.) *Intergovernmental Fiscal Relations in Fragmented Societies* (PIFF, vol.33, Bâle, Helbing & Lichtenhahn, 2001), p. 9.
[205] N. Schmitt, *Federalism: The Swiss Experience* (Pretoria: HSRC Publishers, 1996), p. 72.
[206] R. Watts (2001), *op cit.*, p. 28.
[207] Smith, op. cit., p. 11-12. For instance, Nigeria provides an example of this. In the words of a Nigerian scholar, the ethnic issue brought about an 'intensification of an 'us' versus 'them' syndrome amongst the different ethnic groups and regions, some rightly or wrongly feeling that they have been marginalized and dominated, others...feeling that they have been exploited.' Attahiru M. Jega, 'The Nigerian Federal System: Problems and Prospects', in Lidija R. Basta and Jibrin Ibrahim (eds.), op. cit., p. 205.

on the other hand, some may feel that they are not benefiting equally to the others who have more power at the centre.

In Ethiopia, the above issues specifically relate to issues on how Ethiopian federalism deals with the principles of intergovernmental fiscal transfers. In this regard, the major questions which will be further studied in the following chapters relate to: How could interethnic and intrastate conflicts pertaining to development disparities and the distribution of benefits and revenue transfers be addressed? How could such issues be addressed through the technique of the division and redistribution of resources between the centre and the regions? Accepting federalism as a desired system, what kind of fiscal arrangement is developed will be studied in the subsequent chapters.

3. CONCLUSION

Two major themes have been the subject of the above background chapters. The first is the historical development and the federal system of Ethiopia. The second focuses on the theory of federalism and presented the major issues embodied in fiscal federalism, the latter emphasizing the particular issues surrounding intergovernmental fiscal relations. These two chapters give background information, on the one hand, on outstanding issues that emanate from the history and federal structure of the country, and on the other, on financial issues that require meticulous attention in federations with great diversities.

Although fiscal federalism is concerned with financial and economic issues, it largely responds to the devolution of political, legal and administrative powers. This entails the importance of understanding the present day political structure in light of its historical development. The success or failure of a particular system may also depend on its ability to respond to the outstanding issues that emanate from the country's history. In this regard, the first part of this chapter has described the background of the Ethiopian federal system as it exists against the analysis of the state's history.

By analysing the traditional political structure, the efforts of emperor Yohannes, the Ethio-Eritrean federation and the introduction of autonomous regions during the last few years of Dergue, the tendencies of decentralization have been described. The modern state structure, however which was introduced by emperor Menelik II at the end of the 19th century, was completed by Emperor Haile Selassie I who succeeded in imposing a centralized system. The evolution of the tax system demonstrates how also the fiscal system became centralized. Furthermore, the process and practice of centralization was significantly strengthened during the military regime. The process of centralizing the political, legal, administrative and fiscal system became deep rooted during the 20th century.

The outstanding issues of the current epoch are intertwined with the strong tradition of centralism. As centralization proceeded at different paces, the regional forces and political organizations intensified their opposition to it. Although the challenges were different from the traditional power struggle (between the emperor and regional lords), they clearly demonstrated that the trends of excessive centralization by Emperor Haile Selassie I and the Dergue could not address the issues raised by the oppositions. Thus, after the defeat of the Dergue, some form of decentralization was sought to provide the solution to

the regional demands promoted by the regional forces that fought against the centralized system. However, the post 1991 political structure, particularly the federal Constitution, took a more extreme direction, thereby 'opening a Pandora's box'. This is because of the overemphasis of the Constitution on regional and ethnic interests with its peculiar constitutional principles of the right of any nation, nationality or people to statehood and even the right to secession. It has also led to a territorial organization resulting in a huge asymmetry between regions and groups. We will further discuss this in Chapter V and VIII.

The second chapter discusses the meaning and nature of federalism in general and the principles embodied in fiscal federalism in particular. First, to clarify the concept of federalism various definitions of the term federalism have been described. An attempt has also been made to analyse the concept from the perspectives of the origin of federations, the territorial representation of diversities and the competitive or cooperative functions of a federation. The introduction of federalism has various military, economic, historical or cultural reasons, but it primarily gives an opportunity to accommodate regional diversities while at the same time maintaining their unity. However, federalism is not meant to give territorial representation to every form of diversity. Particularly, where there exists considerable diversity, compromises must be made between different interests and cultural, historical, economical and geographical factors have to be balanced. In this section, the relation between concepts of federalism, federation and decentralization has also been discussed. Despite the difference between federalism and decentralization, it is important to understand a wider meaning of decentralization. This is because there is a possibility to use the concepts for studying different forms of decentralization within the respective levels of government and the allocation of revenue raising powers and expenditure responsibilities between the levels of government.

In the second chapter, four central and interrelated issues of fiscal federalism have been described. The first is the distribution of expenditure responsibilities which depend on the constitutional division of powers and responsibilities; the second issue is the division of revenue-raising powers; third, the fiscal imbalances between the tiers of government and the disparities between them in executing their responsibilities; fourth, the process of adjusting the imbalances and establishing a meaningful relationship between the tiers of government which are indispensable for a viable federal system, both politically and financially.

The discussion highlighted the considerable challenges that the fiscal relation between the tiers of government could face, as there are various diversities in the federation. If the tendency is to emphasize regional or ethnic diversities, this may increase the problem of addressing disparities. In general, this will lead us to a question: How do the principles of fiscal federalism address the issue of equitable transfer or equalizing the regional imbalances in an ethnic-based federal system? It will be the task of chapter VII and VIII which analyse the p ocess of intergovernmental transfer and the challenges of ethnicity related to financial issues.

3 The Division and Implementation of Expenditure Responsibilities

In general, the study of fiscal federalism focuses on how a federal system successfully operates. In particular, it focuses on the distribution of expenditure and revenue responsibilities. It also deals with further issues as to whether there is a balance between the expenditure and revenue sources assigned to each level of government, whether one is more or less dominant, and to what extent they cooperate in or coordinate the performance of their responsibilities. The subject of this chapter is one of the key elements of this study that is the division of expenditure responsibilities[1] between the various tiers of government. The division of expenditure responsibilities means determining the responsibilities of the tiers of government as to where and on what they can spend their money. In principle, the responsibility for expenditure in a federal system corresponds to the extent of the legislative[2] and executive responsibilities distributed to the federal government and the states.[3] In other words, the manner of the division of expenditure responsibility will be affected by the design of the federal system, particularly the division of legislative and administrative powers. In federations, this division of expenditure responsibilities is primarily determined by a federal constitution.

Thus, in its first section, this chapter deals with the distribution of powers in general and the specific distribution of powers and responsibilities in the Ethiopian Constitution. In this regard, it deals with the division of legislative and executive powers, the principle of subsidiarity and symmetrical and asymmetrical division of powers.

The second section focuses on examining the practice and processes of implementing these responsibilities. It mainly focuses at the regional level with a view to understand the causes and extent of disparities between the regions. It analyses the budgetary process, intergovernmental cooperation and factors that may aggravate regional disparities.

1. THE DIVISION OF POWERS AND RESPONSIBILITIES

In the study of the system of the division of expenditure responsibilities in a federal system, there should be careful consideration of the following points. First, the system of distribution of powers between the federation and the states should be analysed. In this regard, the techniques for the allocation of legislative

[1] The 'division' of expenditure responsibilities is also called the 'assignment' of expenditure responsibilities in much of the literature. In this chapter 'assignment' refers to the constitutional division of powers, and powers decentralized in the form of devolution, delegation, or deconcentration in which the scope of power can be ascertained.
[2] Legislative costs are insignificant compared to administrative costs. However, legislative power is essential to understand the extent of a government's expenditure responsibility.
[3] It may also deal with the power of local governments, as is the case in Nigeria, Germany and Switzerland.

power in general and the scope of the powers allocated to each tier of government in particular should be discussed.
Second, and in a similar fashion, the distribution of executive powers should be studied. The distribution of expenditure responsibilities in a federal system corresponds to the division of legislative as well as executive powers between the tiers of government. That is why the discussion of the distribution of executive power must be included.

Third, a discussion of some important notions such as subsidiarity which may help us to understand the nature of the distribution of power between the federation and the states, and the decentralization of power within a state has to be included.

The above issues mainly address constitutional issues that may have an impact upon the performance of expenditure responsibilities. It may also be appropriate to consider the political factors that influence the objective of decentralizing responsibilities.

The actual division of expenditure responsibility deals mainly with the interrelated aspects of the division of legislative and executive powers. Central to this issue is which responsibilities or authorities are divided between the levels of government. In some federations, like the USA, the legislative, executive, judicial and financial powers are divided between the federal government and the states, and then the expenditure responsibility becomes coextensive with the legislative responsibility of each level of government. In other federations, like Germany, the legislative power is mainly entrusted to the federal government while the executive power is mainly reserved to the states. In this case, as we shall discuss it at a later stage, although the federation is resorted to a centralized legislative process, there is a highly decentralized expenditure responsibility which results in a strong interdependence between the two levels of government. Therefore, the method of the division of legislative and executive power has an impact on the division of expenditure responsibility. In Ethiopia, in order to have a deeper understanding of the division of the legislative power under the FDRE Constitution various types of powers will be discussed in section 1.1 (from 1.1.1. to 1.1.5.). These are: exclusive powers, residual powers, concurrent powers, framework powers and implied powers. Next we examine the scope of allocated powers in Ethiopia in section 1.2. Section 1.3 examines how the scope of the administrative responsibility is determined. The relevance of the subsidiarity principle and the symmetrical and asymmetrical division of powers will also be studied in section 1.5 & 1.6 respectively. In general, the essence of the study of the distribution of powers and responsibilities is to determine on which areas a central or regional government can make expenditures. In order to facilitate our analysis of the distribution of powers and responsibilities in Ethiopia, some detailed descriptions of the system of distribution of power in other federations will be included.

1.1 The division of legislative power: types of powers

In the division of legislative power, there are great variations amongst federal systems with regard to the 'form and contents [or scope][4] of the functions

[4] The 'form' of division of powers refers to the techniques of constitutional allocation of powers, whereas the 'scope' or 'contents' of legislative power refers to the substance of power allocated to each tier of government. See R. Watts, *New Federations: Experiment in the*

assigned to each tier of government. The variations are influenced by several factors such as the details of or the list of powers assigned to the tiers of government, the significance and place of the residual power, the problem of delimiting the scope of the power between the federal and state governments, and the manner in which the federation is formed (by aggregation or devolution).[5]

The general technique of the distribution of legislative powers between the levels of government follows either of two options. The first is to enumerate the functions of the central government (and some concurrent power) and to leave the rest under the exclusive authority of the regional governments.[6] In this case the residual power remains under the authority of the states. Those countries which allocate the residual power to the states, however, vary in the lists of powers they provide for the centre and the states, as well as in their concurrent powers.[7] The second technique is to compile exhaustive lists of central, regional, and concurrent powers of both levels of government, where the residual power lies at the centre. This method is criticized for being used to set up a centralized federal system at the cost of the autonomy of the regional governments.[8]

The division of powers between the levels of government, particularly the allocation of residual powers, can be influenced by two factors: the circumstances under which the federation is formed, and the specific conditions of the country.[9] The first factor refers to the formation of the federation either by aggregation or devolution. The general assumption is that when independent units (states) amalgamate together to create a central government they clearly intend to spell out those powers and functions which they agreed to assign to the new central government.[10] This is because those units coming together are expected to agree on those essential powers which they allocate to the centre on the understanding that they retain the remainder.

If, on the other hand, a federation is formed by devolution, residual powers may be left with the central government. Examples are the constitutions of Canada, India, and the new federations of Belgium and Spain.[11] However, federations that have undergone the same process (either devolution or aggregation) may not demonstrate any semblance in the manner of allocating powers. This may be because of the specific circumstances of a country. The extent of power allocated to the centre in two federations formed in the same way, say devolution, may vary since social, economic and political conditions may not be similar. In general, the principles put into use by each country may bring about either of the

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commonwealth, (Oxford, Clarendon, 1966), p. 173; D. J. Kriek, 'The Theory and Practice of Federalism,' in D.J. Kriek (ed.) *Federalism the Solution?* (Pretoria, HSRC pub., 1992),p. 25-26.

[5] *Ibid.*

[6] R. Watts, (1966) op. cit., p. 168-169; Apparently the simpler way is to draw up a single list of exclusive central powers and to assign all residuary powers to the regional governments.

[7] See infra for the discussion of residual and concurrent powers.

[8] The typical example of this model is the Indian Federation. Sharma argues that this was because the drafters of the Indian Constitution had the determination to form a strong central government in order to protect the union from further secessionist (East and West Pakistan had already obtained independence) tendencies and potential conflicts between groups. B.M. Sharma, *The Republic of India: Constitution and Government* (Asia pub. House, Bombay, 1966), p. 410.

[9] Ibid; see also Ronald Watts, *Comparing Federal Systems*, 2nd ed. (Queen's University, Montreal, 1999 a), p. 20-30.

[10] Sharma, op. cit., p. 396.

[11] Watts (1999a), op. cit., P. 20-30

following two characteristics: the central government may possess greater powers than the regions or vice versa. But there cannot be a rigid way of classifying each level of government as having a greater or a lesser power. The constitutional classification of power should be seen in relation to the actual practice of the country concerned. What matters most is the operation of the federal system, not merely the formal division of powers.

1.1.1 Exclusive powers

In legal parlance, the notion of exclusive power refers to 'the powers for which the federal constitution has created a monopoly which either is in the hands of the federation or of the states. The exercise of such an exclusive power as described in the federal constitution is left entirely to the entity to which it has been attributed.'[12] When we look at various constitutions the attribution of exclusive power could be by listing powers either for the centre or for the states only, or for both levels of government. In the definition given above it is not specifically mentioned whether the allocation of residual power gives exclusive power to either level of government. However, if its allocation evidently confers the monopoly of residual power to either level of government, we may conclude that the government retains exclusive power over residual power.

Exclusive powers may only be assigned to the central government leaving the undefined and unenumerated powers to be exercised by the regions, or enumerate the exclusive powers of each level of government. The listing of the exclusive powers of each government is for the purpose of delimiting the scope of the power and for curtailing any unnecessary interference with the power of a government. For instance, in the USA and Australia the exclusive powers are listed only for the federal government, but with some kind of 'catch-all phrases' which broaden the extent of the federal power. The German Basic Law not only provides exclusive powers for the central and the regional governments but also extensively provides the concurrent powers of both levels of government. In general, the Federal government retains exclusive legislative power over most of the matters while leaving their execution to the Länder.

The Indian Constitution follows a different approach where exclusive power is allocated to both the federation and the states. The Indian Constitution, in its seventh schedule, contains three lists: the federal legislative list containing subjects over which the federation exercises exclusive legislative power, the state legislative list containing subjects over which the constituent units (the states) exercise legislative power, and the concurrent legislative list containing subjects over which both the central and the state governments can legislate (the former prevails in the case of inconsistency). The federal government also has exclusive authority over residual powers.[13]

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[12] Flora A.N Goudappel, *Powers and Control Mechanisms in European Federal Systems*, (Gouda Quint, Sanders Institute, 1997), p. 40.

[13] See, in general, provisions of the Indian Constitution, Articles 245-254. The Indian Constitution follows a strange approach by empowering the centre to legislate even on a matter included in the powers of the constituent units. There are at least three cases: when it is in the national interest that the Council of States (on its own) decides to legislate on a subject included in the state list; when a proclamation of emergency is in operation; when two or more states, by consent, require parliament to legislate on a subject in the state list (See Arts. 249, 250 and 252).

The Canadian Constitution is similar to the Indian Constitution by allocating exclusive power also to the provinces (Section 92) and reserving residual powers for the centre. The Nigerian Constitution provides only for the exclusive power of the federation. However, it mentions the power of the states in the case of concurrent powers and the federal law prevails in case of inconsistency.

In the Ethiopian federal system, the powers of the federation are enumerated, with few listed state powers. The Constitution follows an approach of listing the exclusive legislative powers and executive functions of the federal government. It lists several subject-matters where the legislature may enact proclamations. The Constitution provides a limited list of exclusive powers for the states (Article 52(2)). It also mentions the source and type of taxes for which the states may exercise exclusive power. In principle, the Ethiopian Constitution follows the USA model by enumerating the powers of the centre and allocating the residual powers to the states, but it also incorporates some features from India and Canada by listing some powers for the states.

We have mentioned some federations with one exclusive list, while others have two exclusive lists for the centre and for the regions. But is there a federal principle which prefers one form to the other? In this regard, Wheare argues:

> The important point is whether the powers are divided between coordinate, independent authorities or not. This division can be made either by marking off the powers of the general government and limiting it to them ...or the division can be made by marking off and limiting the powers of both general and regional governments.[14]

We may conclude from this that it is not the one or the two exclusive lists that matters, it is rather the supremacy of a government over the powers reserved for it. Therefore, the choice of either of the methods must determine the actual exclusive powers of each level of government. However, if there is a total absence of exclusive power, either for the federation or for the states, it is hardly possible to discuss the existence of a federal system. Wheare says, 'circumstances will decide which method is to be adopted,'[15] but Watts recommends that the simpler way is to draw up a single list of exclusive central powers and to assign all residual powers to the regions.[16] Saunders observes that the tendency in older federations is to make one list, but that recent federations use a two-list system.[17] In fact, there are some practical merits of listing the exclusive powers of both levels of government. Each of them can easily identify its powers and functions and therefore this minimizes the risk of power interference by one level of government as against the other.[18]

1.1.2 *Residual powers*

The other type of power that needs to be considered in the distribution of powers in a federation is the location of residual powers. Residual powers are those powers which are not included in the list of exclusive or shared powers. In some cases they are not specifically enumerated because they were unforeseen by the

[14] K.C. Wheare, *Federal Government*, 4th ed., (Oxford University Press, London, 1963), p. 13-14.
[15] *Ibid.*
[16] Watts (1966), *op. cit.*, p. 173-174.
[17] Cheryl Saunders (1995), 'Constitutional Arrangements of Federal Systems,' (Publius: The Journal of Federalism, Vol.25 No.2, 1995), p. 69-70.
[18] *Ibid.*

drafters at the time of constituting the federal constitution[19], for example, the recent development of computer technology and internet services and their role in commerce. Saunders argued that residual powers may also be left during the initial stage of establishing the constitution for the reason that there were no objections concerning the allocation of subjects between the central and state governments.[20] This could be illustrated by the case of the USA where several civil and criminal matters were left untouched in the federal constitution. It is difficult to conclude that the drafters did not foresee them at that time.

The extent of the actual residual power is contingent upon the coverage of the exclusive power of the regional and central government, and their concurrent powers. In short, the greater the enumeration of exclusive and concurrent powers the lesser the significance of the residual power. It has to be noted that it would be practically impossible for the drafters to enumerate exhaustively the possible powers and functions of both levels of government and to avoid the issue of residual power. Accordingly, in order to prevent any potential dispute between the federation and the states it is imperative to regulate it in a federal constitution. Therefore residual power remains one of the important parts of the distribution of powers in a federation.

Unlike India and Canada, in most federations, residual powers are left to the states. The Ethiopian Constitution also reserves residual power to the states. Article 52 provides, 'all powers not given expressively to the federal government alone or concurrently to the federal government and the states are reserved to the states.' With regard to the residual power of taxation, however, the Constitution has another saving clause that does not automatically allocate it to the states: it is to be decided by a joint meeting of both Federal Houses (Article 99).[21] Moreover, the Constitution reserves major policy matters governing education, health, environment, science and technology and development strategies to the centre which may broaden the power of the federal government over residual maters (see Articles 51 (2 &3), 89-92).

In general, it has been said that if a residual power is assigned to regional governments it supports their autonomy. If, on the other hand, the tendency is to strengthen the centre, the residual power should go to the central government. In instances where a constitution reserves residual powers for the central government, the federal constitution can be classified as quasi-federal in contrast to a proper federal constitution.[22] But what matters is not the location of the residual power either at the regional or at the central level. Rather, the allocation and the exercise of meaningful power by both levels of governments within one political and legal order is what counts. Wheare suggests that in a federal system 'there must be some matter, if only one matter, which comes under the exclusive control, actual or potential, of the general government and something likewise under the regional government. If there were not, that would be the end of federalism.'[23]

[19] Watts (1999a), *op. cit.*, p. 39.
[20] Saunders (1995), op. cit., p. 69-70.
[21] For a discussion of residual taxes, see the next chapter, section 4.4.
[22] Wheare, op. cit., p. 21-22. Wheare argued that a country with a quasi-federal constitution may, however, be considered as a federal government if its workings fulfil the requirements of a federal system.
[23] *Ibid*, p. 75.

1.1.3 Concurrent powers

Concurrent powers are provided for in many federal constitutions. They are powers which are shared by both levels of government. Watts propounds that concurrency has provided an element of flexibility in the distribution of powers. According to him:

> Concurrent lists of legislative power avoid the necessity of enumerating complicated minute subdivisions of individual functions to be assigned exclusively to one area of government or the other, and reduce the likelihood that such minute subdivisions will over time become obsolete in changing circumstances.[24]

Whatever the merits of concurrency may be, the concurrent power of legislation, with great variations as to its extent, is found in many federal systems.

Concurrent powers may exist in either of three ways. First, they may clearly and in a separate provision be included in the constitution, as has been done in the Constitution of India, Germany and Nigeria.[25] Secondly, they may be found in the constitution but not in a separate list. They may be found in the subjects apparently listed as exclusive powers of the federation which may also provide an exception for the possibility of exercising the power by the states in those subject-matters not covered by federal legislation. This type is different from the first one since the concurrent powers are not separately listed but are found by studying the powers assigned to the federation. This has been the case in the Swiss Constitution.[26] Thirdly, concurrent powers may also be acquired by 'practice and convention'[27] as in the case of the USA and Australia since no separate list of concurrent powers is found in their constitutions.

On the whole, there are some issues which have to be addressed with regard to exercising this power; that is whether both levels of government can at the same time provide a piece of legislation, in other words whether the states have equal rights in exercising these powers. And if both levels of government exercise the power, and if there is a conflict between the laws issued by both governments, then the question will be which one prevails.

In the case of concurrent powers, if both levels of government enact laws on the same issue, they may prescribe the same thing or the laws may differ. If the

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[24] Watts (1999a), *op. cit.*, p. 38.

[25] The following are a case in point. The Basic Law of Germany, Art.74; the Indian Constitution, List III, seventh schedule; and the Nigerian Constitution, part II, second schedule.

[26] For instance, the Swiss Constitution provides the specific roles of the governments in the education system of the federation. The federal government concentrates on the research and technical universities, whereas the cantons concentrate on primary education (Articles 62-64). The federation also shares the responsibility for granting scholarships, supporting cultural activities, and sport education (Articles 66 and 69). See the Constitution of the Swiss Confederation of April 18,1999 (as amended up to March 3, 2002). Similarly, in the 1999 Constitution of the Federal Republic of Nigeria, most of the matters included in the concurrent powers are listed in two separate sub-provisions where both governments exercise their powers parallel to each other. For example, both the federation and the states exercise the same power concerning federal and state archives and records respectively. In another provision a state has the power to legislate on the establishment or other arrangement of scientific and technological research, whereas the federation regulates or coordinates scientific and technological research throughout the federation (the 1999 Nigerian Constitution, Art. 21-22 of part II of the Second Schedule).

[27] B. M. Sharma and L.P. Choudhry, *Federal polity*, (London, Asia pub. house, 1967) p. 229.

laws are identical it results in duplication, but if they differ it can be seen from two different angles. The difference may be inconsistent, or one may simply add something to the other without any inconsistency. In the case of the USA, the 'supremacy clause' included under Article VI of the Constitution makes the laws of federal government supreme. In cases where concurrent legislative powers are allocated, the constitution has to specify how the inconsistency can be solved. For example, Article 4(5) of the Nigerian Constitution clearly mentions that if any law enacted by a state legislature is inconsistent with any law validly made by the National Assembly, the law made by the latter shall prevail, and that the other law shall, to the extent of its inconsistency, be void.

In Germany, the issue is not of inconsistency, but rather the existence of conditions subject to which the federation or the states can exercise the concurrent power (the Basic Law, Articles 72 and 74). The states can legislate on the subjects listed under the concurrent legislation so long as and to the extent that the federation has not exercised its legislative power by enacting a law. The concurrent power, on the other hand, can only be exercised by the federation if it is essential for the establishment of equal living conditions or for maintaining legal and economic union throughout the federation. That means that, unlike exclusive power, all powers under the concurrent list are not transferred to the federation. They can be exercised by the federation only when uniform federal legislation is required. If an issue of constitutionality arises, the constitutional court adjudicates the issue. The other exception exists in Canada. Among the very few cases of concurrent powers the federal legislation prevails over the state laws in all but one case, if there is a conflict with regard to old-age pension legislation.[28]

The title of Article 98 of the FDRE Constitution provides for the 'concurrent power of taxation.'[29] A plain reading of the provision may entail that both the centre and the states have the power to legislate when determining the tax rate, the benefits and exemptions it may award to the taxpayer, the obligations of the taxpayer, and the nature of the tax administration within the jurisdiction of the government. However, the amendment of the Constitution[30] has reserved the power for the centre by interpreting the phrase 'concurrent power of taxation' to mean only taxes which are determined and administered by the central government, but the proceeds of the taxes are shared with the states. Thus, one should be cautious when reading Article 98 of the Constitution which says 'concurrent power of taxation' since it does not actually confer a concurrent legislative power over the taxation powers listed in the same provision.

Nonetheless, in Ethiopia, too, it is difficult to avoid concurrent powers. Although specific provisions for a category of subjects falling under concurrent powers are not found, some cases of concurrency could be discerned.[31] The concurrency

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[28] Watts (1999a), *op. cit.*, p. 38.

[29] The text of Art. 98 reads: 'Concurrent Power of Taxation: 1) The federal government and the states shall jointly levy and collect profits, sales, excise and personal income taxes on enterprises they jointly establish. 2) They shall jointly levy and collect taxes on the profits of companies and on dividends due to shareholders. 3) They shall jointly levy and collect taxes on incomes derived from large-scale mining and all petroleum and gas operations, and royalties on such operations.' For a detailed analysis, see Chapter VII on revenue sharing.

[30] However, the text of the amendment has not been promulgated in the official Negarit Gazette.

[31] According to the text of Art. 55 of the Constitution '5) [the House of Peoples' representatives] shall enact a penal code. The states may, however, enact penal laws on matter that are not specifically covered by Federal penal legislation. 6) It shall enact civil laws

exists with regard to civil and criminal laws. States may enact penal laws on matters that are not specifically covered by the federal penal code. The federal legislature may likewise enact civil laws concerning subjects which the HOF deems necessary to sustain one economic community. If exercised, such matters result in concurrent legislation. In another instance, both the federal government and states have the power to declare a nationwide or a statewide state of emergency respectively (Article 93). The federal government has the power to declare a state of emergency in the case of an external invasion, the breakdown of law and order which can not be controlled by the ordinary law enforcement agencies, a natural disaster, or an epidemic. Similarly, a statewide state of emergency can be declared if an epidemic or a natural disaster occurs within a state.[32] The current practice in matters of education seems to be that of concurrency. Although primary education is solely administered by the states, at the tertiary education level both the federation and states administer, regulate and cooperate.

Other cases of concurrency may also be found when the federation and states enact legislation dealing with economic, social and development policy matters. The problem, however, is that the Constitution does not provide a hierarchy mechanism as to how to solve a conflict if it arises between the federation and a state although, in practice, the federal power prevails over that of the states. The constitutional assembly, which adopted the Constitution, deliberately disregarded the concept of *paramountancy* probably fearing that it undermines the supremacy of nations, nationalities and peoples.[33] However, states' Constitutions and legislation which came at a later stage affirmed that all laws and practices should not contradict the federal Constitution as well as other federal laws.

In general, even though countries differ in their approaches towards concurrent powers, practically speaking it is difficult to preclude them, as it is very difficult to have a very strict division of powers. The experiences of many countries also support the view that concurrence is inevitable. The point, however, is to clearly determine the shared powers, and to develop a clear mechanism as to how to resolve the issues of inconsistency and conflict of interests between the centre and the regions.

1.1.4 Framework powers

After discussing the nature of concurrent legislative powers as the shared powers between the central and state governments, attention needs to be devoted to the other shared power, called *framework power*, which does not seem to be explicitly provided for in many federal constitutions. It is similar to concurrent

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which the House of the Federation deems necessary to establish and sustain one economic community.'

[32] However, there is a danger of overriding the constitutional set-up in Ethiopia. When the recent (2002) interethnic conflict (following the decision that the seat of the Sidama zone should be transferred to another city, whereas Awassa should retain the status of a special zone) and anarchy prevailed within the SNNPR state (extrajudicial killings, administrative hierarchies were dismantled), the federal government intervened and settled the matter without any declaration of a state of emergency. In effect, the region was under a state of emergency although the procedures of the Constitution were not followed.

[33] See 'Yehigemengist Kale Gubae' [The Minutes of the Constitutional Assembly], December 1994. Surprisingly, however, the federal legislation (Proc. No. 138/1998) provides that the federal laws prevail when there are conflicts with state laws. The rules of *paramountancy* allow the federal laws to pre-empt the state ones to the extent of the inconsistency between the laws.

powers in the sense that both the federation and the states play a role in the process of exercising their legislative power.

The nature of framework power and its relevance is clearly provided under the German Basic Law. It is somewhat complicated compared to concurrent powers because framework legislation needs some kind of coordination between the federation and the states. The enactment of framework legislation assumes the importance of a state's legislation to implement that area of policy depending on the specific circumstances. The framework legislation issued by the federal legislature is subject to one strict condition: 'to leave substantial room for the states to issue their own legislation within the limits set by the federation.'[34]

As per the Basic Law of Germany, the federation has the power to enact framework legislation for the Länder with regard to those subjects listed under Article 75, such as higher education, legal relations of the press, land distribution, management of water resources, nature conservation, and the registration of persons' residence and domicile. The enactment of framework legislation is subject to the same conditions with regard to concurrent powers, i.e. establishing equal living conditions, and for maintaining legal and economic uniformity.[35] However, there are some differences between the framework legislation and concurrent powers.[35] In the case of concurrent powers, in most cases legislation from either level of government may exhaustively deal with the policy area. But, mostly, it is the federal legislation that plays the major role. Article 72 of the Basic Law, for example, states that the Länder shall have power to legislate concerning subjects listed under concurrent power to the extent that the federation has not exercised legislative power by enacting a law. If both the federation and a state enact legislation, both apply hierarchically in a sense that the state legislation applies to the extent that it is not inconsistent with the federal legislation. However, in the case of framework legislation both the federal and state legislation are expected to exist at the same time. This is because the federation issues the frameworks for the Länder to enact their own legislation. The federal legislation should, in principle, not exhaustively deal with those areas which are the subject of the legislation. It should leave room for the states to enact their own legislation based on their local circumstances.[36] A state is expected to deal with the subject in detail based on the policy frameworks enacted by the federal legislature.

The FDRE Constitution does not explicitly mention framework legislation like that of the German Basic Law. However, we can argue for the application of the principle of framework legislation in the Ethiopian federal Constitution. For instance, the federal government has the power to establish national standards and basic policy criteria for public health, education as well as for the protection and preservation of cultural and historical legacies.[37] The federal government is involved in setting standards and basic policies, but the states are the major actors in the provision of education, public health and the protection of cultural and historical legacies. This division of power requires general, structured federal legislation and detailed state/local laws. Furthermore, both the federation and a state have the power to formulate social, economic, and development strategies and policies for the country and the state respectively. The Constitution does not

[34] Goudappel, op. cit., p. 42.
[35] Watts considers both 'the framework legislation and the joint tasks' provided under the German constitution as cases of concurrent power. Watts (1999a), op. cit., p. 38.
[36] Goudappel, op. cit., p. 57.
[37] Art. 51 (3) of the FDRE Constitution.

expect conflicting policies to be applicable at the same time. There are several options for this provision to be applicable. If policies determined by the federation remain as framework legislation, a state may determine specific policies addressing local needs. Presently there are several policies which have been decided by the federation and the states have acceded to them, implying the need for the uniformity of policies and laws throughout the federation.

In general, it seems that the importance of the framework legislation is more favourable in a federation where the centre mainly retains the legislative power whereas the states engage in implementing the state as well as the federal legislation, as is the case in Germany. However, as we can see from the FDRE Constitution, there is a need for framework legislation for setting uniform standards and policies whereas the details are left to the member states since the expenditure responsibilities lie with them.

1.1.5 Implied power

Although the Federal government of the USA is referred to as 'the government of specified or enumerated powers' since the powers of the federation have been specifically mentioned in the Constitution, the wording of some of the provisions has not escaped from being the sources of controversy between the federation and the states.[38] Accordingly, one such case has led to the development of 'implied powers'. Implied powers are not specifically mentioned in the constitution, but they are necessarily interconnected with those specifically mentioned powers of the federal government and are enforced by judicial review. The source of implied power is Article I section 8 of the US Constitution which empowers congress to make all laws which shall be 'necessary and proper' for executing the enumerated powers. Chief Justice Marshal in the McCulloch vs. Maryland (1819)[39] case construes the necessary and proper clause to include implied congressional powers.

The law based on implied power is valid if it articulates any provision, article or section of the Constitution and thereby promotes the general welfare of society. It implies that the specific power could not have been exercised without the implied power. Further, the Supreme Court of the United States has given power implied in any enumerated power to congress for the reason that the implied power is not expressly reserved for the states.[40] The 'commerce clause' is also another ground extending the power of congress in any issue related to interstate commerce. A comparable case for implied powers also exists in Australia deriving its source from the Constitution which provides that the commonwealth can legislate on 'matters incidental to the execution of power' vested within it.[41] The experiences of these countries signify that the concept of implied power prevails in cases where the powers of the states are not laid down in the Constitutions.[42] If the powers of the states are enumerated in the

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[38] Sharma and Choudhry, op. cit., p. 203.
[39] Laurence H. Tribe, *American Constitutional law*, vol. I, 3rd ed., (New York Foundation Press, N.Y. 2000), p. 798. Marshal (as quoted in Tribe) reiterates in his decision, 'let the end be legitimate, let it be within the scope of the constitution, and all means which are appropriate, which are plainly adopted to that end, which are not prohibited, but consistent with the letter and spirit of the constitution, are constitutional.'
[40] *Ibid.*
[41] Section 51 (39) of the Australian Constitution.
[42] Saunders (1995), op. cit.

constitution, then the scope of implied powers has to be evaluated *vis-à-vis* the enumerated powers of the states.

In Ethiopia, there are no cases (of constitutional adjudication) which have dealt with the issue of implied powers. However, due to the fact that some of the powers of the federal government are provided in general statements, there exists a higher probability for the development of implied powers. For instance, the power of regulating interstate trade may require further detailed implied powers that may deal with the free flow of capital, labour and skill. If, for example, a particular state prohibits traders from importing goods from other states, it will be against the principle of creating an economic union in the country. This will entail an implied power of the federal government to regulate interstate trade. The absence of express and detailed powers for the states may help the development of implied federal powers.

The study of the various types of legislative powers - exclusive, residual, concurrent, framework, and implied powers - is important for determining the expenditure responsibility of a government. The financial expenditure related to the legislative process is insignificant when compared to its implementation. However, it is the scope of the actual legislative and executive powers allocated to the respective governments that indicates the concomitant financial implications. With this in mind the following section will try to determine the scope of the powers of the federal and the state governments in Ethiopia.

1.2 The scope of allocated powers in Ethiopia.

1.2.1 The federal powers

In general, we can divide the legislative powers of the central government into four[43] groups. The first group comprises those powers which by their very nature are considered to be the common concern of all the constituent units of the federation. In almost all federations, they are assigned to the central government. In this category of powers, we may find national defence, international or foreign relations, citizenship, immigration and naturalization, and other powers that are supplementary to the main powers listed in this category. Although these powers exclusively reside in the centre, there are cases where some Constitutions use terminologies that can broaden the power of the centre or involve the role of the states. Unlike Switzerland which organizes its armed forces at the cantonal level or Australia which does not explicitly mention defence or the federal police, the Ethiopian Constitution (Article 55 (7)) explicitly empowers the centre to organize national defence, public security, and the federal police force for similar purposes. But this required further legislation in at least two aspects: the division of power between the federal and state police powers and clearing the way for the intervention of the federal army or security forces in the states. Although the power is reserved for the centre, the other area that requires close cooperation with the states is immigration and citizenship.

In the second group, several commercial powers that are essential for facilitating local as well as international trade can be mentioned (taxation is independently dealt with in the next chapter). In this group, we find the largest category of

[43] Saunders divides the federal powers into the first three types. Saunders, 'Australian Federal systems and the division of powers,' in Peter Drysdal and Hirofumi Shibata (eds.), *Federalism and resource development*, (George Allen & Unwin Ltd., 1985), p. 29-30.

powers, including interstate commerce; postal and telecommunication services; weights and measures; domestic currency coinage and foreign currency usage; and banking, insurance, patents and copyright. These powers are assigned to the federal government primarily for economic reasons and for practical convenience. In all federal countries the central government has power over currency and legal tender, but they may differ on regulating banking by giving a concurrent power to the states.[44] In Ethiopia, however, the central government has the power over monetary and fiscal policy, local currency, the administration of the national bank and foreign exchange. Under the Ethiopian Constitution regulating insurance is not specifically mentioned in the Constitution as the power of the centre. But it seems to be the competence of the federal government as it can be considered as one aspect (implied power) of interstate trade which is left to the centre.[45]

Under the Ethiopian Constitution, like the Indian and the Nigerian, the power over rail and air transport falls within the competence of the federation. In Ethiopia, not only rail and air transport but also water transport and major roads linking two or more states are within the competence of the federal government. The legislative power of the federal legislature also extends to the labour and commercial codes. Unlike India, the FDRE Constitution does not enumerate those issues covered under the labour code such as employment contracts, trade unions, industrial and labour disputes. Nor does it mention various legal concepts included under the commercial code, such as partnerships and bankruptcy. In contrast to the other federations, the conditions relating to labour, wage rates and employment relations are allocated to the regions in Canada, but shared between the centre and the regions in the US and Australia.

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

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

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[44] The power over banking, for instance, is not expressly listed under the exclusive power of the central government in the USA. It is an implied power of the power of congress 'to coin money and regulate the values thereof.' See the US Supreme Court decision in McCulloch v Maryland, 17U.S. (4 Wheat) 316 (1819). In Australia, insurance and banking may fall under state jurisdiction if the insurance/banking business is not extended beyond the limits of the state concerned. (Sections 51, 13-14). In both countries the federal or state governments can charter banks if the activities are limited within one state.

[45] See Proclamation No. 86/ 1994, licensing and supervision of insurance business, which dealt with this issue as the jurisdiction of the central government.

1.2.2 *The states' powers*

In Ethiopia, the federal Constitution has empowered regional governments to enact and execute the state constitution and other laws.[46] To this end, the Constitution provides the states with a legislature, an executive, and a judiciary which are constitutionally independent from the central government in matters assigned to them. However, it is important to note that when powers assigned to each level of government are not mutually exclusive, there may be a greater possibility of encroachment on the power assigned to the other. This is because it is practically impossible to bring about a total power separation between the two levels of government, although the interrelationship between them may vary from one programme to the other. As it is demonstrated below the Ethiopian practice also may not escape this problem.

Under the FDRE Constitution (Article 52(2)) the states have enumerated powers and functions. These powers include the establishment of state police power, the maintenance of public peace and order, levying and collecting taxes and duties on revenue sources reserved to states, the administration of land and other natural resources but based on federal laws, and the employment and working conditions of civil servants. The states also have power over in such areas as education, health and agriculture although the federal government has the power to set national standards. In addition, the states have independent power with respect to matters not mentioned in the federal list. However, it should be noted that the states may not have legislative power over all residual powers. The Constitution has two provisions which limit the residual power of the states. The first concerns the taxation power, and the second is with regard to the enactment of civil laws (Article 98 and 55 respectively). The regions cannot immediately assume the power of taxation that is not specifically provided by the Constitution to either the centre, the regions, or concurrently to both. It has to be determined by a joint session and a two-thirds majority vote in the HOF and HOPR is required.[47] Similarly, the federal legislature may enact civil law if the House of the Federation deems necessary to establish and sustain one economic community.[48]

There are instances in which the legislative power of a state can be suspended. This is during a period of a state of emergency declared by the federal government. But there are also instances in which it would be difficult to comprehend the limits of the powers assigned to the centre and to the regions respectively. In other words the wording of the constitution may not be sufficiently clear to understand the scope of power assigned to each level of government.

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[46] Art. 52 (2, a) of the FDRE Constitution.
[47] Art. 99 of the FDRE Constitution. There is a misunderstanding as to whether this provision gives the HOF the power of legislation. The provision does not give power to the joint session to legislate new tax law. The joint session determines the issue of which level of government shall exercise the power of taxation. The vote is on the allocation of the power of taxation. It is after the decision of the joint session that a new law is to be enacted by the level of government bestowed with taxation or legislative power.
[48] Art. 55 (6) of the FDRE Constitution. One may question whether this provision refers to those powers specifically mentioned as the power of the states or to residual powers. It seems that this provision refers to residual powers since civil laws are not mentioned as exclusive powers. The determining factor is the need to have laws uniform throughout the states because of the necessity to establish and sustain one economic community.

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

In practice, there is a general policy at the federal level and regions also have policies in most cases replicating the federal policy. The Constitution under its Article 51(2) provides '[the federal government shall] formulate and implement the country's policies, strategies and plans in respect of overall economic, social and development matters.' At the same time, the regions have the power 'to formulate and execute economic, social and development policies, strategies and plans of the state'(Article 52(2, c). The Constitution does not spell out the relevance of similar policies at the central and regional levels at the same time. Nor does it indicate any restriction imposed upon the regions to act in areas left by the centre or in areas authorized by the central government like that of the German and the Swiss Constitutions. Such cases may lead to inconsistencies between the federal and regional laws or policies. But this overlap of power of the respective governments can be clarified when seen in relation to the contents of power of the respective governments. For instance, in Ethiopia tertiary education is a federal matter whereas primary education falls within the state jurisdiction. Thus, the repetition could be avoided if the federal policy addresses higher education and states' policy focus on the major parts of primary education. At present the policies are issued at the federal level after being discussed and approved by the meetings of the ruling party.[49] In the long run, however, enough room could be left to states' policies if the scope of powers can be determined by the use of concurrent, framework and implied powers, as indicated in the previous section.

In general, the most important characteristic of a federal system is the existence of two levels of government and the concomitant division of powers between them. This division of powers sets a limit upon each level of government to remain within the territory of power and not to encroach upon the power of the other.[50] In this regard, the states' constitutions in Ethiopia should provide the legislative, executive and judicial powers concerning matters which are reserved for them. The listings in a state Constitution may, to the possible extent, help to clearly demarcate the powers of the tiers of government within the state, and to minimize power conflicts with the centre.

1.3 The division of executive power in Ethiopia

In this section, the focus is explaining the constitutional framework governing the division of executive power between the two tiers of government. By doing so, we explore the mechanisms how the federal government and the states fulfil their expenditure responsibilities. In this regard, there are some important issues

[49] For instance, see one of the policy documents of the federal government. FDRE, *Yemasfesem akim ginbata strategy ena program* [Capacity Building strategy and program] (Ministry of Information, Addis Ababa, 1994 Eth. Cal.)

[50] This division of powers is different from a separation of powers in a government, although the latter is also an essential feature of federalism. The latter refers to the division of legislative, executive and judicial functions.

that should be addressed: Does the executive responsibility of the federal or state government correspond to its legislative power? In other words, does each government have an expenditure responsibility in all areas where it can legislate? How about in areas where it cannot exercise legislative power? Can the central government then participate in the execution of matters reserved for the states? In general, how far does the FDRE Constitution deal with the allocation of expenditure responsibilities to both tiers of government?

Before addressing the above issues, it is perhaps proper to note that although the division of legislative power between the federation and the constituent units is the defining feature of a federal system, the expenditure responsibility may not necessarily follow the legislative competence. This is because the scope of the expenditure responsibility is dependent upon the extent of both the legislative and the executive powers assigned to each level of government. In general there are two approaches for the allocation of executive powers. The first approach is followed by the older federations of the USA, Australia and Canada, by laying down a principle that each level of government retains the executive responsibility in those matters in which it exercises the legislative power.[51] Accordingly, both the legislative and the executive powers concerning a given subject-matter lie with the same level of government. This method works with the assumption that the two levels of authority retain autonomy with respect to their respective powers.

The second approach results in the division of labour where the legislative power is reserved for one of the tiers of government and its administration to the other. This method of allocating executive powers is better explained by the practice in Germany where the federal government is primarily concerned with policy initiation, formulation and legislation, while the states are mainly responsible for implementation and administration. As a result, German federalism is described as 'cooperative federalism' since it involves a strong relationship between the federal government and the states.[52]

Before mentioning which mode of allocation of administrative power Ethiopia follows, let us take a close look at the relevant provisions of the Constitution. According to the Constitution, each government has the power of legislation and execution on matters that fall under the respective jurisdictions. Each tier of

[51] Watts (1999a), op. cit., p. 36; Watts (1966), op. cit., p. 177. Also see William M. Chandler, 'Federalism and Political Parties,' in H. Bakvis (ed.), *Federalism and the Role of the States*, (Toronto, Univ. of Toronto Press, 1987), p. 157; Saunders (1995), op. cit. The merit of this approach is to enable the regions to be politically autonomous in order to manage their own affairs without interference from the others, but they may not escape the influence of the centre through financial instruments (discussed below in Chapter VI). Even though it ensures the uniform application of federal laws throughout the territories, it may result in a duplication of activities and costs.

[52] This typical characteristic is usually explained by the more extensive involvement of the Länder in the federal legislative procedures than is the case in many other federal systems. This is because the German Länder are involved in the legislation and decision-making procedures at the federal level through the direct representation of the Länder in the Bundesrat. This system, although praised by many, has been criticized by some, alleging that it increases the policy-making costs of the federal government. And, institutional changes could be impeded by conflicts of interest between the federal and Land governments. Chandler, op. cit., p. 157-58. See Uwe Leonardy, 'The Working Relationship Between Bund and Länder in the Federal Republic of Germany', in Charlie Jeffery and Peter Savigear (eds.) *German Federalism Today* (New York, St. Martin's Press, 1991), p. 40-59; See Arts. 87-91 of the Basic Law of Germany. Compare Art. 85 with Art. 72 (1&2) and Art. 75 of the Basic Law of Germany.

government shall respect the powers of the other. And both the federal government and the states have to cover all the financial expenditures necessary to carry out all the responsibilities assigned to them by law (Article 94(1)). To this effect, the powers and functions of the federal government and the states are listed under Article 51 and 52 of the Constitution respectively (see 1.2 above). In addition to Article 51, the scope of the legislative and the executive powers of the federal government are indicated under Articles 55, 74 and 77. According to the latter two provisions, the executive power of the federal government is vested in the Prime Minister and the Council of Ministers. The Prime Minister shall follow up and ensure the implementation of laws, policies, directives and other decisions adopted by the HOPR.[53]

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

Thus, in principle, the Ethiopian Constitution follows the USA model of a dual structure by reserving the executive responsibility to each level of government on matters in which they exercise the legislative power. But it has the drawback of assuming complete separation of powers, the possibility of duplicating authority and not considering the efficient use of limited financial resources through administrative cooperation. However, the reasons for adopting this method of division of powers is related to the motive of the constitutional assembly which emphasized the values on 'self rule' rather than 'shared rules' or cooperation, as can also be seen in other provisions as well.[54]

The question may be raised as to whether the Constitution permits the central government to reserve legislative power for itself and to leave its administration to the states. This is possible when the Constitution itself provides for an exception, or when the federal government delegates its powers and functions to be administered by the states, as prescribed in Article 50 (9). For example, the federal government enacts law for the utilization and conservation of land and other natural resources, historical sites and objects, but its administration is reserved for the states.[55] There are certain matters which refer to the legislative power only. For instance, the power to establish national standards concerning public health, education, science and technology is reserved for the centre although the provision of these services is left to the states (Article 51(3)). In these cases, it has to be clear on what basis the states administer the federal laws, because this can have financial implications. If the states are delegated with the administration of federal powers and functions, the financial implications thereof must be dealt with accordingly.

However, with regard to the administration of federal laws by the states the Constitution is not always clear. This is because under Article 55 the federal legislature, the HOPR, has also the power to enact laws in areas or subject-

[53] Although those matters listed under Article 51 are also repeated under Article 77, the Prime Minister has additional responsibilities such as serving as the commander-in-chief of the army.
[54] See Articles 2, 39 and 47, and the Amharic document, 'Ye Higemengist Gubae Kalegubae', [The Minutes of the Constitutional Assembly], December 1994.
[55] See Art. 51(5) and Art. 52(2,d) of the FDRE Constitution.

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

The replicated provisions (of Articles 51 & 55) listing matters that require federal legislation have aggravated the problem of identifying the expenditure responsibility of the central government. Compared to the wording of Article 51, the provision of Article 55 explicitly determines the law-making power of the federal legislature concerning the same subject-matters.[56] However, apparently there is repetition in the allocation of responsibilities to the centre. As the contents of Article 51 indicate, there are administrative and legislative responsibilities belonging to the government. Thus, what is the difference between the power of enacting law in matters listed under Article 51 and Article 55 specifying the legislative powers of the HOPR? For example, both provisions provide that the federal government enacts laws regulating the possession and bearing of firearms, and laws governing political parties and elections, but only Article 55 mentions the legislative power over labour, commercial and penal matters. Does it mean that the federal government has no administrative power with regard to these powers? It seems that there is an intention to leave the administration of these laws to the states. For example, concerning interstate trade and commerce, a closer scrutiny of the relevant provisions implies that, under the general provisions of Article 51, the federal organs are required to regulate interstate trade, whereas the federal legislature is specifically required to enact laws with the help of which interstate trade and commerce can be regulated. In this regard, the confusion as to the specific meanings of the two apparently varying provisions may be resolved.

The allocation of legislative power is also the executive power except in cases where the administration of federal laws is left to the states. But as can be seen above, the administration of federal laws by the states is not clear. In practice, there is also direct involvement of the centre in the regions, as we will see below in section 2.3. This is partly due to the capacity problem in most of the regions. As a result, the expenditure responsibility of the central government may not be limited to its legislative powers. There can also be cases where the executive power of a state extends beyond the scope of its legislative power. In such a case, the major factor that influences the expenditure responsibilities of both tiers of government will be intergovernmental relations through the use of conditional grants, executive agreements or other cooperative mechanisms (see the next section).

[56] However, this does not seem to be an exhaustive list. For instance, Art. 74(10) mentions the possibility of the federal legislature enacting law in order for the Prime Minister to be able to nominate people to be awarded medals and gifts.

1.4 The allocation of powers to local governments

Formally, federal constitutions deal with the division of powers between the federal government and the states. The distribution of power within a state is left to the state concerned. The main reason for this is attributed to the fact that the particularities and diverse interests that exist within a state could not be appropriately dealt with by the federal constitution. Thus, the method of addressing local interests, the manner of administering and providing services to the residents and revenue-generating mechanisms within a state should be left to each state. Therefore, federal constitutions in most cases are limited to providing framework statements emphasizing the need for the decentralization of power to the lowest possible level.[57] However, the nature and extent of these framework statements and general conditions vary in different federal constitutions.

As can be observed, the oldest federal Constitutions of the USA, Australia and Canada do not explicitly deal with the scope of local power, but the autonomy of local government units is practically guaranteed. The Swiss Constitution requires the autonomy of the municipalities to be guaranteed within the limits determined by the cantonal Constitution and other laws (Articles 50(1) and 51). Therefore, each canton decides on the organization of local governments and their jurisdictions.[58] The Basic Law of Germany provides an extensive guarantee for local governments. Although it requires the Länder to deal in detail with the powers and functions of local governments, the Basic Law guarantees the municipalities' self-government which extends to discharging expenditure responsibilities and generating revenue even by setting their own rates.[59] The federal government has the mandate to ensure that local autonomy is guaranteed through the allocation of powers and responsibilities, and that the local government is constituted through democratic electoral processes.[60]

The experience of multiethnic federations such as Nigeria and India reminds us of the importance of the constitutional guarantee for basic local powers. This is because if the actual division of powers and responsibilities depends on the willingness of a state government to devolve functions and powers to the local governments, it may not uniformly guarantee the autonomy of local government. This approach may threaten the autonomy of minorities usually represented at the local level. This is the main reason for the federal Constitution of Nigeria to

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[57] There are also cases where no mention is made of the power of local governments. For example, the Constitution of the United States does not make any reference to the allocation of power to the local level.

[58] The Constitution is limited in dealing with the power distribution at the cantonal level as it mainly deals with those powers that are assigned to the centre because of the aggregation of cantons. The people of the cantons are the very basis of the legitimacy of the power of the cantons and, at the same time, the federal authority is subject to direct democratic control by the citizens. Thomas Fleiner, 'Constitution of the Federal State and the Cantons,' in Lidija B. Fleiner and Thomas Fleiner (eds.), *Federalism and Multi Ethnic States: The Case of Switzerland*, 2nd Rev. ed., (Fribourg, PIFF vol.16, Helbing & Lichtenhahn, Suisse, 2000), p. 110-111.

[59] Art. 28 (2) of the Basic Law provides that 'municipalities must be guaranteed the right to regulate all local affairs on their own responsibility, within the limits prescribed by the laws. Within the limits of their functions designated by a law, associations of municipalities shall also have the right of self-government according to the laws. The guarantee of self-government shall extend to the bases of financial autonomy; these bases shall include the right of municipalities to a source of tax revenues based on economic ability and the right to establish the rates at which these sources shall be taxed.'

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provide for the number and territories of local governments existing in each state, the mode of constituting local councils, the functions of local government councils, and concurrent powers that can be executed with the state government.[61]

Similarly, in India, after the 73rd and 74th constitutional amendments in 1992 the rural and urban local governments are given a constitutional status to allow them to participate in their own administration in a meaningful manner. Following recognition by the Constitution, each state enacts separate laws dealing with the formation of local governments through a democratic electoral process, and the assignment of expenditure and revenue sources to the local governments.[62] The 73rd and 74th amendments of the Indian Constitution list, in a separate schedule, the revenue and expenditure assignments concurrent with the states' responsibilities.

The present FDRE Constitution does not list the exclusive powers of the local government, nor does it enumerate the concurrent powers with the states. It merely states the need to establish administrations below the state level and emphasizes the devolution of concomitant power to them.[63] The states do not have (as per the Constitution) absolute discretion as to whether or not to decentralize power to the local level. And local governments are not merely agencies of state government. The states are, therefore, expected to deal with the nature and scope of powers devolved to the local level (the weredas).

According to state Constitutions, the powers and responsibilities of local governments are either concurrent with state responsibilities or the states have to demarcate local powers. Formally, the weredas can prepare budget, implement economic and social development projects, manage public services and exercise decision-making power at the local level. However, the extent to which these powers and responsibilities are exercised in practice is not clear. Moreover, they are accountable to zonal administration and regional government.[64] The actual assignment of specific powers still depends on the extent to which each state is willing to devolve power. Of course, the extent of the devolution of powers and functions to local governments may show a wide variation depending on local factors and circumstances such as urban, rural, pastoralist, agrarian or other variations. This is because diversities at the local level are expected and they can be addressed through the asymmetrical distribution of power. However, there are some common functions that can be performed by all local governments without undue interference from the tiers of government above them.

An appropriate devolution of functions requires the establishment of democratic institutions and the devolution of political power at the local level. This creates an opportunity for the public to administer themselves as much as possible and for the authorities to be responsive to the citizens' needs. At the same time it

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[61] Art. 3 of the 1999 Constitution of Nigeria provides that the federation comprises 36 states, 768 local governments and 6 area councils. Art. 7 also provides the mode of constituting local government councils.

[62] M. G. Rao, 'Fiscal Decentralization in India', http://www.imf.org/external/pubs/ft/seminar/2000/fiscal/rao accessed on May 14, 2002.

[63] See Art. 50 (4) and the discussion on the principle of subsidiarity for the allocation of powers to the local level, infra 1.5. It should also be noted that if no adequate power is devolved, any nation, nationality or people represented at the local level could demand for the formation of its own state as per Art. 47 (2,3) of the FDRE Constitution.

[64] For instance, see Art. 91(2) of the Constitution of SNNPR.

emphasizes the need for expressing consent through the ballot box. On the whole, in order to become successful in the devolution of expenditure responsibilities to local governments, the contemporary discourse on decentralization suggest that the following conditions should be put in place:

> -An elected local-level government council is required. If local officials are not elected, voters may not express their preferences through elections, and may not replace those who do not represent their views,
> -Local councils should directly or indirectly appoint local authorities. If the local authorities are appointed by the centre their accountability will be upward and not [towards] the local population. Implementation will not be directed locally, but actually decided by the centre,
> -Local governments must have some taxing power and tax administration capacity to collect those revenue sources that are assigned to it, and also to determine their budgets,
> -Local governments should have some freedom as to use how they will allocate their revenue sources among competing expenditure demands. [65]

The whole procedure of laying down the political process is a precondition for the successful empowerment of local governments which can enhance a successful devolution of responsibilities. This requires, *inter alia*, democratic elections that can bring about accountable and efficient government which can make a real difference in the provision of goods and services to the citizens. The basic step towards this goal is recognizing that 'one's vote and one's voice' count in empowering the people. In a country where there is a dire need for the basic necessities and democracy, it is imperative to secure political legitimacy.[66]

1.5 The subsidiarity principle and the division of powers

The principle of *subsidiarity* has been the subject of much discussion in the system of the distribution of powers between the European Union (EU) and its member states.[67] The powers attributed to the EU are those powers transferred from the exclusive powers of the sovereign states and are codified in the EU treaties. Since the EU is formed by 'aggregation' the treaties are supposed to embody mainly those powers transferred from the member states to the EU. Thus, the EU retains only those powers which are mentioned in the treaties in several forms, while those not transferred remain in the hands of the member states. But the treaties have not in all cases given exclusive authority over the enumerated powers. Thus, the principle of subsidiarity as embodied in Art.3 of the treaty applies in order to analyse the enumerated powers and to determine

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[65] Roy Bahl, '*Implementation Rules for Fiscal Decentralization*', World Bank, 1997, p. 2; see also Anwar Shah, *The Reform of Intergovernmental Fiscal relations in Developing and Emerging Market Economies,* Policy and Resources Series 23, World Bank, 1994, p .1-2.

[66] In this regard, the recognition of a multiparty system and elections in Ethiopia is one step forward, but whether the election process and the 'elected officials' always represent the peoples' preferences is another matter that requires close scrutiny. In principle, power must be closer to the people, and therefore they must have the power to appoint and remove their representatives at a national and subnational level. The emphasis on the participation of individuals in the decision-making process reflects that it may have a profound effect on the quality of goods and services provided by the government.

[67] Klauss Gretschmann, 'The subsidiarity Principle: Who is to Do What in an Integrated Europe?, 'the Proceedings of Jacques Delores Colloquium, infra (p. 47-48). He says that, although some trace it back to the works of Aristotle and Thomas Aquinas, the principle is deeply rooted in Catholic tradition as a concept of social philosophy - the individual in social and political life. The modern discussion shifts towards its legal concept concerning the relationship between political bodies and authorities.

whether the EU institutions have competence. According to the principle, powers at the EU level should not be exercised unless the objective sought to be achieved cannot be attained at the state level.

The value of the subsidiarity principle, contends Michael Keating, can be invoked to defend three different positions: First, to seek an upward power transfer (to the EU) from the European nation-states; second, to protect the traditional sovereignty of member states against the encroachment of the EU; third, to move power downwards from states to more local or regional governments.[68] Thus, this principle may not be limited to the EU or federal systems; rather it may be seen in relation to power distribution in a decentralized unitary system concerning the division of power between a state and local governments, and even between governmental or non-governmental institutions.[69]

The relevance of the principle of subsidiarity rests upon making a decision regarding the proper division of powers between the local and federal levels of government. According to this principle, power should stay at the lowest possible level which is competent to deal effectively with the issue. In other words, the power should stay with the region if an issue can be competently dealt with by a provincial government rather than being shifted towards central government. This preference for assigning power to the regions applies even in cases where the federal government may also effectively deal with the problem.

The principle has been the subject of much debate concerning whether the powers to be found under the subsidiarity principle amount to shared powers or concurrent powers, the impact of the variation in the stage of development of member states, the challenges involved in putting it into practice, and whether it is *justiciable*.[70] Nonetheless, since the principle of subsidiarity places the policy-making power at the lowest level of government which is capable of performing such powers, it is assumed to be of assistance in accomplishing the values of democracy, self-determination, diversity and flexibility. It is also considered crucial for maintaining the balance within federal systems between promoting common interests and respecting particularity and diversity.[71]

While the idea of subsidiarity is potentially useful, we may be curious as to whether it occupies a place in the FDRE Constitution for addressing the division of power and autonomy of each level of government. It is, therefore, important to scrutinize the provisions of the Constitution from different perspectives: whether the principle is included to define the division of power, whether the states should be protected from transgression by the central government, or

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[68] As quoted in Will Kymlicka and Jean-Robert Raviot, 'Living Together: International Aspect of Federal Systems.' A Report on the Conference on 'Identities – Involvement - Living Together in Federal States' September 30-October 2, 1996 (March 1997), p. 10.

[69] For a general analysis, see L.F.M. Besselink, H. S. J Albers and W.T. Eijsbouts, 'Subsdiarity in Non-Federal Contexts: The Netherlands and the European Union,' (Sociaal-economische wetgeving vol. 42, issue 5), p. 275-320.

[70] Jacques Santer, 'Some reflections on the principle of subsidiarity,' in *Subsidiarity the Challenge of Change*, (Proceedings of the Jacques Delors Colloquium, European Institute of Public Administration, Maastricht, 1991), p.23; Goudapel, op. cit., p. 191; Also see Besselink, *et al*, op. cit,.

[71] George A. Berman, *Subsidiarity: does it have a future*? (Centro di studio E recherché, 26, 1997), p. 2.

whether to devolve power from the states to the local administrations.[72] In principle, the Ethiopian Constitution enumerates the federal powers, and reserves the residual powers to the states. But it does not always give exclusive power over the enumerated powers. Thus, the principle of subsidiarity might be a useful analytical tool in dealing with the concurrent and parallel powers and the federal framework legislation that are discussed above. The federal legislature may make use of the principle in cases where it has no exclusive authority over several policy matters such as education, health, culture, natural resources, interstate trade and the regulation of political parties and elections.[73] Thus, the subsidiarity principle would play a role in the division of powers between the federal government and the regions since the Constitution does not set limits in that respect.

The FDRE Constitution seems to have included the value of the principle of subsidiarity in its provisions by imposing an obligation on the states to establish local administrations and to devolve power next to the hierarchy of the administration at state level.[74] Art. 50(4) provides, 'the 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.' According to this provision states are free to determine the number of levels of administration next to administration at the state level. This is to bring the government as close to the people as possible. Although the division of power between the state government and the lowest levels of the administration seems to be left to the states, it requires considerable powers to stay at the lowest level if they are able to deal effectively with the subject-matter in **question**. It can be considered as a crucial step for maintaining a balance between unity and diversity.

The provision referred to above could be considered as an essential step to secure local autonomy. But a question may arise as to what form of decentralized power is envisaged by this provision. For example, would a deconcentration or delegation[75] of power from the state administration to the lowest level of administration be sufficient for the autonomy envisaged under the above provision? There could be divergent views as to this provision. But it does envisage the formation of an administrative level where people can have meaningful self-administration. If the objective is to bring the administration closer to the people and to make it transparent and accountable to the people, then adequate power should be devolved to the local level. Indeed, it means that the local administration should have significant spending power and expenditure responsibilities. This, however, requires the extent and the manner of devolving power to the local administration to be determined.

The subsidiarity principle as implied by Article 50(4) of the FDRE Constitution may, on the one hand, provide a means to check the centralization of power at the state level, and, on the other, to help secure the local autonomy by retaining meaningful expenditure responsibilities. And the wording of Article 50(4), which

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[72] In Europe the debate was pushed further by the German Länder to apply the principle in a way that can guarantee their participation at the EU level concerning their interests. See Gretschmann, op. cit., p. 53-54.
[73] See, for instance, Art. 51 (3, 5, 17) of the FDRE Constitution.
[74] Normally, constitutions deal with the division of power between the two (federal and state) tiers of government.
[75] The concepts of deconcentration, delegation and devolution are discussed in Chapter II above.

requires 'the granting of adequate power' to the lowest level, should also be understood in the sense of devolving revenue raising power so long as this power can effectively be carried out at the same level. As a result, local governments will have their own locally generated financial resources, although the major redistributions have to be carried out by the state government. This approach is important not only in the sense of enhancing local participation, but also, as in the Ethiopian case, safeguarding the rights of nations and nationalities which exist at the subregional level of government.

Thus, we may argue that Article 50(4) promotes local autonomy and addresses local preferences by making the localities the major actors in the implementation of the principles of fiscal federalism. In addition, the defenders of the subsidiarity principle argue that it provides a considerable amount of flexibility compared to the listing of power divided between the various levels of government. Therefore they benefit from this flexibility, the division of power being amenable whenever new circumstances arise. However, this position is challenged by many who assert that it fails to properly secure local autonomy. The danger emanates from the possibility of increased centralization which may erode local autonomy. Similarly, Article 50(4) of the FDRE Constitution is not sufficient to guarantee this local autonomy.

In the EU, the principle of subsidiarity is used to regulate the shifting of power from the nation-states to the newly formed central authority. In our case, by contrast, the issue is how to shift power downwards from the state level. But a problem relates to who must prove that power belongs to the local or to the regional government. In other words, should the regional government prove that a certain power falls under its authority or under the authority of the local government, or should it rest with the local government unless otherwise proved by the higher level? In principle, the latter proposal is the governing principle.

The provision in the Ethiopian Constitution is framed in such a way that the state constitution has to address the issue of power distribution to the local administrations. The principle as framed under Article 50 (4) serves as a guideline as to how power distribution should be carried out, by leaving those powers that can effectively be dealt with at the local level. Thus, it should be seen in relation to the objective of limiting the negative side-effects by identifying the respective responsibilities. The other problem is related to whether the principle requires the powers to be distributed symmetrically to all local administrations, or whether power should be distributed asymmetrically depending on the capacity and the willingness of local governments to exercise this power. In sum, subsidiarity as a principle can also be a useful tool for starting the debate on the allocation of powers in Ethiopia.

1.6 Symmetrical and asymmetrical distribution of powers

The constitutional division of legislative, executive or judicial powers to each order of government varies from country to country according to the specific circumstances and interests involved. Each federal system may also exhibit different approaches in the allocation of power between the constituent units. The variations may, however, affect the operation of the system in a particular country. The allocation of power, the variations therein and the relationships between the regions will lead us to the study of the asymmetry and symmetry of

federations. The concept of the symmetry of a federation is defined in different ways. Tarlton describes it as follows:

> An ideal symmetrical federal system would be one composed of political units comprised of equal territory and population, similar economic factors, climatic conditions, cultural patterns, social groupings, and political institutions... In it no social, economic or political peculiarities would exist which might demand special forms of representation or protection. The basic justification for having a federal constitutional arrangement rather than a unitary one would be found in the completeness and integral character of the various political subsystems. [76]

The given definition may indulge us to speculate about perfect equality between the constituent units of a federation in order to describe it as a symmetrical federal system. In fact, it is a far-fetched assumption to expect this kind of symmetry between the units of a federation fulfilling all the weighing factors. The same author, on the other hand, defines asymmetries in federations as opposed to the symmetries of federations. Accordingly,

> The ideal asymmetrical federal system would be one possessed of political units corresponding to differences of interest, character, and make up that exist within the whole society. In it the diversities in the larger society find political expression through local government possessed of varying degrees of autonomy and power...In the model asymmetrical federal system each component unit would have about it a unique set of features.[77]

The definitions provided above by Tarlton address the entire social, economic and political conditions for the asymmetry/symmetry of units in a federation. This approach gives all federal systems an asymmetrical character despite the fact that power may be symmetrically distributed to the constituent units. This is because it is less likely for the units to similarly manifest the factors stated above. A federal system can be designed asymmetrically in order to address several issues such as historical inequalities or other factors, different bargaining powers of the constituting units, or geographical differences depending on its impact on the development of a federal system.[78] In order to address any of these reasons in a federation, a special status can be accorded to a state.

Ronald Watts deals with the issue of symmetries and asymmetries in a federation, but emphasizes on the study of the latter. He classifies asymmetries in two forms: political and constitutional asymmetries. According to Watts political asymmetry exists in every federation and 'arises from the impact of cultural, economic, social and political conditions affecting the relative power, influence, and relations of different regional units with each other and with the federal government'.[79] These factors lead to variations among regions with respect to their population, territorial size, economic characteristics, resources and wealth. In many federations, we observe asymmetries in territorial and population sizes, i.e., some of the constituent units of a federation have a considerable territorial size or population while others are smaller. This may bring about undesirable consequences and sometimes may even lead to 'tension and instability'.[80] In order to reduce asymmetries countries have engaged in

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[76] Charles D. Tarlton, 'Symmetry and Asymmetry as Elements of Federalism: A Theoretical Speculation', (The Journal of Politics, vol. 27, Issue 4, 1965), p. 868; For a similar analysis of asymmetrical and symmetrical federalism, see Peter Pernthaler, 'Asymmetric Federalism as a Comprehensive Framework of Regional Autonomy', in Ann Griffiths (ed.), *Handbook of Federal Countries*, (Montreal and Kingston: McGill-Queens University Press, 2002), p. 472-493.

[77] *Ibid.*

[78] Stauffer and N. Taperwien, 'Balancing self-rule and shared rule', in Lidija Basta and Thomas Fleiner (eds.), op. cit., p. 46-47.

[79] Watts (1999 a), *op. cit.*, p. 64.

[80] *Ibid.*

several reshuffles and constitutional revisions. Some federal systems, for instance India and Russia, have granted special status to regions within their territory. The case of Nigeria is one of the worst scenarios which resulted in the redrawing of territorial regions increasing the number of states from three to thirty-six, mainly for the purpose of reducing economic asymmetries.

Watts propounds that the above asymmetries are politically significant for at least two reasons[81]: firstly, the asymmetry affects the relative capacity of different regional units to exercise their constitutionally assigned powers, because it may have an impact upon the economic capacity of the regions. In other words, they may not have the capacity to perform constitutionally assigned tasks, or they may have limited financial resources so that they cannot generate sufficient revenue to cover their expenditure. These factors, *inter alia,* normally call for the adoption of appropriate financial transfer mechanisms, or intergovernmental cooperation.

Secondly, they may affect the degree of regional units' influence within those institutions of the federal government in which representation is based on population. The representation of regions at the federal level may serve as a mechanism to narrow the asymmetries of representation or to curb the political dominance of larger regions at the federal level. Watts emphasizes certain factors of asymmetries such as size and the potential economic sources available in the regions. He does not directly mention the impact of the political system prevailing in the country. Even though the usual trend is to protect smaller states from dominance by the larger regions, we should not underestimate the possibility of political control by the minority group at the federal level.[82] Thus, representation may also be utilized to control any form of political domination at the cost of some weak (large or small) regions.

Constitutional asymmetry, on the other hand, refers to differences in the status of legislative and executive powers, and financial resources assigned by the constitution to the different regional units.[83] It implies that if all the constituent units of a federation have the same jurisdiction over legislative and executive powers, as well as the utilization of financial resources, the distribution of power is constitutionally symmetrical. If a federation is comprised of fully-fledged regional governments and different units such as federal districts or federally administered units, an asymmetrical relationship with the federal government will exist. The difference in status between the states and other units presupposes some kind of asymmetry in the legislative, executive or financial power between them. The Indian Constitution, for instance, provides for 'states, union territories, municipalities, and scheduled and tribal areas'.[84]

If we restrict ourselves to only the asymmetry of power between fully-fledged states, we can observe an explicitly provided constitutional asymmetry between the states. In doing so, the drafters of a constitution may follow either of the following approaches:[85] first, to provide a constitutional provision which restricts certain functions under specified conditions and reserves them for the federal government. The second approach is to provide certain matters which fall under

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[81] *Id.*
[82] See Merera Gudina, *Ethiopia: Competing Ethnic Nationalisms and the Quest for Democracy: 1960-2000,* (reprint, Addis Ababa, Chamber Printing House, 2003), p.144-150.
[83] Watts (1999a), *op. cit.*, p. 66.
[84] See Arts. 152-244 and the first schedule of the Indian Constitution.
[85] Watts (1999a); *op. cit.* p. 66-67.

the jurisdiction of the federal and regional governments, but also to provide for a particular member state to increase its power and functions.[86] In this category, we can find, for example, India and Canada. In India Jammu and Kashmir, and in Canada, Quebec, have some powers which are not assigned to the other states. The third approach is simply to provide a provision that permits all governments, regional as well as federal, to delegate their power to another.[87] In this approach there is no specific mention of power and functions being asymmetrically assigned to a particular member state. Rather, the constitution symmetrically allocates power to all states, but it also mentions the possibility for the states to assign or delegate powers to another. The asymmetry of power distribution between the states takes place only when a state exercises its delegating power. In practice, compared to the first two approaches, the third is hardly asymmetrical in the allocation of power. It is a kind of 'de facto asymmetry' unlike the *de jure* constitutional asymmetry that may emanate from the first two approaches.

In Ethiopia, all powers and functions are symmetrically assigned by the Constitution to all regional governments, except the federal capital.[88] The administration of the federal capital is responsible to the federal government (Article 49 (2)), and the particulars of the powers and functions of the administration are determined by legislation.[89] As to the constitutional division of power, the Ethiopian federal system is symmetrical. According to the Constitution, all the regional governments have the same formal and legal relationship with the federal government. However, if we consider this in the light of the definition given by Tarlton, the Ethiopian federal system is far from being symmetrical. The main reason for this can be attributed to the unequal set of features of the constituent units in geographical size, population, economic and political peculiarities and administrative capacities.

The asymmetry is also related to inconsistency in the use of the main determining factor – language – which resulted in different ethnic compositions in various regions. Some regions are mainly inhabited by a distinct ethnic group, while others are inhabited by a conglomeration of several ethnic groups. In some regions, certain groups have a territorially defined administration while in others they are subjects of a 'government of minorities'.[90] It has also led not only to interstate but also to intrastate asymmetry between the autonomy of subregional or local government units. Therefore, the asymmetry can be observed in their social, economic and political contexts, and in population and geographical size.

Importantly, the asymmetrical or symmetrical allocation of power between the regions is but one of the many factors that can influence the success of the

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[86] *Ibid.*
[87] *Id.*
[88] The FDRE Constitution provides different bargaining power to the Oromia region although the details thereof have not yet been determined by legislation. Art. 49(5) provides that Oromia has a special interest over the capital city regarding the provision of social services, the utilization of natural resources or joint administrative matters due to the fact that the city is located within the territory of the Oromia region. In Ethiopia there are nine regional governments, one federal capital and one administrative council. The Dire Dawa Administrative Council is a *de facto* region which has no founding constitutional provision, except the statute which came into force in 2004.
[89] See The Addis Ababa City Government Revised Charter, Proclamation No. 361/2003.
[90] The phrase 'A government of minorities' is used to refer to the case where minorities completely control the state government (e.g. the Harari state) or have a power of veto in the government, while the majorities live in the state as is dictated by the minorities.

federal arrangement. Thus, it could be prudent of the system to take measures that can minimize the *de facto* asymmetries that exist between the regions. This requires reducing the territorial and population size of some of the regions into modest and manageable sizes. Similarly, it would necessitate providing *de jure* asymmetrical autonomy identifying the regions that cannot viably survive to execute their responsibilities due to serious capacity constraints, and to subject them to special federal assistance, at least for a fixed transitory period.[91] It may also need a specific allocation of power for urban municipalities. Such far-reaching reforms could be a recipe for designing effective tools for the equitable distribution of resources, and for maximizing the benefits of the federal arrangement.

1.7 Conclusion

The study of the division of expenditure responsibilities is an important aspect of the study of fiscal federalism. And the study of a constitutional distribution of legislative and executive powers has constituted a fundamental aspect of the expenditure responsibility. While the constitutional distribution of responsibilities is common to all federations, there are enormous variations in the scope and form of their powers.

The division of expenditure responsibilities between the federal government and the states is laid out in the FDRE Constitution. By listing the exclusive power of the federal government the Constitution mainly allocates the executive powers in conjunction with the legislative power. But interpreting the constitutional provisions is necessary to understand the specific distribution of powers to the regions and local governments. Looking at the constitutional provisions and the practice we have seen the extent of powers assigned to each jurisdiction and the powers shared by the centre and the states in the form of concurrent, parallel and framework legislation. An examination of the principle of subsidiarity has also shown the possibility of determining the devolution of powers to the local level. This is because a constitutional recognition of certain powers and responsibilities of each level of government has to be legitimized.

In principle, the Constitution emphasizes the regional 'self-rule' over the administration of responsibilities independently from the centre. But the asymmetry that exists between the states inevitably broadens the role of the centre and transforms the way the Constitution works in some of the regions. Some of the states virtually cannot administer their territories, as shall further be examined in the next section. Thus, the study stresses the formal recognition of the asymmetrical power distribution and the need to institutionalize intergovernmental cooperation guided by the constitutional division of powers and responsibilities analysed in this section. This could be one of the steps in ensuring a transparent way of balancing the centralization of powers with the recognition of regional autonomy. In general, it is emphasized that besides striving to identify exclusive and shared powers, it is also important to consider other factors that hover around the need for good governance, accountability and efficient economy.

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[91] In this regard, the principle of subsidiarity may also permit to provide asymmetrical distribution of power at the federal or regional level.

2 THE PROCESS OF IMEPLEMENTING EXPENDITURE RESPOSNBILTIES IN ETHIOPIA

The present section focuses on how the distribution of expenditure responsibility discussed in the preceding sections takes shape in the implementation process in the Ethiopian context. For this purpose, this section focuses on three interrelated issues. The first addresses the political procedure and institutions involved in the budgeting process for the performance of expenditure responsibilities in the regions. In this regard, Section 2.1 discusses the structure and roles of the political and administrative institutions of the tiers of government. And the budget preparation, implementation and evaluation stages of the budgeting procedure are discussed in subsections 2.2.1-2.2.3.

The second issue focuses on the importance of implementing expenditure responsibilities through intergovernmental cooperation and the relevant trends in Ethiopia in Section 2.3. Although the Constitution allocates powers to the states symmetrically, there are considerable variations between the constituent units in terms of economic situation, geographical and population size, and administrative capacity. In such a situation the importance of vertical as well as horizontal intergovernmental cooperation could be undisputed, but we need to focus on what legal and institutional bases the cooperation exists and on the importance of reducing the *de facto* asymmetry.

The devolution of expenditure responsibilities has shifted attention towards the performance of regional and local governments with regard to narrowing down the economic disparity between the regions. In Section 2.4, the focus is – thirdly – on factors that can influence the performance of regions with regard to this objective, and which can actually aggravate regional disparities, in particular direct federal spending, extra budgetary resources, capacity constraint, corruption and political conflicts.

2.1 The structure and role of institutions

The structure of the FDRE is comprised of the federal government and the nine member states. Both the federal and the regional governments have legislative, executive and judicial organs. Expenditure responsibility lies with the executive organ of both levels of government. The structure and functions of institutions in the post-1991 period can (at the federal and state level as well) properly be described by classifying it into three periods: the transition period, the period between 1995 and 2001, and the post-2001 period.

During the transition period the structures of the central and the regional governments were laid down in a series of laws which mainly devolved decision-making power to the regional governments. The President was the head of state and the transitional government. The Transitional Council was the highest body and the legislative organ of the transitional government. The Council of Ministers, headed by the Prime Minister, was responsible for the execution of the major expenditure responsibilities of the government.

The second period covers the period following the adoption of the federal Constitution up to 2001. The FDRE Constitution consolidated the powers and responsibilities provided under several pieces of successive legislation adopted during the transition period. The Constitution vividly mentions the adoption of a

parliamentary system, whereby the power distribution of the President and the Prime Minister is made clear. The Prime Minister heads the executive branch of the federal government, while the President remains with some nominal power. The executive power of the federal government is vested in the Prime Minister and the Council of Ministers. The planning, implementation and evaluation of the expenditure responsibilities of the federal government are under these two important offices and, ultimately, under the political organization which runs the government.

The major difference between the two periods mentioned above is the power division between the Prime Minister and the President. During both periods some ministries and coordination offices existed under the Prime Minister's office without the respective powers and duties mentioned under the applicable laws. For that matter, neither the Prime Minister nor other government offices may be expected to have listed the powers and duties of every department they organize; however, the relevance of this should not be underestimated as some of the powers of these offices may require a constitutional mandate. For instance, until 2001, there was a 'Regional Affairs Department' managed by a minister, but the powers and responsibilities were not mentioned under the legislation.[92] As we shall explore in detail below section 2.3, there was no clear legal framework as to how the Regional Affairs Department assisted or interfered in states' matter. The authorities of the office were presiding over every state matters, so that the activities of the office were viewed as a mechanism of controlling the states rather than enhancing their low level of capacity.

The third period, post-2001, has uncovered the powers and functions of those offices which are alleged to be consolidated under the powers and functions of the Prime Minster.[93] Furthermore, as part of the civil service reform programme undertaken by the government some new offices have been established, and the relationship and accountability of those executive offices and the public enterprises have been indicated in the same proclamation.

The structure of the administrative agencies of the regional governments can be seen parallel to the three periods mentioned above. Regional governments were established in late 1992 under the transitional charter and proclamation No.7/1992. Proclamation No.7 proclaims the establishment of national/regional self-governments by listing the names of nations/nationalities and peoples and the level of their administration. It recognizes the level of administration at the regional, zonal, wereda and kebele level while attributing the election of administrative councils only to the regional and wereda levels. It also mentions the powers and duties of the central, regional and wereda levels of administration.[94] Later on the federal Constitution laid down the division of power between the federal government and the nine member states. Before the amendment of the states' constitutions in 2001/2 the executive power of the regional governments used to be vested in the presidents of the regional governments who presided over the State Councils and the Administrative

[92] After the coming into force of the Constitution, the 'Regional Affairs Department' traced its mandate from the national policy principles and directives mentioned in the Constitution, Art. 89 (4). It states that the government shall provide special assistance to nations, nationalities, and peoples with the least economic and social advantage. However, this provision seems to be remote in providing a mandate to intervene in the autonomy of a state.
[93] See Proclamation No. 256/2001, for the reorganization of the executive organs of the FDRE.
[94] See Proclamation No. 7/1992, to provide for the establishment of national/regional self-governments.

Councils. The Administrative Council organizes sector bureaus, which are analogous to ministries, and they are responsible for executing the expenditure responsibilities.

Each regional government, at its apex, has a State Council, with council members directly elected by the people. For example, the Oromia State Council consists of 353 members drawn from 197 weredas.[95] The State Council has a legislative authority. The Administrative Council, on the other hand, exercises the executive authority and is responsible for the day-to-day activities of the region, and regions are complemented by an independent regional judiciary. The regional sector bureaus are accountable to the Administrative Council. Most of the regions have an Executive Committee which supervises the implementation of responsibilities by the administrative council and the sector offices.[96] The Executive Committee is much more identified with a political role rather than the execution of day-to-day activities. The members of the committee are powerful and higher up in the political hierarchy within the ruling political party. For example, the Oromia executive committee which is chaired by the president of the region consist of 21 members, 12 of them zonal administrators and 9 elected Council members. Owing to the fact that the zonal administrators cannot always be available in the region, the nine members are much more powerful and influential in the decision-making process. The major reform introduced in 2001 was intended to clearly provide the division of powers between the State Council and the Administrative Council, and the role of these institutions in the performance of expenditure responsibilities.[97]

The composition and roles of zonal administrations vary depending on whether several nations, nationalities and peoples exist within a region. The zones that are mainly inhabited by the same group, such as in Tigray, Oromia and Somali do not have elected councils. They have an executive committee whose members are appointed by the State Council from its own composition but they are elected from the locality of that particular zone. However, in the regions (e.g. SNNPR) where there are several nations, nationalities and peoples, zones have Councils whose members are directly elected by the people. The zonal Council again elects the zonal administrator and executive committee. In Amhara too, there are three zones mainly inhabited by Agaw Awi, Himra, and Oromo who have their own elected councils forming their own executive committee. In all regions the sector bureaus have offices at the zonal level. However, after the major reform undertaken in late 2001 the size of sector bureaus at the zonal level is expected to be reduced and they remain with a coordinating role.[98]

In sum, the member states of the FDRE are divided into zones, which in turn are divided into weredas and further subdivided into smaller units called kebeles.[99] The weredas can be considered as essential units of government which may appropriately decide on the choice of the provision of public goods such as provisions of clean water, health centres and primary education, and effectively

[95]The figures refer to the period until the 2002/03 fiscal year.
[96] For further discussion on the Executive Committee and the Administrative Council, see Lovise Aalen , 'Ethnic Federalism in a Dominant Party State: The Ethiopian experience, 1991-2000,'(CMI Institut Development Studies and Human Rights Report 2002, 2), p. 70-82.
[97] See, for instance, the preamble to the 2001 revised Constitution of the SNNPR.
[98] Interview with Ato Hailu, Head of the Amhara Finance and Economic Development Bureau, January 2003, Bahr Dar. For challenges and opportunities of decentralizing power to weredas, see The World Bank Country Office in Ethiopia, 'Ethiopia: Wereda Study', Vol. I, (Manuscript, Addis Ababa, November 2001).
[99] In 1995, there were 66 zones, and 550 weredas.

administer them as their capacity grows. The kebeles may also enhance community participation at grass root levels in the formulation and implementation of policy decisions.

We may conclude our observation of the executive structure of each level of government by classifying the system into, at least, two structures: the normal administrative channel which is classified into sector offices and staffed by civil servants, and the 'executive committees' formed by elected members of the regional and wereda councils in which, and this is their major political role, the primary responsibility is to give policy directions and to oversee the implementation of those policies. The executive committees are composed of high-level officials from the political organization who control the regional, zonal or wereda governments. It is common knowledge that EPRDF, through its member or affiliate political organizations, effectively controls all levels of government including the federal government. The point that can be raised is whether the executive committees exercise their right independently at every level of government and decide on their own concerning expenditure. The information which the author has received from the party members and the prevailing public perception is that all levels of government are centrally controlled by the EPRDF. This can also be observed in Aalen's study of the ruling party system which states:

> The constitutional rights for the regions to formulate and implement plans and policies are severely diminished by the fact that the regional governments, which are all under the EPRDF's hegemony, follow the centrally designed policies and five-year plans.[100]

Based on the party rules, all government plans and policies approved by the EPRDF central committee will pass down to the lowest administrative level. In effect, local spending lies on the parameters set by the party. This may create a danger of loose accountability to the local people, but strong upward political allegiance. This may also restrict the decision-making power of the regional and subregional governments concerning matters of local priority.

Although the general prevailing circumstances show a centralized political structure, the constitutional structure can enable the regional and wereda governments to possess independent budgetary autonomy, including the power of taxation. Therefore, in the following section an evaluation will be made of the process of budget preparation, implementation and the evaluation process at subnational levels, and whether they can promote regional autonomy and narrow down regional disparities.

2.2 Decisions on expenditure allocation: the budgetary process

In a federal system, constitutionally recognized levels of government can formulate their own economic, social and development strategies and determine their expenditure preferences. This is because they are constitutionally recognized jurisdictions having the respective autonomy to impose tax and to spend on expenditure needs. It should be noted that both the autonomy and accountability principles are applicable to both levels of government. This financial autonomy (and of accountability to the electorate) of both levels of jurisdiction is considered as 'a necessary and appropriate feature of

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[100] Lovise Aalen, *op. cit.*, p. 80; See also the discussion on the mechanisms of intergovernmental cooperation in Ethiopia under 3.3 below.

federalism.'[101] The principle of expenditure autonomy is consistent with the federal system, but the budget allocation procedure can have an effect on the outcome of the spending. Therefore, which institutions are involved and to what extent they promote public participation, and whether the procedure respects local autonomy, will be studied.[102]

Expenditure allocations and the budgetary processes in Ethiopia broadly follow government policies. For instance, the budget proclamations show that the greater share of the federal budget is being devoted to roads, agriculture, capacity building and grant subsidies to regions. According to the recently introduced 'Sustainable Development and Poverty Reduction Programme' (SDPRP),[103] the budget allocation is expected to intertwine with the political and economic processes of the strategies indicated in the document. Accordingly, it should focus on agriculture and food security projects, capacity building in the public sector, decentralization towards wereda and municipal governance, education, health and roads. As we have seen above, the ruling party oversees the budget allocation at all levels of government as to whether it reflects the policy directions of the federal government. In this regard, regional autonomy will be limited. However, their discretion is broader in the process of allocating recurrent and capital budgets and in prioritizing other expenditures. But regions may show immense variations in their performance capacities, and in the expenditure evaluation and control mechanisms. In the following subsections we will deal with the budget preparation, implementation and evaluation process in the regions and the challenges surrounding them. This discussion will be supplemented by analysing the factors that can contribute to the disparity in the performance capacity of the regions and the importance of appropriate actions.

2.2.1. Budget preparation

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

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[101] C. Saunders, 'Budgetary Federalism: Balance of Interest and Contradictions', a paper presented for the XVIth Int'l Academy of Comparative Law, Brisbane, 14 to 20 July 2002, p. 15.

[102] For a general discussion on how the process of decentralizing power to the regional and local governments influenced the country's planning policy, see Tegegn G/Egziabher, 'Decentralization and Changing Local and Regional Development Planning in Ethiopia', in K. Fukui, E. Kurimoto and M. Shigeta (eds.), *Ethiopia in Broader Perspective, Papers of the XIIIth International Conference of Ethiopian Studies*, Vol. III, (Kyoto, Book Publishers, Japan, 1997),p. 691-720; for a non-ethnic perspective for economic development in Ethiopia, see Sisay Assefa and Ahmed Hussien, 'Perspectives on Economic Development in Ethiopia', in K. Fukui, E. Kurimoto and M. Shigeta (eds.) *Ethiopia in Broader Perspective, Papers of the XIII [th] International Conference of Ethiopian Studies,* Vol. III, (Kyoto, Book Publishers, 1997): 671-681

[103] See the Federal Democratic Republic of Ethiopia, 'Sustainable Development and Poverty Reduction Program,' MOFED, Addis Ababa, July 2002.

states' budgeting and spending activities. The weredas have a 'wereda council' and a 'wereda administration'.

In general, the study of the regional budgeting process in Ethiopia can be classified into two periods: before and after the 2002/03 fiscal year. The budgeting process before the 2002/03 fiscal year involved the coordination of several channels which ultimately make up the state's budget. This coordination involved a 'bottom-up'[104] information flow before the final amount was determined at the regional level. The bottom-up process refers to the process in which the budget was consolidated at the regional level by taking into consideration the requests from the wereda and zone levels.

The budgeting process in general had two dimensions: the identification of priorities and goals, and managing funds in order to fulfil these goals.[105] In the process of identifying priorities and goals the major activity was to gather the budget needs of each administrative office. All the information about their needs was finally consolidated at the regional level and became approved by the state council. Information includes a draft budget request indicating the plan, the amount, the activities and the budget ceiling. This information flow began at the wereda level, where the wereda sectoral offices prepare and send the budget request to the bodies concerned. This information flow took two directions: horizontal and vertical flows.

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

The horizontal information flow existed at three levels: The wereda, the zonal and the regional levels. A horizontal information flow existed at the wereda level when all sector offices (and other government offices) prepared their plans and the budget request, and sent them to the wereda council. This flow of information was designed to be facilitated through a wereda development committee (within the council) mandated with the power to review, consolidate and adjust the plans, and to submit the budget request, together with its own proposal, to the wereda council for approval.[106] The World Bank study revealed that the horizontal information flow was not as effective as planned for the reason that the weredas had no financial autonomy to decide, and because of the shortage of skilled manpower.[107] Even the planning office was not available in many weredas. Further, the wereda council did not have the minimum amount of

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[104] World Bank, 'Ethiopia: Regionalization Study,'Report No.18898ETH, June 15, 2000, p. iv.
[105] The following description is based on the World Bank, 'Ethiopia: Regionalization Study'(op. cit.), Budget Manuals, interviews conducted with the Heads of the Amhara and Oromia Finance and Economic Development Bureaus.
[106] World Bank, 'Ethiopia: Regionalization Study', *op. cit.*, p. iv-v.
[107] *Ibid.*

manpower to prepare its own budget request, let alone to review the reports of the sector offices. In most cases, the requests of the sector offices were transferred to the zonal administration.[108] In Gambela, Benishnagul-Gumuz, Somali and Afar, the regional sector offices mainly handled the budgeting processes. However, they were inhibited from properly handling budgetary issues because of a lack of expertise in the field.[109]

The final step was followed by the regional planning and economic development bureau to aggregate the entire budget request submitted by all zonal sector offices and other government agencies. Its duty was to evaluate the information in the light of the zonal and regional economic development goals. The information gathered from sectoral offices and the budget request from the wereda council created the zonal budget divided into recurrent and capital budgets. Here the aggregates of the recurrent and capital budget requests made up the zonal developmental plan. The recurrent budget was then passed to the regional finance bureau, whereas the capital budget was sent to the regional planning bureau.[110] The final regional budget was consolidated by two separate bureaus; on the one hand, the regional finance bureau consolidated the regional recurrent budgets, and on the other, the planning and economic development bureau consolidated the regional capital budgets.

There were some common features of the budgeting process in the regions. First, the amounts requested for a particular year were measured in the light of the budget performance of the previous year. If there were underspending, a budget amount higher than the previous year had little chance of being approved, unless there were convincing reasons for the underspending and the strategies for a better performance in the new budget year. This approach was criticized due to last minute spending and financial embezzlement in many public institutions.[111]

Second, priority was given to recurrent expenditures (salaries, supplies, administrative costs) rather than to capital expenditure. Most of the recurrent costs were permanent costs. It was also easy to verify, i.e., the spending in the previous year helped to determine the amount requested for the next year. Normally, it was only after the recurrent budget has been set that the remaining amount is allocated for capital expenditure. This, of course, did not apply to the budget whose source was either foreign assistance or loans. The allocation of the fund from these sources was dependent upon the nature of the agreement (bilateral or multilateral), but mostly it goes towards capital expenditure.[112]

Third, the regional budgeting process was and still mainly carried out to reallocate the funds that came from the federal government. Thus, the consolidated budgets of the regions depend on the amount of grants rather than the expenditure need of the level of government. The imbalance between the expenditure needs and the available fund resulted in budget cut-offs, or shifting finance from one sector to the other depending on the reason appreciated by the

[108] Interview, *Ato* Hailu, head of the Finance and Economic Development Bureau, Amhara region, January 2003, Bahr Dar.
[109] Interview, *Ato* Melaku Fenta, Ministry of Federal Affairs, Dec. 2002, Addis Ababa.
[110] After 2001/02 the Finance and Planning and Economic Development bureaus merged to form the Bureau for Finance and Economic Development.
[111] See, for instance, the study conducted by the Ethiopian Economic Association/ Ethiopian Economic Policy Research Institute, 'Quarterly Report on the Macroeconomic Performance of the Ethiopian Economy', Vol. 1 No. 1, November 2003.
[112] Interview, Ato Hailu, Amhara Region Bureau for Finance and Economic Development, January 2003, Bahr Dar.

regional government.[113] Normally, the state councils have the authority to evaluate whether the budget requests were in accordance with the general development strategy, and the activity of the planned projects.[114]

The other dimension of the budgeting process was managing the finance available at the regional or subregional levels. As we observed, in the budgeting process the ultimate power lay with the regional government not only to allocate the budget to recurrent and capital expenditures but also to create specific development plans with a view to addressing the demands of the region. It is the sole body responsible for the equitable allocation of resources between all the units within the region. The zones also had an upper hand over the process of evaluating the overall budget requested by the weredas, the allocation of recurrent costs, and the nature and amount of capital expenditures at the wereda level. Even the zones retained a greater share of revenue. The centralization of power at the regional and zonal levels hindered the flow of skilled labour to the local level. Urbanization was mainly focused on the regional capitals. The provision of services and public goods and the setting up of infrastructures also remained at the lowest level. The weredas simply served as agents of regional governments that closely resembled a unitary state. For these reasons we can say that the devolution process in Ethiopia remained between the central and the regional governments. It was with this centralized approach that the regions used to work.[115]

The post-2002/03 fiscal year budgetary procedures aim to reverse the trends of the previous years and focus on the autonomy of local governments (weredas).[116] According to the new approach, in principle, the weredas receive general grants but the budgetary process which allocates recurrent and capital budgets is only approved at the wereda council. This approach intends to address the major drawbacks of the preceding period; weak local participation, the broader financial and administrative autonomy of zonal administrations, and the possible fragmentation of regional government. Particularly, a greater share of revenue at the zonal level led to some form of clashes of interest between zones and weredas in some states. For instance, by comparing the allocated budget to zones in SNNPR, the weredas claimed for a zonal status in order to maximize their share of the total budget of the region.[117] The case of *Wolayta* and *Silte* claiming for the respective zonal administration was not only a case of exercising their constitutional right[118] but also maximizing their budget share. So, by focusing on the budgetary autonomy of weredas and by reducing the role of zones, the new approach intends to contain any claims for zonal administration or statehood.

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[113] Expenditure allocation decisions are usually limited depending on the revenue available from the centre. For instance, during the 2000/01 fiscal year the Tigray Planning Bureau identified 307 million *birr* for capital expenditure but only 196 million was approved. World Bank, *et al*, 'Public Expenditure Review Report of Tigray Region', p. 35.

[114] Interview, Ato Mohammed Ali, Section head, Oromia Finance Bureau, January 2003, Addis Ababa.

[115] But since the 2002/03 fiscal year further decentralization to the wereda level has been introduced in SNNPR, Tigray, Oromia and Amhara regions.

[116] The budgetary process also followed the transfer of revenue to the weredas (see Chapter VII (2.5)). However, the post 2002/03 budgetary process which focuses on the autonomy of local government has not been implemented in all states. Moreover, the pre-2002/03 budgetary process is widely observed in most of the states at present.

[117] Interview with a member of Parliament, confidential, December 2002.

[118] See Art. 47 (2) of the FDRE Constitution. Every nations, nationalities and peoples of Ethiopia have the right to establish, at any time, their own states.

It is recommended that the problems attributed to zones should be revisited in order to see whether, by focusing on wereda autonomy, the problems could be addressed. For example, out of the four principal regions it is only Tigray that abolished zones. Oromia and Amhara retained zones for the major reason that they have an unmanageable territorial and population size unless they have zonal administrations between the regional government and the weredas. SNNPR has similar problems but the ethnic factor prevails above all. Thus, in these regions zones remain to play a vital role in coordinating and executing the responsibilities of the regions at the local level.

However, the existence of several layers of government in a federation can lead to some degree of conflict among priorities established by them. Thus, as indicated above, priorities were given to the regional governments, then to the zones and finally to the weredas. Therefore, it is natural for the wereda administrations to claim a zonal or regional status so that they can maximise their share of the budgetary process. According to the author's informants, it is the intrastate budget allocation that triggered the establishment of five new subregional units from one zone (Semien Omo zone) in 2000: These are Dawro, Gamo-Gofa, Wolayta, Basketo and Konta. Similarly the Keffa-Sheka zone is divided into three separate zones; Keffa, Sheka and Banch-Maji.[119] The presence of zones has major drawbacks in increasing conflicts and limiting local autonomy and financial capacity. The problems, however, can be fairly addressed if there is a strategy to narrow the *de facto* asymmetries between the regions by at least reducing them to a comparable size so that the budgetary process could focus on local governments.

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

2.2.2. Budget implementation

Each administrative unit, either at the federal or regional level, is responsible for the management and execution of its own budget approved by the respective governments. This in principle grants autonomy to each federal, regional and subregional administrative unit over the execution of its capital and recurrent budget. But this autonomy is firmly defined by the financial laws that regulate the proper execution of the budget.[120] The laws require the head of every public body to ensure the proper implementation of the budget consistent with the rules and regulations defined by the finance laws. The laws also require that the

[119] Interview with Ato Markineh, Supreme Court Judge, SNNPR, December 2002; Ato Assefa Kesito, Vice Commissioner, SNNPR Anti-Corruption Commission, December 2003, Awassa.
[120] See Art 64(2) of the FDRE Constitution; the Financial Administration Proc. No. 57/1996, and Council of Ministers Financial Regulation No. 17/1997.

budget execution against planned expenditures at the federal level be reviewed by the Ministry of Finance[121] and by the regional finance bureaus at the regional and wereda levels. This may entail a reallocation of the remaining amount if there is underspending during the budget year.

The disbursement of the recurrent budget normally takes place on a monthly basis from the authorized finance office and is collected from the banks. For payments from the federal government the ministry itself orders payment, at the regional level payments are made at the regional, zonal and wereda finance offices depending on the nature of the claim.[122] The major actors within the respective regions are the sector offices that are organized with three tiers where the lower level is accountable to the higher one.

In principle, the budget implementation follows the decisions in the budgeting process. This budget allocation process itself shows how the sector offices implement the expenditure responsibilities of subregional levels. In general, the role of the sector offices was decided based on a general principle that if the function was essential for several weredas then the budget could be implemented by the zonal sector offices. Similarly, if it became the concern of several zones, then the regional sector offices would better handle it. For example, in agricultural sector, regional agricultural sector bureaus are responsible for research and training centres whereas zones and weredas are responsible for expertise advice in agriculture and veterinary services to the needy at the rural areas. In health sector, the regional sector bureaus distribute medicine and health equipment and mobilize fund and resources to fight statewide epidemics like malaria. Zones and weredas administer hospitals and health centres respectively. However, in some matters, identifying and allocating powers in this manner may be complex and more difficult to identify. When it is difficult to identify as common concerns there is a tendency to centralize power. But there is also 'poor awareness of the proper role and function of a responsive local government.'[123] The other reason to restrict the autonomy of local governments is financial constraints or financial mismanagement at the local level. For example, construction of rural roads, hospitals and technical schools are administered by the regional sector bureaus. This highlights the need to clearly define the responsibilities of local governments and the areas of cooperation with the regional government. It is therefore suggested that serious consideration be given to the administrative capacity of each local government, say between the urban and rural weredas. It is one of the steps to augment the implementation capacity of the subregional governments.

Although the reform intends to achieve certain objectives, there are several constraints that pertain to it. The first is a capacity constraint. In this regard, the shortage of manpower even to execute recurrent expenditures cannot be underestimated. It is therefore recommended that power should be distributed asymmetrically which corresponds to the respective wereda capacity; say, for example, between urban and rural weredas. It is also important to determine clearly whether the weredas can engage in executing capital projects. This helps to determine the area of cooperation between the weredas and the region and as

[121] See budget proclamations of the fiscal years
[122] Interview, Ato Hailu, Amhara Region Bureau of Finance and Economic Development, January 2003, Bahr Dar
[123] Mehret Ayenew, 'Decentralization in Ethiopia: Two Case Studies on Devolution of Power and Responsibilities to Local Authorities', in Bahru Zewde and Siegfried Pausewang (ed.) *Ethiopia: The Challenge of Democracy from Below*, (Stockholm, Elanders Gotab, 2002), p.144.

between the weredas themselves. The others are the danger of financial mismanagement, corruption and lack of accountability. All the necessary political and legal instruments should be put in place to create a meaningful accountability to the electorate. The weredas should also be accountable to the regional government and responsible for the budget they spent. This requires an established governmental agency that can enforce fiscal discipline in the region.

2.2.3 Evaluation of the budgetary expenditure

The budget evaluation begins at the institutional level by the internal auditor.[124] The finance laws require the internal auditor to produce a monthly report stating the monthly revenue and expenditure of the institution and this report is sent to the finance office of the level of administration (Article 57 of the financial regulation). At the federal level, all public bodies which execute the federal fund should account monthly, quarterly, semi-annually and annually to the Ministry of Finance.

The state governments are also required to report to the Ministry of Finance corresponding to the financial reporting system of the federal government (Article 74 of the financial regulation). Accordingly, they are required to submit financial reports monthly, quarterly, semi-annually and annually to the finance ministry. The report should at least contain 'the details of their receipts and disbursements by revenue and expenditure source codes; their cash balances and levels of outstanding debt; and their performance against the objectives stated in their subsidy requests'(Article 74(4) of the financial regulation). In practice, however, the report does not contain the details as required by the financial regulation, and reports are not compiled in a timely fashion due to delays in reporting from lower levels of administration and a shortage of manpower within the finance bureaus.[125] The federal government, through the Ministry of Finance and the Auditor General, also has the power to conduct an audit of the federal offices as well as the state governments concerning the use of subsidy grants they have received from the federal government.[126] The available reports of the Auditor General, however, have revealed serious financial mismanagement.

Budget evaluation at the regional level has to be done formally every quarter on the basis of the activity reports submitted by each sector bureau.[127] All state government institutions have to be audited by internal and external auditors. And the audit reports have to be published. The whole purpose of the evaluation process is to reassess (the approved budget) the progress achieved and the remaining activities. This helps to take timely action by the regional council or the finance bureau such as to study the problems encountered by the responsible office, or to reallocate the remaining amount of the budget.

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[124] Art. 2(14) of the Council of Ministers' Regulations on the Financial Administration of the Federal Government, No. 17/1997.
[125] Report of the Minister, MOFED, to Parliament, 2003; see also the report of the Auditor General to Parliament (unpublished), June 2001.
[126] Art. 80 of Council of Ministers Financial Regulations No. 17/1997; and Art. 95 of the FDRE Constitution.
[127] Interview with Ato Hailu, Finance and Economic Development Bureau, Amhara Region, January 2003.

At the federal as well as at the regional level, internal auditing is conducted more regularly (statistically) than the external one, but less effectively due to incapacity problems.[128] But most of the projects financed by foreign assistance and foreign aid are regularly audited by external (non-governmental) auditing firms.[129] The federal and the state Auditor Generals have a backlog of auditing cases due to a lack of human as well as financial capacity. In many regions there are several offices which have not been (externally) audited for at least five years. For instance, what the federal Auditor General can do is to focus on selected federal or regional institutions based on his own judgments considering the financial capacity of institutions (e.g. the customs office), the trends of financial malpractices and serious complaints from the public.[130]

The financial administration and the evaluation (in)capacity of both levels of government are factors related to the efficiency of the provision of public goods and services to the recipient.[131] The issue involves important control mechanisms such as transparency, accountability and institutional building free from undue political interference. It also requires not only legislation on fiscal responsibility, but also enhancing intergovernmental cooperation, mobilizing experts, and introducing modern budgeting and management techniques. Further, it is asserted that:

> Budgetary rules, such as strong position for the head of the financial department in the state or local government, transparency rules providing the citizens with reliable information about both sides of the public budget, or rules creating close connections between public expenditure and revenue, can induce fiscal discipline...as well as lower public debt.[132]

2.3 Implementing responsibilities through intergovernmental cooperation

According to the Ethiopian Constitution, a competitive approach is the norm with regard to powers exclusively assigned to each level of government, unless both levels of government enter into cooperation for a better performance of responsibilities. But it would be difficult to imagine that each level of government can implement all the responsibilities independently. Considering the nature of the federal system and the asymmetries that exist between the constituent units, it would be appropriate for the states and the federal government to engage in continuous cooperation.[133] In general, vertical and horizontal intergovernmental relations may exist in a federal system. In this section the intergovernmental relations in Ethiopia is studied in order to scrutinize the role of both tiers of

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[128] See the Auditor General's report to the HOPR, June 2002. The Auditor General also reported that the government is not taking any meaningful action based on the reports of his office.

[129] See the reports of the Auditor General, *op. cit.*

[130] *Ibid.*

[131] World Bank, 'Ethiopia: Regionalization study', *op. cit.*, p. 10.

[132] Richard Bird *et al*, 'Assignment of Responsibilities and Fiscal Federalism', in Raoul Blindenbacher and Arnold Köller (eds.), *Federalism in a Changing World Learning from Each Other: Scientific Backgorund, Proceedings and Plenary Speeches of the International Conference on Federalism 2002*, (Montreal, McGill-Queen's University press, 2003), p. 359.

[133] A number of Constitutional and institutional factors determine the nature of intergovernmental cooperation in a federation. Some of these are issues related to the nature of governmental structures, whether the government is structured according to presidential, parliamentary or congressional principles, the degree of asymmetry within a federation, and the political party system. D. Cameron, 'The Structures of Intergovernmental Relations,' International Social Science Journal, Vol. 53 No. 167, 2001), p. 126.

government in discharging their respective expenditure responsibilities enshrined in the Constitution.

We first examine the extent to which the Ethiopian Constitution recognizes and regulates intergovernmental cooperation, before we look at the terms and institutions which exist in practice.

Reading the preamble to the Ethiopian Constitution reveals the importance of cooperation between the 'nations, nationalities and peoples' of Ethiopia. It provides:

> Fully cognizant that our common destiny can best be served by further promoting our shared interests; convinced that to live as one economic community is necessary in order to create sustainable and mutually supportive conditions for ensuring respect for our rights and freedoms and for the collective promotion of our interests.

The preamble implies that the nations, nationalities and peoples of Ethiopia want the country to continue as one economic union. Accordingly, they gave the federal government a constitutional mandate to protect and promote their economic interest. However, the assignment of power to the central government may not suffice to promote cooperation between the nations, nationalities and peoples of Ethiopia. Thus, the Constitution recognizes the importance of cooperation among the levels of government by including somewhat scanty provisions to that effect.

One of the instances in which the Constitution provides for cooperation is when a legislative power is allocated to the centre while its implementation is left to the states (see 1.3 above). And also in cases where the federal executive plays a crucial role in developing appropriate national policies while the states primarily assume responsibility for the execution of the same policies.[134] Some of the cases that could be interpreted as instances promoting cooperation are the regulation of interstate trade, the process of constitutional amendment, conducting population censuses, elections, and administering places declared to be under a state of emergency.[135]

The importance of intergovernmental cooperation is also envisaged in a particular reference to the relations between Oromia region and the centre or the administration of Addis Ababa (the federal capital as one of the constituent units of the federation). Article 49(5) of the federal Constitution states that:

> The special interest of the state of Oromia in Addis Ababa, regarding the provision of social services or the utilization of natural resources and other similar matters, as well as joint administrative matters arising from the location of Addis Ababa within the state of Oromia, shall be respected. Particulars shall be determined by law.

The constitutional provision envisages the possibility of interaction in social, economic and political aspects of life, and the need for proclaiming further laws addressing the issues. As the location of Addis Ababa is within the Oromia region, several socio-economic, cultural, legal and administrative issues may arise. For instance, Environmental issues, employment and the displacement of the rural population because of the territorial expansion of Addis Ababa, *inter alia*, would be the major issues. Environmental (and health) issues, for instance, can easily

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[134] See Arts. 55 (2, a) and 52 (2,d) of the FDRE Constitution.
[135] See Arts. 51(12), 93, 102,103 and 105 of the FDRE Constitution.

arise since the rivers flowing to the neighbouring Oromia region are highly polluted because of the wastewater emissions from the industries located in and around Addis Ababa. Moreover, if Addis Ababa continues to be also the seat of the Oromia state government, the latter may raise complex issues claiming the share of revenue collected in the city. Therefore, in order to address these and other issues intergovernmental collaboration between the Oromia region, the federal government and the Addis Ababa administration seems inevitable, but has not yet been given due consideration.

The other instance in which the Ethiopian Constitution provides for extensive interaction between the centre and the states is the process of financial transfers. These are issues involving the sharing of revenue, the provision of grants and loans, and auditing the proper utilization of grants allocated to the states. The mode of addressing such financial issues also determines the nature of intergovernmental cooperation in Ethiopia. Also with a view to addressing these financial issues, the Constitution established the House of Federation (HOF) as the formal intergovernmental body. The power of facilitating and promoting cooperation between the groups is assigned to the Upper House, HOF, which is composed of representatives of 'nations, nationalities and peoples'. The above issues are further discussed in Chapter VII, Section 4.

The other case in which the Constitution envisages relationship is through the delegation of power (Article 50(9)). The constitutional provisions explicitly recognize the delegation of any of the central functions to the states. However, it does not qualify delegable and non-delegable powers, although the nature of some of the powers confirms their non-delegable nature. Thus, if the federal government can delegate any of its powers (including its legislative power) to the states, it can bring a change to the constitutionally-stipulated division of powers. Further, it is not clear whether the centre can make preferences concerning a specific state when delegating power. These are some of the issues that should be addressed in the future by legislation clarifying the constitutional principle and the types of powers and functions that can be delegated to the states.

2.3.1 Vertical intergovernmental cooperation

From a structural point of view, the executive is the main institutional factor in promoting intergovernmental cooperation. However, there are also instances where other constitutionally-assigned institutions such as the legislature play some significant roles in promoting collaboration between the federal and state governments. In Ethiopia, there are formally established institutions and other ad hoc mechanisms that are involved in the process of cooperation between the centre and the regions. They are discussed below.

The role of the HOF (the Upper House)

In many federations, since the upper House is composed of representatives of states and participates in the legislative process, it plays an intergovernmental role by representing regional interests at the centre.

However, the Upper House (the House of Federation) in Ethiopia has no legislative power but has important intergovernmental roles. It has the power to deal with matters concerning the relations between the constituent units of the

federation.[136] On the basis of this power, the House decided in one case in cooperation with the state where the *Silte* people claim their own identity and self-administration. It also held referendums in areas bordering on Somali and Oromia states to resolve territorial disputes. The major role of the HOF in promoting cooperation is related to determining the sharing of joint revenues between the federal and regional governments, and the bases on which grant subsidies can be allocated to the member states.[137] However, there are other constitutional mandates that need to be clarified for the House to play a role in promoting intergovernmental relations. These are the power to promote the equality of the peoples of Ethiopia and consolidate their unity, to determine civil matters which require federal laws, to order federal intervention, to find solutions to disputes or misunderstandings between states, and to interpret the constitution on matters of division of powers

Institutional mechanisms for promoting cooperation

The Prime Minister, in most of his annual speeches to Parliament on the working plan of the federal government, mentions the importance of intergovernmental cooperation in order to assist the relatively less developed regions and to promote proportional development between the regions. The working plan further states the importance of cooperation between the federal government and the states in tackling the social, economic and political problems besetting the country. The desirability of creating a 'single economic community' is also highlighted by the Constitution. Similar statements are found in several policy documents that have been issued by the government since 2001.[138]

The problem, however, is maintaining the fundamental principles of the federal Constitution: interdependence for common interests and respecting regional autonomy. Identifying and limiting the areas of cooperation and the process of involving the levels of government for addressing common concerns should be properly dealt with.

The FDRE Constitution gives the federal government responsibility for promoting cooperative relations between the federal government and the states.[139] As a result, the federal government has established an executive body. At present, the most formal institution endowed with the relevant powers and responsibilities

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[136] For instance, the HOF, according to Art. 62 (3) 'shall, in accordance with the Constitution, decide on issues relating to the rights of Nations, Nationalities and Peoples to self-determination (4) It shall promote the equality of the Peoples of Ethiopia enshrined in the Constitution and promote and consolidate their unity based on their mutual consent. (6) It shall strive to find solutions to disputes or misunderstandings that may arise between States. (7) It shall determine the division of revenues...and the subsidies that the federal government may provide to the states. See the annex, particularly Articles 61, 62, 82-84, of the FDRE Constitution. Also see Proc. Nos. 250 and 251/2001.

[137] See Arts. 62 (7) and 98 of the Federal Constitution of Ethiopia. For a more detailed analysis of the role of the HOF in the revenue sharing and allocation of grants to the states, see Chapter VII.

[138] For instance, see the Amharic documents, 'Yemasfetsem Aqim Ginbata Strategina Programoch', [Capacity Building Strategy and programmes] Ministry of Information, Audiovisual Department, 1994 (Eth. Cal.), 'Be Ethiopia Yedimocracy Sirat Ginbata Gudayoch', [Some Issues on Building a Democratic System in Ethiopia] Addis Ababa, Ministry of Information, Audiovisual Department, Yekatit 1994 (Eth.Cal.); 'Yeteklay Ministru Ye1996 Yefederal Mengist Yesira Iqid LeParlama Yaqerebut Report', [The Prime Minister's Working Plan of the 1996(Eth. cal) report to Parliament] Addis Ababa, Ministry of Information, 1996(Eth.Cal)

[139] Article 89 of the FDRE Constitution

is the 'Ministry of Federal Affairs' (hereafter, MOFA). It is not an institution whose establishment is formally required by the states. Rather, it is the need to address the *de facto* asymmetries that exist between the states, and the failure of some of the states to resolve interethnic conflicts that were prevalent within their own territory.[140]

The MOFA has its origin under Proclamation No. 256/2001 which reorganizes the executive organs of the federal government. The ministry assumes several missions and tasks under this Proclamation. Some of them are: to assist the execution capacity of less developed regions and to promote equitable development, to resolve disputes between states and between ethnic groups and to forge cooperation between them, to support the development of modern urban centres, to help pastoralists participate and benefit from the development activity of the country, and in general to implement a working federal system.[141]

The MOFA is a federal executive but it also plays the role of an intergovernmental institution enhancing cooperation between the centre and the regions. In principle it can engage in relations with all states, but the main focus of these relations is the lowland regions of Afar, Benishangul-Gumuz, Gambela and Somali and deals particularly with capacity-building, good governance and conflict management.[142] Compared to other regions, these regions lack the essential technical and administrative manpower, and basic infrastructure to administer their own affairs. The ultimate goal of this cooperation is to enhance the capacity of these states so that in the future they will be able to administer the respective states properly. So the cooperation and assistance from the centre is pertinent. However, it requires a genuine and transparent relationship to delimit the area which needs cooperation, and also clear legal and political frameworks. Above all, the regions should be active partners in the process of cooperation.

Although the MOFA formally came into existence in late 2001, it was preceded by 'Yekilil Guday Zerf' [Regional Affairs Department] under the office of the Prime Minister. Therefore, it would be unwise if we fail to shed some light on the then relationships between the centre and regional governments.

It is important to note that the powers and responsibilities of the department were not promulgated. However, it was officially declared on a number of occasions that the department was established to assist the Prime Minister in regional affairs with a view to promoting relations between the centre and the regions and assisting the performance capacity of the latter. The Department, which was headed by a minister, was organized in three main offices dealing with infrastructure development, capacity-building and expertise assistance, and cooperation on political and administrative matters.[143] The offices were organized with some staff staying at the head office but frequently visiting the regions, others based in the region and normally assigned to serve there for two years. The technical experts were supposed to advise the regional government. Since

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[140] Proclamation No. 256/2001, for the Reorganization of the Executive Organs of the Federal Democratic Republic of Ethiopia.'

[141] *Ibid.*

[142] Interview with Ato Melaku Fenta, Ministry of Federal Affairs, January 2003, Addis Ababa. See also Proclamation No. 256/2001, for the reorganization of the Executive Organs of the Federal Democratic Republic of Ethiopia.'

[143] Interview with some former employees of the Kilil Guday Zerf, January 2003, Addis Ababa.

the regions lack technical experts, the advisors evaluate projects, decide on bids, and supervise and approve the performance of projects.[144]

The anomaly was that the experts and personnel decided on several regional matters, but they were not accountable to the region. This had created mal-administration such as nepotism, corruption, and inefficiency.[145] The political and administrative advisors were much more powerful than they were expected to be. Instead of focusing on assisting the regional government in legal and administrative issues, they were dictating the day-to-day activities and were even presiding over the meetings of the regional councils. These people were the ruling party officials and were considered by the peoples of the region to be *de facto* regional administrators.[146]

In general, this has led to the existence of a 'dual administrative structure' in the regions. The second 'administrative structure' was managed by party officials of EPRDF and people assigned by the central government. The first one being the regional government, however, it was required to be accountable to the second one. In this regard, Jon Abbink argues:

> EPRDF cadres and army units in most of the country form a kind of dual administration. They are acting behind the locally elected administration, and the local officials are ultimately accountable to and dependent (for their jobs) on the EPRDF representatives.[147]

Although Abbink made his remarks in the earlier days of the federal system, his conclusion was affirmed by EPRDF itself in the 2001 conference evaluating its ten-year performance. Since many of the authorities of 'the second structure' were from TPLF,[148] the most influential party in the EPRDF, it can be said that TPLF was converted into a regulatory body in the above stated regions.

As a whole, relations led by the regional Affairs Department were dominated by the centre and characterized by paternalism rather than partnership between the orders of government. It is obvious that these regions lack the minimum skill and manpower to carry out the responsibility devolved to them. It can be said that the federal intervention had brought about some changes. It is also evident that the intended cooperation would result in upgrading the capability of the regional governments so that they would be able to administer their own affairs efficiently. However, the experience demonstrated that the authorities of the regional affairs department dominated the local administration and had direct control over day-to-day activities. Thus, such an administrative fiat eroded the confidence of the people in the system, and many became suspicious about everything that comes from the centre. Furthermore, despite the fact that the objective of the department was to enhance the capacity of the four regions mentioned above, its activities had no defined legal parameters.

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[144] *Ibid.*

[145] The technical advisors decided on specific projects. But the then Minister had the power to decide on the major expenditure decisions of the regions. For instance, in his defence against the corruption charge, the former chief of SNNPR proved to the court that the former Minister for Regional Affairs had approved a 70 million birr project.

[146]. Interview with students at the Civil Service College who were from Gambela and Benishangul-Gumuz regions, and who were also former regional authorities of the regions, December 2003, Addis Ababa.

[147] Jon Abbink, 'Breaking and Making the State: The Dynamics of Ethnic Democracy in Ethiopia,' (Journal of Contemporary African Studies, vol. 13, no. 2, 1995), p. 159.

[148] For the list of names of these authorities, see Merera Gudina, *op cit.*, p. 161; also see L. Aalen, *op cit.*

In the post 2001 period, the most important question would be whether the new structure, the Ministry of Federal Affairs, has rectified the misguided approaches of its predecessor, the Regional Affairs Department, and performs its duties within the ambit of federal principles. And can it play an intergovernmental role by focusing on good governance rather than by monitoring the regional administration? In other words, what are the emerging trends in the new structure of the ministry concerning the objective of enhancing cooperation between the centre and the regions?

The MOFA has a formal mandate and structures under proclamation No.256/2001 which are responsible for intergovernmental collaboration, although there is an overlap of power with the HOF. In this regard, a member of parliament from Benishangul-Gumuz region remarked immediately after the reform,

> There is no so-called advisor who permanently supervises the activities of the regional government. The 'technical experts' are coming to the region at the request of the regional government and for a fixed period of time.[149]

One of the authorities at the Ministry of Federal Affairs also remarked that unlike its predecessor, the ministry is trying to address local needs rather than directly implementing federal policies. For instance, policies for pastoralist areas have been drafted in consultation with the local administrators and the elders.[150]

However, the facts on the ground demonstrate that there are several issues that should be handled with due care.

First, as has been the case with the department of regional affairs, several activities are still taking place through interpersonal relationships (between the federal and regional higher officials).[151] This approach will not have a long-lasting effect. Thus, there should be a formally established intergovernmental council where states are represented and engage in institutionalized negotiations.

Second, it is difficult to distinguish activities that can solely be carried out by the state administration and those that are administered in cooperation with the ministry. Although several technical experts and administrative officials are assigned to assist the less developed regions, they continue to intervene in almost every economic, administrative and political concern of the regions. Its drawbacks partly emanate from the centralized party system where the regional authorities are accountable to the federal authorities that are at the top of the party structure. That is why an institutionalized cooperation where the areas of cooperation can be defined not only by the federal institution is recommended.

Third, the MOFA is not broadly organized to facilitate intergovernmental relations between the states and it has not established federal executives throughout the states. The ministry is not engaged in cooperation with all the constituent units, but only with the less developed states. However, to achieve a meaningful relationship with all constituent units, there should be a legally established asymmetric relationship between the federal government and the states. This is because some of the states cannot take their own affairs due to a serious problem of manpower and infrastructure, while the others can even execute federal laws and policies.

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[149] Interview with Mitt Mihi, Member of Parliament, December 2002, Addis Ababa.
[150] Interview with Melaku Fenta, Ministry of Federal Affairs, January 2003, Addis Ababa.
[151] *Ibid.*

Fifth, on the part of regional authorities there is a lack of understanding concerning the federal system per se and with regard to defining the nature of cooperation with the federal government. This relationship should promote partnership rather than the centre's paternalistic approach.

Fifth, and more importantly, the December 3, 2003 interethnic conflict in the Gambela region gave an effective lesson to cautiously study federal-state relations and to define the future roles of the Ministry of Federal Affairs.[152] The problems are partly related to the nature of the relations between the centre and the Gambela region, such as the mishandling of the situation during and after the occurrence of the conflict, the swinging back and forth of favourable treatment to either of the major ethnic groups (Nuer and Agnuak) in the region, and the army intervention and the partial treatment of parties in the aftermath of the conflict.

The principle of federalism requires the levels of government to identify the objective conditions which foster cooperation and the authorities to act in a responsible manner. At the same time, the tendencies of over-centralization under the guise of cooperation should be avoided. Regional governments' dependence on the federal government is equally problematic because it not only contradicts the principle of federalism, but also leads to a greater disparity between the regions. Therefore, it is necessary to examine the role of institutions to discover how they can assist the regions in implementing the responsibilities and the achievement of the objective of proportional development between the regions.

Delegation of power

One of the mechanisms for promoting intergovernmental cooperation in a federal system is the delegation of power from one level of government to the other. Some federal constitutions emphasize the delegation of power either from the centre or the region only, while others permit any form of delegation. According to Article 50(9) of the Ethiopian Constitution, the federal government can delegate any of the matters reserved to it.[153] The provision covers a wide range of powers, and accordingly, the federal government can delegate legislative power, administrative power (execution) or adjudicative power.[154] However, federal practices demonstrate that it is the executive power rather than the legislative power of the federal government that is delegated to the states where the federal government have not established its agencies.

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[152] The nature of conflicts in the regions is discussed below, sec. 2.4.5.

[153] Art. 50(9) reads: 'The Federal Government may, when necessary, delegate to the states powers and functions granted to it by Article 51 of this Constitution.' Although the Constitution seems to provide only centre-state delegation of power, the states are not expressly prohibited from delegating their powers. Delegation, after all, does not permanently alter the division of power enunciated by the constitution. In fact, the draft Constitution and the minutes of the constitutional assembly considered federal-state, state-state, and state-federal delegation of power. But the latter two cases of the delegation of power have been omitted from the final version to protect the powers and functions of the states. See the draft constitution and 'the minutes of the constitutional assembly' (in Amharic), vol. 6, December 1994, p. 1.

[154] However, the federal government cannot delegate all its powers and functions. For instance, owing to their nature certain powers and functions are non-delegable. The legislative power to print money, to regulate foreign exchange, foreign trade and customs duties, and most of the matters of international relations cannot be delegated.

Apparently, in Ethiopia until some attempts were witnessed very recently the new some federal institutions have not been established in all the states and the[illegible] was no formal delegation of power as enshrined by the Constitution. Rather, as we have studied above, the federal government has been using the 'Regional Affairs Department' and presently, the MOFA, and the party structures for the implementation of federal laws and programs. There is also a popular misconception that federal laws are issued to be implemented only in Addis Ababa and Dire Dawa. At present, the courts promote intergovernmental relations as the Constitution delegates judicial power to the state courts following the formation of a dual court structure in Ethiopia. The federal Constitution delegates the jurisdiction of the federal high court and of the first instance courts to a state supreme and high courts respectively, until the House of Peoples Representatives decides on the establishment of federal first instance and high courts in some or all states.[156]

By transferring the powers vested in the federal government to the states, the Constitution also provides for the delegating government to cover the financial burden (Article 79 (7)). It requires that the House should allocate compensatory budgets to states whose supreme and high courts concurrently exercise the federal jurisdiction. However, the House has not yet allocated any compensatory budget as required by the Constitution.

In general, delegation may pose substantial concerns with regard to the execution of policies or laws. Some of the problems are related to the problems of identifying which federal powers are delegated to the states. In particular, the nature of cooperation between the federal and state governments with regard to the delegated powers, the nature of responsibility of the level of government, and the funding mechanisms have to be addressed. The cooperation between the orders of government addressing the funding issue is important, albeit the other problems may not always be resolved.

Other ad hoc mechanisms

Although the importance of formal intergovernmental institutions has been emphasized above, cooperation concerning the better performance of responsibilities is actually facilitated through other mechanisms as well. It could be promoted through various forums, conferences, workshops, advisory ad hoc bodies, the exchange of personnel and technical experts, or through personal exchange of information between the authorities of the levels of government.[157] The meetings, discussions, and other forms of cooperation between the centre and the regions take place as the occasion demands. Some of them may remain as forms of informal cooperation between authorities, while others may evolve into more formal institutions with a clear mandate and staffed with skilled labour. Some of the informal relations may disappear or remain without a meaningful role.[158] The practice of several federal systems exemplifies the existence of

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[155] For instance, despite a clear constitutional authority to establish federal police force, the federal government did not have one except in Addis Ababa, until at least 2002.

[156] Article 80 (1, 2) of the FDRE Constitution. See also Federal High Court Establishment Proc. No. 322/2003, which established six federal high courts in six of the nine regional governments.

[157] Elazar (1966), *op. cit.*; Watts (1999, 2003), *op. cit.*

[158] Brian R. Opeskin, 'Mechanism for Intergovernmental Relations in Federations,' (International Social Science Journal, vol. 53 No.167, 2001), p. 129-138. It is also a problem in Ethiopia. Vertical as well as horizontal relations are dependent on the personalities of the

different forms of informal governmental relations, vertical as well as horizontal, some of which evolve into formal institutions.[159]

An important feature of semi-formalized intergovernmental relations through administrative agencies has been emerging in Ethiopia since 2002.[160] Each federal ministry or administrative agency is required to engage in cooperation with their counterpart regional bureaus in order to share information, discuss common problems, contemplate joint action on common concerns, exchange experiences, share technical expertise and personnel, and even establish joint agencies.[161] In this regard, the relations concerning trade and investment, taxation and revenue sharing, judicial reform and capacity-building have shown significant development in coming within the terms of intergovernmental cooperation.

A consultative forum between the Ministry of Trade and Industry and sector bureaus has been established to strengthen the partnership between them. The forum creates an opportunity to share information, taking a concerted effort to attract investment, to discuss land lease and related problems, and the need to address problems encountered by investors.[162] This kind of forum is vital not only to promote partnership between the levels of government but also to address administrative hurdles that the private sector faces.

Another forum of cooperation involves the Ministry of Revenue, the Ministry of Finance and Economic Development, other federal offices working on tax-related issues and sector bureaus of the regions.[163] The forum convenes at least twice a year and deals with important issues concerning the harmonization of tax laws, the uniform application of tax laws, enhancing taxing capacity, solving tax-related problems and issues related to shared taxes.[164]

One of the major achievements of this consultative meeting is the recommendation which it has submitted to the HOF for a division of revenue generated from shared taxes, and for a better administration of VAT.[165] The forum also boosts the awareness of regional governments calling for their active participation in the collection of federal taxes since it also upgrades their share.

There can also be some short-term cooperation to address a particular problem. Such cooperation may exist when there is an outbreak of epidemic, war or sectarian violence. For instance, in October 2003 in order to control and protect the malaria epidemic, the federal Ministry of Health sent a team of experts, and

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authorities, sometimes with strong and fruitful cooperation and in others gloomy and destructive. (Interview with Ato Melaku Fenta, Ministry of Federal Affairs, January 2003).

[159] Watts (1999a, 2003), *op. cit* ; Elazar (1966), *op. cit*.

[160] Before the 2001/2002 reform within the ruling party (called in Amharic 'tehadso' – which means a Renewal Process), for instance, Ato Hailu (Head, Amhara Finance bureau) complained that the Federal Ministry of Finance and Economic Development, and for that matter, most of the Ministries, did not have any formal cooperation with the region. He said, 'They contact us only when they require some data. We have never been heard when commenting about cooperation nor consulted us before they decide on matters concerning our interest, concerning training and solving common problems. We have been dictated to act accordingly on matters devolving from the centre.'

[161] See the FDRE policy documents, *op. cit.*; Interview with Ato Zeru, Secretariat of the tax reform programme at the Ministry of Revenue, January 2004.

[162] Interview with Ato Zeru, *op cit*.

[163] *Ibid.*

[164] *Id.*

[165] *Id.*; For a detailed analysis of revenue sharing, see Chapter VII, sec. 2.1.

allocated 140 million birr to the weredas most affected by the epidemic.[166] It also gave training programmes to local experts on how to protect against similar problems in the future. The national campaign against polio was conducted through coordinated efforts by governmental, non-governmental and international organizations.[167]

A relatively longer period of collaboration exists between the federal Disaster Prevention and Preparedness Commission and sector bureaus of the regions. They exchange information among themselves and disseminate it to the national or international bodies concerned using their early warning systems.[168] They also form joint committees to study the problems peculiar to each locality, identify the needy, and estimate the type of assistance, the amount needed and its duration. It is one of the areas where the government effectively performs its duties through cooperation although the final decision does not involve the states.[169]

The other area where the federal government effectively cooperates with the regions is in the provision of training programmes to fill the gap in the shortage of skilled labour in the regions. In this regard, the Ethiopian Civil Service College plays a pivotal role by offering training and education in different disciplines to people who are willing to serve in the regions.

In general, there are numerous occasions when the relevant representatives engage in workshops, conferences, training programmes and consultations for a specific period or purpose. The process and implementation of capacity-building programmes and reforming the existing civil service system involve close cooperation between the centre and the regions. The proliferation of these interactions has led to sharing experiences, gathering opinions about reform programmes and the uniform application of federal legislation and national policies. Most of the relations discussed, however, are overshadowed by a formidable centralized party system which primarily implements decisions through the party structures, where reforms are hardly the outcome of negotiations and joint decisions of the levels of government.

2.3.2 Horizontal intergovernmental cooperation

Horizontal intergovernmental cooperation exists between states in their venture to perform constitutionally allocated responsibilities. Federal practices indicate that the constituent units of a federation engage in horizontal cooperation between themselves, despite the absence of an express constitutional clause to do so. This horizontal cooperation is important for several reasons. It can be used for addressing conflicts (related either to borders or to resource sharing) between states, for achieving common objectives with a lesser cost since it may be costly for each of them to perform certain activities, for states to lobby against the central government or to initiate some kind of reform within the federal system.[170]

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[166] Interview with an expert, who preferred to remain anonymous, at the Ministry of Health, January 2004, Addis Ababa
[167] *Ibid.*
[168] Interview with an expert at the DPPC, December 2003, Addis Ababa
[169] *Ibid.*
[170] R. Watts, 'The Distribution of Powers, Responsibilities and Resources in Federations,' in Ann Griffiths, *Handbook of Federal Countries*, (Montreal, Forum of federation, McGill-Queen's University press, 2002), p. 468-69.

The first step towards promoting interstate cooperation and setting up intergovernmental institutions in Ethiopia was taken when the association of five neighbouring governments was established comprising of Oromia, Afar, Somali, Harar and Dire Dawa Council in 1996. The Association was initially mandated to bolster cooperation between the peoples of these regions, to solve common problems and amicably to solve border disputes that prevailed between them. The major problems which the regions still share concern the lives of pastoralists, conflicts between people bordering the regions and disputes concerning border demarcation.

The overall evaluation of the cooperation demonstrates that it was not meaningful and sustainable as it perished together with the dismissal of authorities in these regions. However, the issues which were raised by the authorities at the time are now the concern of the MOFA. The issues of border disputes, interethnic conflicts, and the lives of pastoralists are the major tasks of the ministry. It is difficult to assess whether the ministry has brought about any meaningful changes, but it is reported that the ministry has mediated an interstate border disputes and interethnic conflicts between the Afars and the Somalis, and between the groups existing within the SNNPR region and within the Gambela region. The ministry has also reported that one of its departments coordinates relations between the states mainly inhabited by pastoralists. Thus, although its primary role is to facilitate intergovernmental relations between the centre and the regions, the ministry can also serve as a responsible organ promoting horizontal relations between the states, particularly for addressing interstate conflicts.

Another form of cooperation can be observed when a government engages in relations with other governments in infrastructural projects and technical assistance. The main reason for this type of cooperation was the need to assist the least advantaged regions in terms of skilled labour and administrative experiences. In this case, the Amhara state was verbally committed to assist Afar and Benishangul-Gumuz regions as it shares boundaries with these regions. Similarly, the Tigray region had expressed its commitment to cooperate with the Afar region.

The commitment to promote horizontal cooperation is appreciated, but there is a danger when this relationship involves special procedures and arrangements other than what the law requires. For instance, the 2002 report of the Auditor General indicated that Afar region had paid 80 million birr to the Tigray region for a certain project which was not subjected to bidding, nor supervised according to the financial rules. Also, the nature of the contract and the payments made were not in accordance with what the financial regulation requires. Similarly, the Amhara regional government paid 5 million birr to the Tigray Rural Road Authority (state public enterprise) for rural road construction. These cases indicate that interregional relations also involve commercial contracts which can be carried out by the private sector.

Other criticisms show that the form of cooperation declared by these regions has not demonstrated significant progress towards benefiting the least developed regions. However, the possibility of horizontal cooperation will be extensive in issues involving areas bordering the regions such as security, transportation and other common concerns like controlling epidemics. Thus, as interregional

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cooperation seems inevitable, it is important to deal with issues of regional concern without necessarily resorting to the centre.

2.3.3 An interim conclusion

Despite the constitutional division of power, the study has revealed that the governments work together in the performance of responsibilities. Intergovernmental cooperation can be introduced by the very constitutional set-up, or it can evolve in course of time out of practical necessity. In principle, intergovernmental cooperation refers to the relationship between the tiers of government acting as equal partners. But it can be influenced by several factors related to human and financial capacity, and the political system. However, the impact could be contained if the mode of interaction is institutionally entrenched. The importance of intergovernmental cooperation in a country like Ethiopia with a limited financial and human capacity should be given paramount importance.

The major objectives of establishing intergovernmental institutions in federal systems are to promote cooperation between the levels of government in order to address the needs of the peoples of the cooperating units, to resolve some disputes between them and to efficiently perform the functions and responsibilities assigned to each of them. Thus, the governing principles for cooperation with regard to powers and functions should be given a clearly stipulated framework in the constitution or in other relevant laws. This should apply to both the vertical and the horizontal dimensions of cooperation.

The Ethiopian Constitution provides some rudimentary provisions for intergovernmental cooperation, and its implementation is also at a very early stage. It also mainly focuses on vertical relationships. Thus, the previous section of this study brought into focus the greater role of the federal government and the institutions at the central level as the principal actors in intergovernmental cooperation. The institutional mechanisms for this vertical relationship are the HOF and the Ministry of Federal Affairs (MOFA). However, their role is found to be inadequate and it is dominated by a strong central influence over state governments. This can be attributed to two main reasons: the centralized party system that can effectively control the regional governments and the capacity constraints. As the study indicated above, the centralized party structure and the use of the party channel for administration contradict the division of power envisaged by the federal constitution. It is suggested that this should be geared towards the institutionalization of formal intergovernmental mechanisms that can also involve the subnational governments.

Horizontal intergovernmental relations may exist at the same level of government at the regional or local level in the absence of coordination by the central government. This relationship may take shape through different structures and arrangements to facilitate cooperation between governments. As can be seen in other federal systems, interaction between governments may develop through formal institutions or conferences, or in practice through their endeavours in solving day-to-day problems. In Ethiopia, in some instances, attempts have been made by some regions and, in other instances, by all regional governments to formally engage in relations, but these have not played a significant role in discharging their responsibilities and in addressing common problems. It is, therefore, suggested that there should be an institutional mechanism that can create a forum for horizontal cooperation between

governments of the same level, i.e. between the regions or between the weredas. This can provide an opportunity for the regions to work together by coordinating their policies, and influencing any federal policies concerning their interest. The local governments can also exert joint efforts to efficiently utilize their limited finances or to participate in the allocation of regional grants. The horizontal cooperation at the wereda level will be more relevant as the need to devolve power to the weredas increases.

In sum, the functioning of cooperation between equal partners could be hampered by a lack of capacity on the part of regions or weredas, but there should be a legal requirement to consult and to involve the organized regional or wereda governments.

2.4 Expenditure performance: towards aggravating regional disparities?

The success or failure of the federal arrangement cannot be measured by the division of powers and responsibilities between the tiers of government only. Rather, it is by properly implementing them in order to bring about a meaningful performance in the provision of public goods and services, and by balancing the level of development between the regions. However, the efforts of the regions to implement their responsibilities may not produce the same result. Thus, this last section focuses on some important factors that have a bearing on the execution of responsibilities and thereby on the disparities between the regions. This section examines the important factors such as the federal spending in a region, the flow of extra-budgetary sources, the problem of corruption and administrative incapacity and the impact of political conflicts. It is argued that these factors present a fundamental challenge to the federal objective and should be taken into consideration in any corrective mechanism at the federal and regional levels.

2.4.1 Direct spending by the federal government in a region

In the process of discharging its responsibilities, the federal government may spend part of its resources in the constituent units of the federation. It spends in major expenditure areas such as road construction, aviation facilities, universities, etc. Enterprises owned and controlled by the central government are also the major actors in the provision of basic infrastructures and services, such as electricity, telecommunications and roads. Spending in these areas contributes to providing better social/economic services and creating job opportunities. But the 'urban-rural inequalities, interregional disparities and the excessive size of Addis Ababa relative to other urban centres'[171] have become the major challenges currently facing federal spending.

Therefore, all the spending at the federal level should be directed towards desirable outcomes and it should contribute to achieving equitable public services in the regions. Since the powers and responsibilities reserved for the federal government are essentially presumed to be matters concerning the interest of the whole nation, it is assumed to benefit all citizens. Thus, irrespective of the sector on which and the place where the government spends, the major objective is expected to be to strengthen solidarity between the constituent units of the

[171] Lincoln Joshua, 'The Effect of Federalism on Inter-group Relations in Multi-ethnic States: Evidence from Nigeria and Ethiopia,' (UMI services, dissertation, 2000), p. 210.

federation. However, the federal government should be transparent in the reasons for prioritizing its spending and should assess the benefit of a region from the point of view of a federal spending. But it is not always easy to determine the extent of benefits internalized by a region from the federal expenditure.[172] Whatever the extent and the nature of benefit may be, one may wonder whether there is any checking mechanism against the federal spending decision, and its possible impact upon interregional balances.

It this regard, the role of the parliamentary system which Ethiopia follows has been found to be lame. The relationship between the executive and the legislature is regulated by the parliamentary principle which minimizes the separation of power and checks and balances.[173] Further, unlike other bicameral parliamentary systems, the second chamber (HOF) has no major role concerning powers reserved for the executive. As the HOF is restricted to non-legislative powers and lacks an effective role in order to influence the federal policies and laws proposed at the federal level, the states remain devoid of effective power. Therefore, the HOF or the states may not directly influence federal spending in the states. Nonetheless, the HOF is mandated to determine the provision of grants and the sharing of revenue. It is therefore recommended that the HOF should evaluate the impact of federal spending on interstate disparity in its decision on revenue sharing and federal grant formulas, as the HOF is entrusted with this power. Furthermore, there should be a transparent mechanism in the federal spending (through its enterprises) in order to balance the benefits of the regions. In this regard, the parliamentary hearing should be more than informative and the parliamentary committees' findings should bring about a satisfactory solution.

2.4.2 The impact of extra budgetary[174] resources

The expenditure performance at all levels of government is not only dependent upon the budgetary resources allocated and made available to each level of government, but also the extra-budgetary resources which are available in the region. Normally, the budget laws of each government show its own revenue sources and finance secured from other sources. The federal budget is composed of revenue derived from federal tax sources, from foreign aid and foreign loans. The budgetary sources of the regional governments are comprised of their own revenue and the federal subsidy, the latter comprising of finances from the federal treasury, external assistance and loans. There are also sources which are distinguished from the normal budget statute, but may have a considerable impact on the capacity of regions in their effort to implement their responsibilities. These sources may emanate from donor institutions and governments, non-governmental organizations -NGOs (local or international) - or from the institutions of the federal government.

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[172] However, any substantial federal spending could be subject to evaluation along the ethnic lines, as the federal system is characterized by its aim to ease interethnic disparities and tensions.

[173] Paul H. Brietzke, 'Ethiopia's Leap in the Dark: Federalism and Self Determination in the New Constitution', (Journal of African Law vol. 39, no. 1, 1995), p. 25.

[174] Extra budgetary ('off-budgetary') resources refer to resources that might actually be utilized by a government administration but are not accounted for by a regional budget law and not formally accounted for by the regional government. Budgetary resources mean resources and expenditures included and accounted for in the regional government's budget. World Bank *et al*, 'Public Expenditure Review Report of Tigray Region, 2001,' p. 11.

NGOs operate in different regions. National NGOs start to operate in these places only after fulfilling the legal requirements and obtaining the necessary permission from the Ministry of Justice, while regional NGOs obtain permission from a regional justice bureau. Most region-based NGOs have been mentioned as the major actors at the local level in assisting the poverty alleviation scheme. However, there are controversies as to the extent of the variation in the number of NGOs working in the regions, and whether the targeted groups are the real beneficiaries. A general survey on the public expenditure of some regions shows that NGOs play a prominent role in providing extra budgetary resources and, accordingly, have a considerable impact on the overall performance of the regions.[175] It also demonstrates the variation in these institutions in upgrading the overall performance of the regions.

The survey in the Benishangul-Gumuz and Tigray regions illustrate two contrasting realities. In addition to the basic budgetary resources, both regions benefit from extra-budgetary resources being made directly available to the sector bureaus by some UN agencies, bilateral donors, NGOs and federal institutions. The extra budgetary resources available in the Benishangul-Gumuz region over five fiscal years (1996/97-2000/01) amounted to about 70.34 million *birr*.[176] Over one-third of the amount, however, came from a federal institution in support of community-based activities (elementary education, the provision of clean water, health centres).[177] The amount of extra budgetary resources made available to the region was very small, almost 15 million birr per year, compared to the other region (Tigray).

The review of Tigray's extra-budgetary resources (from donors, NGOs, federal institutions, and relief food aid) shows that the region has a higher flow compared to others. The 'off-budgetary' resource flows (including the cost of food aid) during the fiscal year 1998/99-2000/01 was almost equal to the budgetary resources of the region. It doubled the total resource flows during the period mentioned above (that is, the government budget was 340 million birr per year, and an almost equal amount was generated through off-budgetary resources).[178]

According to the review, the region obtained direct support from international donors such as the Irish aid, USAID, German aid, and multilateral institutions such as the World Bank, WFP, UNICEF, and UNDP which are very active in directly supporting the region. The major NGOs include, *inter alia*, Farm Africa, the region-based 'NGOs' such as REST (the Relief Society of Tigray) and TDA (Tigray Development Association). Most of the activities of REST are funded by international governmental and non-governmental donors which has enabled it to play a major role in food distribution, agriculture and natural resource management. The TDA is mainly funded by the people of the region both living in the region and abroad. These organizations work in collaboration with the sector bureaus of the regional government.[179] The direct support (resources) which these local NGOs generate for the region may not have any impact upon the flow

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[175] See the Regional Public Expenditure Review Report of Tigray and Benishangul-Gumuz Regions, World Bank, *et al*, 2001.
[176] World Bank, 'Public Expenditure Review Report of the Benishangul-Gumuz Region', 2001.
[177] *Ibid.*
[178] World Bank, *et al*, 'Public Expenditure Review Report of Tigray Region', 2001, p. i, and 13-16.
[179] Actually it is very hard to make a distinction between the local NGOs and the regional government.

of resources from the centre. For instance, although REST receives specific support (food aid) from the EU or USAID, the region may still receive aid from the federal DPPC and WFP.[180]

Normally, all regions obtain benefit from businesses and industrial developments in the respective regions due to the reason that they increase revenue capacity, level of employment and provision of services. In this regard, there are suspicions and allegations that the Tigray region obtains support from businesses run by EFFORT affiliated to the local NGOs and TPLF. These business enterprises established with a paid up capital of more than 1 billion Ethiopian birr have dominated business in the country.[181] There are also unsettled issues as to who owns them (individuals, the political party, NGOs or the people), whether they serve to promote a political interest, whether they obtain support from the ruling party to unduly promote business interests and whether there is unfair competition with regard to private business. The law of the land should govern the operation of such business enterprises. Particularly, the law which forbids political parties engaging in business should be respected.[182] Nonetheless, the budgetary review claims that the development of these enterprises has augmented the capacity of the region to become competitive in the economic activity of the country.

All the extra-budgetary resources and the businesses play a major role in implementing the expenditure responsibilities assigned to the region. Further, they contribute to the socio-economic development of a region; they increase the GDP, per capita income, and alleviate the problem of unemployment. The structure and performance of the institutions, the level of industrialization, the growth of per capita income and GDP in a region demonstrate the benefits of self-administration.

Federalism, however, does not promote absolute interstate competition and does not tolerate merely any form of disparity between the states. Rather, it calls on the centre to take a concerted effort to bring them to a comparable financial capacity by implementing a transparent and fair transfer mechanism. The return from private investment (domestic and foreign) may also have an impact on increasing disparities. It is therefore recommended that the extra budgetary sources should be considered concerning at least two aspects. First, the policy of the government that aims to consolidate all foreign aid in its budget and to determine the share of each region should be transparent. It should, at least, identify the sources that have to be consolidated with the planning process and resources which can directly flow to the regions.[183] Second, the impact of extra-budgetary sources in addressing some of the expenditure needs of the regions should be taken into consideration in the actual assessment of federal revenue transfers (see Chapter VII).

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[180] The World Bank, *et al*, report states that Tigray probably ranks very high compared to other regions in its capacity to mobilize NGOs and donor resources; World Bank *et al*, 'Public Expenditure Review Report of the Tigray Region', 2001, p. 39. For a detailed description of the budgetary and extra-budgetary sources of the Tigray region, see the same report

[181] Merera Gudina, *op. cit.*, p. 150 & 174.

[182] See Proclamation No. 64/1993, Electoral Law of Ethiopia Proclamation; and Proclamation No. 111/1995, a proclamation to make the electoral law of Ethiopia conform with the Constitution of FDRE.

[183] See Gizachew Bizuayehu, 'Integration of NGO Intervention into the Planning Process' (Quarterly Magazine, MEDAC Vol. 3, No.1, Addis Ababa, 1998).

2.4.3 *The capacity constraints*

It is sometimes argued that the devolution of power to the lower level of administration requires well-trained staff and effective government. The importance of administrative skill and capacity cannot be underestimated, but should not be set as an absolute precondition for decentralizing power. One of the reasons is the difficulty of setting a standard for the capability of carrying out responsibilities. On the other hand, completely underestimating the importance of capacity also has the danger that the implementation of decentralized responsibilities will be hindered and the disparities between the regions will be widened. In a federal system where regions compete for better performance the impact of capacity is an evident factor.

In a country which is large and varied, like Ethiopia, the importance of decentralizing power has been promoted as opposed to centralized structures. However, it is apparent that some of the regions (Afar, Somali, Gambela, and Benishangul-Gumuz) have suffered from a lack of skilled capacity relative to other states such as Tigray, SNNPR, Oromia and Amhara. The danger is not only the variation in capacity, but also inefficiency in using the limited available resources and the lack of readiness to employ appropriate measures. In this regard, one of the aggravating factors could be the reluctance of the regional based ethnic parties to secure the free flow of labour despite individual ethnic background. Although the gravity of the shortage of capacity in some regions has been indicated, there is a widespread problem at the regional as well as at the federal level. With a view to rectifying these problems, the federal government has taken several measures in addition to the financial support it devolves to the regions. It provides short and long-term training programmes at the Ethiopian Civil Service College, has adopted an ambitious capacity building civil service reform programme and provides special support to the least developed regions.

Decentralization inevitably involves some kind of duplication of functions and responsibilities at several levels whereby the governments may suffer from scarce resources, a shortage of skilled and efficient administration and less productive functions. The immediate remedy could be the asymmetrical distribution of responsibility depending on their capacity. The administration may become effective, for example, by isolating functions demanded by urban areas as opposed to rural ones. For a better and salutary effect, it is suggested that there should be institutionalized intergovernmental cooperation, vertically as well as horizontally, in order to enhance the performance of governments.

2.4.4 *The dangers of corruption*

It is observed that substantial powers and responsibilities devolved to the regional governments after the change in government in 1991. This has the objective of a better performance of expenditure responsibilities and addressing local preferences. However, in order to properly discharge responsibilities, there should be a clear division of powers and concomitant financial resources. But in practice the centre retains a wider discretionary power and substantial financial resources. The reasons could be partly a lack of accountability and the dangers of corruption at the regional level. Some have argued that because of lax financial administration and insufficient auditing systems corruption has become increasingly more prevalent at regional and local levels than at the federal level. Corruption in general is a daunting problem. But it is not evenly distributed throughout the regions. The problem of rampant corruption in the infamous

regions of Afar and Somali is also attributed to their low level of development. This is consistent with the assertions by Prud'Homme, who in his studies forcefully warns against the dangers of decentralization and says that:

> Local politicians and bureaucrats are likely to be more subject to pressing demands from local interest groups (whose money and votes count) in matters such as taxation or authorizations... On the other hand fewer obstacles to corruption exist at the local level. Corruption in many cases requires the cooperation of both politicians and bureaucrats, and the distinction between them is generally less rigorous at the local level.[184]

These reasons cannot be sufficient to argue that by reversing decentralization the problems could be avoided. This is because the solutions applied at the centre should also be used at the local level. Moreover, the reasons mentioned above by Prud'Homme are also common at the centre. They also provide a convincing argument that corruption is an obstacle to executing responsibilities and to development. However, it is not possible to conclude that corruption is evenly distributed among the lower levels of government. But its impact on implementing the responsibilities is greater in places where it is rampant. It is not only the direct impact of corruption that increases interstate disparities, but also the correlated impact of combating the corruption itself. The fight against corruption 'increases cost, favours ineffective technologies and wastes time'[185] and, therefore, affects the performance capacity of the regions.

2.4.5 The impact of political conflicts

In many parts of the member states there have been or are currently conflicts between several groups existing within a region and this has an impact in one way or another as regards the capacity to implement the responsibilities. The conflicts in the Gambela and Benishangul-Gumuz regions have been between the major ethnic groups existing within the regions. In Gambela, the conflict between the Agnuak and the Nuer is aggravated especially after the Agnuak lost their dominance in the regional government. Until very recently, the Agnuak retained power with the help of the EPRDF and also brought about the intervention from the centre. Although the Nuer people are the majority, they have been marginalized from sharing power in the region. The reason for this is mainly historical since they had collaborated with the Dergue and had been engaged in assisting the SPLA (Sudanese Peoples' Liberation Army). But the Nuer's discontent has led to a power rivalry between the two ethnic groups, which ultimately resulted in the absence of stable government that can deliver good administration. The major reasons for this rivalry between them are the refusal of the minority to share power with the majority, and the absence of an equitable share of resources.[186]

Similarly, the two major ethnic groups in the Benishangul-Gumuz region, the Berta and the Gumuz, were in conflict until a new political party was formed by the assistance of the EPRDF in 1998 (the Benishangul-Gumuz Peoples' Democratic Unity Front BGPDUF). In Somali, there have been conflicts between different clans or tribes following the conflict between parties or individuals who

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[184] Prud'Homme, *op. cit.*, p. 10.
[185] *Ibid.*
[186] Interview with a Member of Parliament, November 2002; Getachew Assefa, 'Protection of fundamental rights and freedoms in the Ethiopian federalism,' A paper presented to the Conference on Ethnic federalism in Ethiopia, 2003, p. 18. Since December 2003, the Agnuaks have also been attacking peoples of other 'nations and nationalities', often called as *highlanders*, who live in the region.

were in power. The Ogadens, for instance, used to dominate the politics after the fall of the Dergue but later refused to share power in the government. They have now resorted to an armed struggle. In Afar, during the transition period, the ALF and ARDUF had shared power but were later replaced by the Afar National Democratic Party (ANDP) which is now affiliated with the EPRDF. In Harari, although the Oromo and the Amharas are the majority living in the city, the Harari people have control of the government and also have a power of veto in the regional council. The party in power is the Harari National League which is affiliated to EPRDF.

The situation in the SNNPR was gradually evolving as the most threatening factor even to the viability of the region, if not to the federation. The region is the most ethnically heterogeneous with the number exceeding fifty.[187] During the establishment of the regional governments in 1992, it was organized into five regions which later merged together to form the SNNPR. Although there already existed independent parties when the region was formed, EPRDF organized and supported its own wing the 'Southern Ethiopian Peoples' Democratic Front' (SEPDF) a coalition of several ethnic-based 'democratic organizations'. It was usually mentioned as the weakest member of the ruling party due to a lack of institutionalized strength. The major administration problem which the region faced was related to the political structure of the SEPDF which controlled the regional government. There were many 'democratic organizations' named after each nation and nationality who shared power at the subregional levels. Each of the member organizations of the front solely represented the group on which it is based, controlled the administration at the zone or wereda level, and organized the police force which was primarily loyal to the party.[188] For example, the Sidama Peoples' Democratic Organization controlled governmental power in the Sidama zone. The highest officials of the ESPDF controlled the regional administration and remained at the region's capital (Awasa) whereas the member political organizations predominantly controlled the subregional administrative levels. However, there was no hierarchical relationship between the levels of government. Accordingly, the subregional administrative levels were not accountable to the execution of the budget and there was no meaningful evaluation at the institutional level. In general, EPRDF has reported that the political organizations that were organized along ethnic lines had become absolute autocratic organizations and finally brought about a situation of state failure in the region.

As a result of the above problems, EPRDF and SEPDF held a series of conferences and reported the following: first, the concept of self-administration was misunderstood by the authorities who caused a rift between the regional and the zonal/wereda administrations. Second, the financial resources divided between the levels of administration were not accounted for by the zonal or wereda

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[187] Historically, the region was administered under three different provinces - Sidamo, GamoGofa and Kafa.

[188] Interview with Ato Assefa Kesito (SNNPR), November 2002. In this regard, it is important to note Stedman's argument. He says, 'If ethnic groups or classes or political parities can capture the machinery of state, they can use the identity of the state to justify their domination and exploitation of the population. By justifying their power and advantage with reference to pursuing the state interest, elites in the power obfuscate the relationship between regime and state so as to give the pursuit of private interest where political parities are based on ethnic identity and represent a smaller community at the expense of other communities. 'Stephen J. Stedman, 'Conflict and Conflict Resolution in Africa: A Conceptual Framework', in F.M. Deng and L.W. Zartman (eds.) *Conflict Resolution in Africa* (The Brookings Institution, Washington D.C. 1991), p. 376.

administrations. Third, the region, which was praised as the symbol of a successful multiethnic federal system, had fallen into the hands of local tyrants who neither represented the interest of the local people nor the interest of the region as a whole. This political turmoil has brought about a lack of good governance in the region which was manifested in an inability to use the financial resources for the provision of goods and services to the residents. Further, members of the local political parties sponsored acts of human rights violations, were engaged in mass killings, and failed to engage in development activities. As a result the SEPDF, which was declared the winner of the elections and controlled the administration of the region, was dissolved and reorganized in 2002. Although the history of the SNNPR implied the otherwise weak functioning of the administration and a troublesome region, now there is a speculation that the newly reorganized political organization will be relatively capable of rendering effective administration.

Despite the fact that there have been several forms of political conflicts in the above mentioned regions, the regional political organizations have survived to run the governments due to the powerful centralized political structure that has existed in the country. The regional governments are assisted, monitored and at times dominated by the representatives of the TPLF (representing EPRDF). But this also implies that the conflicts have led to a disparity with the other relatively stable regions. Further, in the above cases those parties or individuals in power were much more concerned with their accountability to the EPRDF. Therefore, it is recommended that this upward accountability should be dominated by process of accountability to the local people.

The situation in Amhara and Oromia is somewhat different. These two large regions are controlled and administered by the coalitions of the EPRDF - ANDM and OPDO. Although many opposition parties claim that they have substantial support in these regions, they were not able to challenge the power base of the ruling party. However, these two seemingly powerful and relatively developed regions have experienced similar problems in the administration of the regions: they have a major problem in mobilizing skilled labour for development activities. The situation in Oromia is a little different. There is heightened tension compared to the Amhara region due to the Oromo Liberation Front (OLF) which has declared an armed struggle against the government.

Besides the conflicts and the tense political situations described above most of these regions have also experienced some difficulties. Regions such as Benishangul-Gumuz, Gambela, Afar and Somali have been created during the post-1991 period and as administrative units they have little experience. But Tigray and Harari regions, and Dire Dawa and Addis Ababa Administrative Councils may benefit from the administrative experience they had before the introduction of the federal system. For example, until 2001 Tigray was a single administrative province, while Harari was the seat of an administrative province and had a municipal administration. Similarly, the Oromia and Amhara regions have combined several former administrative provinces so that they have benefited from the pre-existing administrative structures. They also are very big in terms of size and population. However, although they have the potential to dominate the other member states of the union, they do not seem to benefit from these asymmetries to effectively administer and provide the required public goods and services. The performance capacity of the regions is better in the regions with a manageable size.

Tigray also benefits from the relatively 'ethnic homogeneity and conerent political organization' in the region.[189] Although it is not uncommon to identify someone in terms of his/her locality (*awraja),* the people speak the same language and the TPLF forged unity because of its influence during the struggle against the Dergue and its command over the region for a long period of time. Because of the close relationship between the people and the TPLF, there is a little room for opposition or political conflict in the region.[190] Moreover, it is the senior partner in the EPRDF and, therefore, has a strong influence at the federal level as well as in the regions controlled by the EPRDF.[191] As a whole, the better regional autonomy which Tigray enjoyed, TPLF's acceptance as the legitimate ruler of Tigray, and the effective control which TPLF has over the administration make conflict less probable in the region at present. This stable situation has created an atmosphere conducive to the effective implementation of expenditure responsibility.

In sum, although powers and functions have been distributed between the member states and the federation, the state governments should be able to contain conflicts and effectively implement their responsibility in order to achieve comparable growth in socio-economic developments. If, on the contrary, some regions remain languishing in political turmoil, they remain behind others in the provision of public goods and services to their inhabitants. Political stability at all levels of government is then the basis for discharging their responsibilities. If, however, conflict prevails, it may widen the disparity between the regions, and it may ultimately extend to endangering the union itself.

3 CONCLUSION

This chapter has analysed the division of expenditure responsibilities as laid out in the FDRE Constitution and the general trends of implementing the responsibilities at the subnational level. From the analysis the following conclusions can be drawn.

First, with regard to the distribution of powers and responsibilities the Ethiopian Constitution provides exclusive powers and functions to the two tiers of government by explicitly reserving the residual powers to the states (except the residual taxes awaiting the decision of the Federal Houses). The division of executive power generally follows the legislative power, unless otherwise provided or unless the centre delegates its power to the states. An examination of the division of expenditure responsibilities in Ethiopia shows that the regions are important actors in major areas of public interest. However, its drawbacks emanate from the failure to recognize the disparity between the constituent units and to provide a *de jure* asymmetrical power distribution or asymmetrical intergovernmental relationships, as well as from the lack of explicit constitutional recognition of shared powers.

Second, the existing interstate asymmetry has made necessary an inter-governmental cooperation between the federal government and the regions. But the existing mechanisms operate under the dominance of the central government mainly through informal ways or through a centralized party structure.

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[189] Aalen, *op. cit.*, p. 90.
[190] *Ibid.*
[191] *Ibid*, p. 92-93.

Third, despite the fact that the federal arrangement is believed to help address the issues of proportional regional development, some of the trends of expenditure performance demonstrated factors which can aggravate regional disparity. In general, a low level of capacity to implement functions is observed in the relatively less developed or historically marginalized places. But factors such as the policies and operations of direct federal spending, extra-budgetary flows to a region and interethnic conflicts could have counterproductive effects on the federal system and need to be addressed promptly.

Although the Ethiopian federation *de jure* allocates powers symmetrically, we have looked a little more deeply into the *de facto* federation that influences the implementation of expenditure responsibilities. In order to improve the situation, the budgetary process itself also has to be taken into account. Parliament should review whether federal expenditures in the regions have been fairly distributed. The impact of extra budgetary resources should also be taken into consideration in the revenue transfer mechanisms (see Chapter VII). Further, there should be a lasting solution to the legal issues surrounding political parties and their businesses.

Therefore, it is suggested that, first of all, the existing rules (see also Chapter VII) should be reconsidered in order to create close connections between public expenditure and fair distribution of revenue. Factors that can improve the administrative capacity must be taken into consideration, at least by promoting intergovernmental cooperation or by securing the free flow of labour despite individual ethnic background. Further actions for promoting public participation, transparency, rules and accountability measures should be developed. The transparency of the budgetary process not only allows the citizens to control the (state or local) government more effectively, but also gives them the opportunity to compare the results of different jurisdictions at the same level. Coordinating the budgetary process and promoting cooperation towards adopting similar budget formats can also facilitate the budget evaluation process. Above all, a 'fiscal discipline' that might reduce any form of public fund embezzlement should be a target.

The impact of capacity constraints at all levels cannot be underestimated, but the major obstacle is a lack of institutional capacity at the subnational levels. Thus, several measures must be taken to improve the technical and administrative capacity of local levels, if not also at the central level. The measures could target the technical capacity by 'reforming recruitment policy (competitive hiring), pooling the services of the professionals, sharing equipment, or outsourcing services to private providers. Technical knowledge can also be borrowed from higher-level governments. Moreover, decentralization can be adapted or organized according to the capacity of each subnational government to provide public services (asymmetric decentralization).'[192] This requires amending the organization of states to a manageable size and designing effective intergovernmental institutions.

[192] Richard Bird, *et al*, op. cit., p. 368.

When we discuss federalism, we are not limited to the study of the autonomy of each tier of government and the protection of citizen's civil and political rights.. We are also concerned with the means for discharging all the responsibilities borne by the government. These are the monopolistic powers of taxation. The exercise of the power of levying and collecting taxes by a state should be a reflection of the people's control over the political power. In other words, there must be a direct relationship between the power of the state and the power of the people. That is to say, if people are taxed in order to finance a government for the purpose of discharging its responsibilities, they should have a decisive role in determining the nature of government to underline the political legitimacy of the government. Thus, the people must have the power to select the persons who are in power in the government, to reject them freely if their decisions are unsatisfactory, and, they must also have the opportunity to participate in and influence the decision-making process. Defining this relationship between the people and the government is one of the basic principles of a democratic government – 'there can be no taxation without representation and consent'.[2] In general, the discussion of federalism, democracy and taxation in a government which is constitutional must uniformly apply to all tiers of government - central, regional and local.

Thus, when considering the above concise delineation of democratic norms, several issues can be raised concerning the distribution of revenue sources. The most concise question is: How do federations allocate the revenue-raising powers between the tiers of government? This chapter mainly addresses how the FDRE Constitution has dealt with this issue, as well as the major problems which the tiers of government may face in exercising their powers.

2 GENERAL REMARKS ABOUT TAXATION

Revenue, as a source of financing, is often supplied by the instrumentalities of taxation. There are also other sources of non-tax revenues such as fees and charges that may have implications for the financial autonomy of a government and are thus sometimes treated as taxation powers. This is because they do not create administrative difficulties in their application from the point of view of federalism. There are also non-tax methods of financing government expenditure: foreign loans, aid, borrowing, and the selling of property and treasury bills. However, the major financial resource of government in order to achieve the desired objectives is tax. At this juncture it is relevant to elucidate some basic points concerning taxation.[3]

Tax is a burden or charge which is only imposed by the legislative power on persons or property to raise money for public purposes. Tax is exacted not on the basis of direct *quid pro quo* relations. Moreover, the payment of tax can not

[2] This universal principle traces its origin to the *Magna Carta* of 1215, which was used by the early English judges to develop rights against the arbitrary exercise of the monarchical prerogative. J. C. N Paul and C. Clapham, *Ethiopian Constitutional Development*, vol. I (Addis Ababa, oxford Univ. press, HSI University, 1967), p. 75-76.

[3] For a general discussion of the concepts of tax, see Musgrave, *Public Finance in Theory and Practice*, 5th ed. (1989), p. 211-217; H.L Bhatia, *Public Finance*, 19th ed. (Vikas Pub. New Delhi, 1996), p.37-50

be imposed except by law. Therefore, developing tax legislation requires proper consideration in order to achieve its objectives.[4]

As a major source of raising government revenue, tax in either a planned, mixed or liberal market economic system plays several additional roles.[5] Tax serves as an income distribution mechanism. The distribution of income and wealth among the members of a society is one of the functions of a government. The government performs this function through the mechanism of fiscal policy, particularly through tax. Tax also plays an important role in stabilizing the economy. As an essential component of fiscal policy, tax aims to bring about high employment and acceptable price levels.[6]

In a market economy, the private sector participates in planning and implementing development projects. The government also designs incentive schemes to maximize the use of private capital. Such incentive schemes can be utilized through taxation by introducing exemptions, deductions and depreciation mechanisms in order to stimulate the private sector to participate in the overall economic development endeavours of a country. It also plays an important role in guiding the movement of private capital towards areas given priority within the economic policy. The tax incentive scheme, for instance, could be designed to deflect capital towards activities favoured by the policy or towards hardship and less developed areas.[7]

Usually, tax bases are classified into direct and indirect, or tax in *persona* (individual) and tax in *rem* (property). In any tax legislation defining the tax base together with its appropriate rate is emphasized. In this regard, tax on income is the most discussed issue. For example, in levying income tax, there are two methods for fixing rates: the 'global' and 'scheduler' method.[8] By global, we mean all income obtained either from business or employment added together and taxed as such. This complicates the administration and the payer may become exposed to a higher percentage of rates, particularly in the case of progressive taxation. In a scheduler system, a specific rate is imposed upon the appropriate category of income. This is easier to handle and also offers an opportunity to impose progressive taxes.

In developing tax legislation, tax jurisdictions must be established. There are two principles in establishing tax jurisdiction.[9] A state following the 'territoriality' principle (source method) has taxing power only if the activity that produces the tax base is carried out within a country. If, on the other hand, a state follows the 'personality' principle, also called the 'worldwide income' method, it has the power to tax its nationals or residents irrespective of the place where the income is derived. In international transactions, adopting either of the principles may not suffice, since a conflict may arise resulting in double taxation. So, international agreements may be called for.

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[4] Geoffrey Morse and David Williams, *Davies: Principles of Tax Law*, 4th ed. (Sweet & Maxwell, London, 2000), p. 4-6.
[5] *Ibid.*
[6] *Id.*
[7] The Ethiopian investment code provides incentives in areas specified under the law through exemptions from taxes. For instance, see Proc. No. 15/1992 Encouragement, Expansion and Co-ordination of Investment; and Council of Ministers' Regulation to provide Investment Incentive, No. 7/1996.
[8] For a detailed analysis, see B. J. Arnold and M. AcIntyre, *International Tax Primer*, (Kluwer Law International, Den Hag, 1995), p. 19-32.
[9] *Ibid.*

In developing tax legislation, different social and economic interests are relevant. Thus, in order to develop a fair tax structure, there is a need to balance the various interests. Taking these interests into consideration, many authors have enunciated the following principles:[10]

- The distribution of the tax burden should be equitable; everybody should be made to pay his/her fair share proportional to income (canon of equity),
- Taxes should be chosen so as to minimize interference with economic decisions in otherwise efficient markets (canon of efficiency),
- The tax structure should facilitate the use of fiscal policy for stabilization and growth objectives;
- The tax system should permit fair and non-arbitrary administration and it should be understandable to the taxpayer;
- Administration and compliance costs should be as low as compatible with other objectives. (should be economical to collect).

3 GENERAL PRINCIPLES OF THE DIVISION OF TAXATION POWER

3.1 Some economists' theories for the division of taxes

Much of the discussion on the principles for the allocation of taxation powers has been carried out by economists in deciding which type of tax can be assigned to which tier of government. The traditional normative view set out by Musgrave enumerates the principles which, according to him, can secure independent autonomy and efficient utilization of resources by the two tiers of government. Thus he proposes:

1. Taxes suitable for economic stabilization should be central; lower level taxes should be cyclically stable;
2. Progressive redistributional taxes should be central;
3. Personal taxes with progress rates should be levied by the jurisdictions which are most capable of implementing a tax on a global basis;
4. Lower-level governments should tax bases with low mobility between jurisdictions;
5. Tax bases distributed very unequally between jurisdictions should be centralized; and
6. Benefit taxes and urban charges might be appropriately used at all levels.[11]

Some others, such as Roger Gordon, have analysed the principle of tax assignment based on the theory of 'optimal taxation' by trying to address the problems that may arise from decentralizing taxation powers.[12] According to him, the assignment should be seen in the light of the externalities effect that may occur as regards non-residents when a subnational government exercises its expenditure and taxation autonomy. Von Hagen further explained the cases of inter-jurisdictional tax *spillovers*.[13] According to him, this may occur when tax is

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[10] The four major canons were initially enunciated by Adam Smith in his book 'The Wealth of Nations'; see Bhatia, op. cit., p. 43-50.

[11] R. Musgrave, 'Who should tax, where and what? 'in Charles McLure, (ed.) *Tax Assignment in Federal Countries*, (The Australian National University, Canberra, 1983), p. 11.

[12] Roger H. Gordon, 'An Optimal Taxation Approach to Fiscal Federalism,' in Charles McLure (ed.), *Tax Assignment in Federal Countries*, (The Australian National University, Canberra, 1983), p. 26-38.

[13] Jurgen von Hagen, 'Fiscal Federalism and Political Decision Structures', Raoul Blindenbacher and Arnold Koller (eds.), *Federalism in a Changing World – Learning from Each Other: Scientific Background, Proceedings and Plenary Speeches of the International Conference on Federalism 2002* (Montreal & Kingston, McGill-Queen's University, 2003), p. 383.

exported to other jurisdictions as a result of buying a product produced and taxed in another locality. In order to reduce the externalities effect, Gordon proposed to identify those taxes, for example company tax, which cause that effect and to assign them to the centre, while addressing the financial costs of the units (revenue which could have been collected from these taxes) through revenue-sharing mechanisms.[14] By doing so, the objectives of decentralizing taxation power can be attained.

The other approach to the problem of the division of taxation powers is viewed from the effectiveness of taxes. Tax should not be assigned to be collected by any predetermined level of government although it seems convenient at the local or central level. The formulation for tax assignment, argues Russell Mathews, should be based on the assumption that tax avoidance and tax evasion is the general behaviour of taxpayers rather than taking tax compliance for granted.[15] According to him, unless the behaviour of taxpayers is taken into consideration it could be difficult to effectively address the issues of the tax rate structure, the definition of the tax base and assessment procedures. Therefore, in order to bring about equitable tax allocation between subnational jurisdictions and to achieve the income redistribution role of the centre, the response of taxpayers to a particular tax must be evaluated. According to this principle, there should be an equitable distribution of tax evasion in attempting to set equitable revenue capacity.[16]

The different perspectives appear to have arrived at similar conclusions with respect to the assignment of specific taxes.[17] As a whole, the general approach is to give the central government power over sources that can help to redistribute income and to stabilize the economy, whereas those immobile taxes which primarily provide a benefit to the local government are to be left to the subnational governments. To be more specific, they proposed taxes such as corporation income taxes and VAT to be assigned to the centre, whereas those taxes such as personal income taxes and retail sales taxes are to be left to the states.[18] This classification mainly fits the mobility/immobility factor of the tax bases. The theories also proposed that although some are immobile, they might be assigned to the centre because they are unevenly distributed between the subnational levels and may substantially result in horizontal inequities (such as tax on natural resources).[19]

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[14] Gordon op. cit., p. 26-38.
[15] Russell Mathews, 'Tax Effectiveness and Tax Equity in Federal Countries', in Charles McLure, *Tax Assignment in Federal Countries*, (The Australian National University, Canberra, 1983), p. 70-85.
[16] *Ibid.*
[17] C. McLure, 'Introduction. The Revenue Side of the Assignment problem', in Charles McLure, (ed.) *Tax Assignment in Federal Countries*, (The Australian National University, Canberra, 1983), p. xiv.
[18] *Ibid.*
[19] Arguments for a possible decentralization of tax on natural resources is presented by Peter Mieszkowski, 'Energy Policy, Taxation of Natural Resources, and Fiscal Federalism', in Charles McLure, (ed.) *Tax Assignment in Federal Countries*. (The Australian National University, Canberra, 1983), p. 129-145.

The above theoretical guidance seems to focus on the perspectives of the 'economic efficiency criterion', but there are also additional considerations. Anwar Shah summarizes the arguments that[20]

> *National equity* considerations warrant that progressive redistribution taxes should be assigned the national government. This assignment limits the possibility to attract high-income people and to repel low-income ones. The *administrative feasibility* criterion (lowering compliance and administration costs) suggests that taxes should be assigned to the jurisdiction with the best ability to monitor relevant assessments. The *fiscal need*, or *revenue adequacy*, criterion suggests that, to ensure accountability, revenue means (the ability to raise revenues from own sources) should be matched as closely as possible to expenditure needs.

The main question that follows is whether the practices of federations do correspond to the norms propounded by economists. In general, the assignment of each and every tax may not conform to the normative theories as suggested above. Some may fit within the suggestion and others may not. This is because the actual system of constitutionally dividing taxation powers is country specific due to evolution of taxation, experiences and political cultures, although federations do demonstrate some general principles.[21]

3.2 General constitutional methods for the division of tax powers

Theoretically, as a method of distributing taxation powers, the entire revenue sources can be given either to the centre or to the states, or can be divided between them.[22]

If a constitution prescribes complete authority over all aspects of taxation power to the states, they will be required to transfer part of their revenue to the central government through the system of 'upward revenue sharing'(others call it 'reverse revenue sharing').[23] This option is challenged since it does not facilitate the principal functions of the central government, such as income redistribution through the tax system, its stabilizing role and tax harmonization policies.[24] Furthermore, it may create reluctance on the part of states to participate in the central government particularly where there is considerable regional economic disparity. If a country opts for this approach it will be forced to embark on extensive negotiation between the centre and the states concerning revenue sharing.[25] Generally, this kind of approach requires a confederal format or a country with a strong tradition of close economic policy coordination.[26]

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[20] A. shah, 'Introduction: Principles of fiscal federalism', in A. Shah (ed.), *The Practice of Fiscal Federalism: Comparative Perspectives* ((Forum of federations, McGil-Queen's Uni. Press, 2007), p. 20

[21] Ewald Nowoton, 'Tax Assignment and Revenue sharing in Germany and Switzerland,' in Charles McLure, (ed.) *Tax Assignment in Federal Countries*, (The Australian National University, Canberra, 1983), p. 273.

[22] John Norregaard, '*Tax Assignment*', in Teresa Ter-Minassian (ed.), *Fiscal Federalism in Theory and Practice* (International Monetary Fund, Washington D.C., 1997), p. 50; See also The Federalist Papers No 30-36

[23] For a detailed argument in favour of reverse revenue sharing see Dwight R. Lee, 'Reverse Revenue Sharing: A Return to Fiscal Federalism', (Cato Journal, vol. 14, No. 1, 1994), p. 75-85

[24] Norregaard, *op. cit.*, p. 50; For a discussion of allocation, distribution and stabilization functions see R. Musgrave and P. Musgrave, (1989), op. cit., p. 6-14; Wallace Oates, 'The Theory of public Finance in a Federal System', in W. Oates, *Studies in Fiscal Federalism*, (Edward Elgar, Aldershot, 1991), p. 3-20.

[25] Norregaared, *op. cit.*, p. 50.

[26] *Ibid.*

If, on the other hand, the entire revenue sources are retained by the centre, subnational governments become fully dependent on the revenue transfer mechanisms. This option challenges the very principle of the devolution of powers and responsibilities to subnational governments. Therefore, the usual trend followed by most federal systems is to divide the revenue sources between the federation and the states. But this option is not as simple as it appears. As a general principle, there should be a framework in which each tier of government can levy or generate its own finance without there being a conflict between them. In practice, however, the degree of tax autonomy enjoyed by the state governments demonstrates wide variations. This can be attributed to the method for the allocation of powers as envisaged by the various constitutions. We can distinguish three methods:

First, exclusive power of taxation: the constitution may assign several tax sources to the federal government and to the states separately, allowing each to have exclusive tax powers within its own sphere.[27]

Second, concurrent power: the constitution may allow both levels of government to exercise the power to legislate, collect and appropriate in relation to some or all taxes. This system entails the concurrency of specific types of taxes exercised by both levels of jurisdiction, which may lead to competition between them.[28]

Third, shared power of taxation: the constitution may in principle reserve the power of legislation and levying taxes to the federal level, but guarantees the states' right to some or all of the proceeds from specified taxes.

Let us discuss them in order in relation to federal constitutions that exhibit the above patters of distribution of tax powers.

If the federal or regional governments have an independent power of taxation on a particular thing, business or category of persons, there is said to be an exclusive taxation power.[29] The exclusive taxation power may simply follow the general division of legislative powers. That is, in principle, each tier of government can impose all types of taxes upon all revenue sources the subject-matter of which falls within the boundary of legislative power.[30] It can also exist where the right to impose a particular type of tax is constitutionally assigned to the federal government or to the states only, or to both levels of government.[31] The exclusive taxation power can exist in cases where each level of government

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[27] Werner Heun,, 'Budgetary Federalism: Balance of Interests and Contradictions, German Reports on Public Law,' in Eibe Riedel (ed.) *Stock Taking in German Public Law* (Baden and Baden, 2002), p. 224.

[28] Cheryl Saunders, 'Budgetary federalism and balance of interest and contradictions,' paper presented to the XVIth International congress on comparative law, Brisbane, 14 to 20 July 2002, p. 7.

[29] However, some constitutions authorize the federal government to enact laws with respect to the exclusive tax powers of the states. For example, the Swiss Constitution confers on the central government the power to enact uniform regulations with respect to tax on exemption from military service which is the exclusive taxation power of the cantons. Art. 59(3) of the Swiss Constitution.

[30] Heun, *op. cit.*, p. 224.

[31] The Constitution of Brazil is a typical example by providing exclusive taxes to the centre, the states and the municipalities. Arts. 153, 155, 156 of the Constitution of Brazil.

is constitutionally authorised to impose the same type of tax but upon different subjects.[32]

A concurrent power of taxation, in general, exists where the federal government and the states have equal constitutional authority to levy the same kind of tax with respect to the same category of persons, business or particular thing.[33] In principle, each level of government is entitled to exercise the power of taxation independently of the other. But constitutions vary in providing concurrent taxes. A concurrent tax power is a dominant feature of the Constitutions of countries such as the USA, Canada and Switzerland. In principle, it is a characteristic of the federal principle that gives utmost regional autonomy over tax legislation, administration and the execution of revenue that accrues from several tax sources. However in some cases, concurrent power may apply to specified types of taxes, while in other cases it may apply to all types of taxes.

The Constitution of Canada, for instance, provides for the application of concurrent powers to a certain extent. It empowers the states to levy direct taxes only. On the other hand, the federal government is authorized by the Constitution to raise revenue by any method of taxation.[34] Hence, the federal government and the states have concurrent power in the sphere of direct taxation.

Compared to the other federations it is the Constitution of the USA that confers the widest range of concurrent powers. For instance, both the federal government and the states can impose individual and corporate income, payroll and excise taxes on such items as motor fuel, alcohol and tobacco products.[35] The federal government of the USA draws its taxing power from Art. I (8) of the Constitution which affirms that Congress has the right to levy and collect taxes, duties and excise charges. The taxing power of the states, on the other hand, is implied from the federal structure itself and the constitutional provision that affirms all powers which are not specifically denied by the Constitution.[36] However, this seemingly equal constitutional authority in taxation has sometimes led to duplication and inconsistency on the part of federal and state tax laws. Nevertheless, the 'supremacy clause'[37] of the Constitution appears to have reduced these problems with the effect of restricting the power of the states. As a result, the states have become increasingly dependent on federal grants as the federal power of taxation has expanded.

Besides the division of exclusive and concurrent powers of taxation, a number of countries demonstrate shared taxes where the taxing powers of the centre and the states have been elaborated on the basis of the division of powers and functions inherent in the taxation power. The power of taxation can be envisaged as a bundle of law-making powers, the administration of tax laws and the right to

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[32] For instance, in Australia and India corporate and personal income tax is the exclusive authority of the central government.

[33] Heun, *op cit*.

[34] Art. 91 (3) and 92 (2) of the Canadian Constitution.

[35] Bradly C. Karkkainen, 'Conceptions of Fiscal Federalism: Dual and Shared Sovereignty' (2 Colombia Journal of European Law 565, 1996), p. 566-567.

[36] Art. 10 of the Bill of Rights Amendment. The constitutional limits on the power of taxation are discussed infra Section 5.

[37] The supremacy clause is provided under Art. 6(2) of the U.S. Constitution which reads: 'This Constitution and the Laws of the United States which shall be made in pursuance thereof; and all Treaties made or which shall be made under the Authority of the United States shall be the Supreme Law of the Land; and the judges in every State shall be bound thereby.'

appropriate the levied tax (irrespective of who administers the law). Thus, one level of government may enact laws, the other may administer the law to collect the levies, and still others may be entitled to the proceeds arising from the tax.[38]

The constitutions of several federal systems exhibit instances which have been worked out on the basis of the above principle. The Indian Constitution, for example, gives the federal government the power to impose 'such stamp duties and such duties of excise on medicinal and toilet preparations as are mentioned in the Union List.'[39] Nonetheless the collection of revenue from these sources is assigned to the states. Similarly, the federal government has the power to legislate and collect 'taxes on the sale or purchase of goods and taxes on the consignment of goods' but the net proceeds from these levies are assigned to the states, and distributed among the states in accordance with such principles of distribution as may be formulated by Parliament by law.[40]

The German Basic Law is typical of the shared tax power. It separately indicates those taxes the proceeds of which belong to the federal government, the Länder and the municipalities, respectively, irrespective of which tier of government actually collects them.[41] It also prescribes the type of taxes the proceeds of which are shared by the two levels of government. According to Article 106 (3) of the Basic Law, revenue from income tax, corporation tax and turnover tax belongs to both the federation and the Länder. It prescribes that both levels of government have an equal share in the revenue derived from income tax and corporation tax while laying down the principles that guide the apportionment of the receipts from turnover tax.[42]

There are many arguments in favour of centralizing tax legislation and administration as in the case of Germany.[43] The uniformity of legislation can avoid the burden of different forms of taxation within a country. And, administratively, it is cost effective as taxation is imposed uniformly. Thus, individual taxpayers and firms face less hardship in complying with tax burdens. But it is less persuasive towards decentralizing taxation autonomy.

In federal practices one may observe centralization of tax power or some differences in implementing the constitutions which are attributed to the changes that occur overtime. Sometimes it is due to constitutional amendments, but in most cases due to other reasons. For instance, in Australia, the federal

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[38] Some federal constitutions not only indicate which level of government is entitled to the proceeds from a given tax but also specify the purpose for which the levied tax should be applied. For example, the Swiss Constitution provides that tobacco tax belongs to the confederation but it should be earmarked for old-age and surviving dependents insurance. Similarly, each canton has the constitutional obligation to spend at least ten percent of its share from the taxation of distilled beverages in combating the cause and effects of alcoholism. See Art. 131 of the Swiss Constitution.

[39] Art. 68 of the Indian Constitution.

[40] Art. 69 of the Indian Constitution.

[41] According to Art. 106 of the Basic Law, receipts from customs duties, road freight tax, capital transaction taxes, insurance tax, tax on bills of exchange, and income and corporation surtaxes accrue to the federal government. Revenue from property tax, inheritance tax, motor vehicle tax, beer tax and tax on gambling establishments belongs to the Länder, while the proceeds from tax on real property and trade accrue to the municipalities.

[42] The German taxation system is identified with a unified and centralized system with a subsequent sharing of revenues from shared taxes. According to Art. 106 (3) of the Basic Law, the respective shares of the federation and the Länder in the revenue from the turnover tax shall be determined by a federal law requiring the consent of the Bundesrat.

[43] Ewald Nowoton, *op. cit.*, p. 272

government has exclusive power over personal income and corporate income taxes, but not because the constitution forbids the states to exercise these powers. Rather, it is because during World War II they agreed to transfer taxation powers to the federal government in return for federal grants. And, following the tax reform in 2000, the Goods and Services Tax (GST, a kind of VAT) is collected by the centre and transferred to the states based on the recommendations of the Grants Commission.[44] In the USA, on the other hand, the judicial interpretation of the taxing and commerce clause has broadened the federal power. However, the federal government may not always impose its broader taxing power for the provision of services or the attainment of certain objectives. Especially when there is tension between the taxpayers' interest to pay less but a dire need for goods and services, the federal government may only fulfil its fiscal need through legislative measures. Such a legislative measure imposes an obligation known as an 'unfunded mandate' on the states. Under this scheme:

> Congress passes legislation that requires compliance with certain federal standards, objectives or goals with full knowledge that it will cost money without making any federal financial provision for that end. As a result, the states are put in a situation where they will be obliged to make in their respective budget an allotment of funds to meet federal requirements. Thus, instead of employing its taxing power to raise the revenue requisite for the purpose, the federal government enacts laws that enable it to achieve the goal with the use of state funds.[45]

The aim of a federal principle is to enable each level of government to be autonomous concerning matters independently assigned to each of them and financially secured in order to meet the expenditure needs.[46] However, in practice there is a problem in balancing the revenue sources and the expenditure needs of subnational governments. This is because the distribution of tax powers between the federal and state governments demonstrates the competing political interests of centralization or decentralization and the trends of the federal system.

In general, those who promote diversity advocate a greater devolution of tax powers to the subnational governments as a reflection of regional autonomy and local self-rule. On the other hand, those who argue in favour of proportional development and lesser diversities recommend the concentration of tax powers at the federation. There are several reasons for the latter argument: the problem of tax administration, tax duplications, macroeconomic considerations, the uneven distribution of tax resources and disparity in expenditure performance capacity.[47] For a country like Ethiopia, which is marked by the asymmetry that exists between the regions and the heterogeneous groups, the division of tax powers should not increase the disparity that exists between the regions. This may be achieved by carefully sorting out and allocating the types of taxes that are local in character and can raise sufficient revenue for the constituent units, while leaving the rest to the centre. This adjustment seeks to balance the revenue sources and the expenditure needs of each level of government.

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[44] For the 1999 tax reform in Australia, see Cheryl Saunders, 'Federal Fiscal Reform and the GST,' (11 Public Law Review, 2000), p. 99-105.
[45] Bekele Haile Selassie, 'Ethiopia: The Constitutional Law of Taxation and its Implication for Federal -State Relations', (LL.M thesis, University of Wisconsin Law School, unpublished, 1999), p. 67.
[46] Saunders (2002), op. cit., p. 15.
[47] Anwar Shah, 'The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Market Economies,' Policy and Research series No. 23, World Bank, 1994; Remy Prud'Homme, 'on the dangers of Decentralization,' World Bank Research Observer vol. 10, No. 2, 1995.

All the above discussion shows the importance of the analysis of constitutional provisions which deal with the distribution of tax powers. In the subsequent sections the manner in which the Constitution of FDRE defines the division of tax power between the federal government and states will be the subject of analysis.

4 THE STRUCTURE OF THE ALLOCATION OF TAXATION POWER IN ETHIOPIA

The division of taxation powers is a principal aspect of the Constitution that provides the legal foundation of the Ethiopian federation. The FDRE Constitution divides the taxation power into three categories, namely 'the federal power of taxation', 'the state power of taxation' and 'concurrent power of taxation.' It also prescribes the conditions under which the regional governments could acquire revenue through loans and grant subsidies. Here the analysis of the assignment of tax powers will focus on the tax sources that constitute each category of powers, and the manner in which the sources are divided between the three categories. Whether the division of specific kinds of taxes in Ethiopia has its counterpart in other federations and whether this approach makes each level of government self-sufficient in meeting the respective expenditure responsibilities will be unravelled in the following sections.

4.1 The exclusive power of taxation of the federal government and the states

The most important question in the discussion of the exclusive power of taxation is whether each level of government can determine its own tax basis and tax rates. This raises the question whether a specific tax assigned to the state also signifies the power to change tax rates and to set the tax base? Can the states individually determine the tax rate, exempt taxpayers or determine tax relief? The general approach in revenue assignment does not stop at assigning a specific tax to either of the orders of government. It ranges from complete autonomy to determine both tax rates and tax bases to a little discretion as regards the administration and collection of taxes.[48] In most cases, it is argued that states should have the power to determine the tax rate if the power of taxation is exclusively given to the states.

In Ethiopia, the federal Constitution declares that the federal government shall levy taxes and collect duties on sources reserved to it, and the states likewise exercise the same power with respect to sources that fall under their jurisdiction.[49] Thus, the two tiers of government exercise their legislative and administrative powers within their respective taxation competence. As a result, the revenue generated from the respective sources belongs exclusively to each level of government. Each level of government is bound to respect the powers of

[48] Norregaard, op. cit., p. 53-54. This means, for instance, that income tax can be assigned to states with complete freedom to set tax rates and even to influence the tax base itself or by limiting the power to collect the tax. In countries like Germany, all tax legislation is enacted by the federal government which fixes the rate unless an exception is specifically provided. German Basic Law, Art. 105 (2a).

[49] Art. 51 (10) and 52 (2, e) of the FDRE Constitution.

harvested in a few regions. Some have expressed their resentment concerning the problem of identifying the benefits for the producing regions although it is known that the revenue collected by the centre from these sources is used for the benefit of the country at large.[56] The issues could be serious if the potential for the exploitation of 'large scale mining and natural resources' materializes. This is because the revenues from these sources accrue to the centre. Moreover it could also be a focal point in the process of financial redistribution as it may involve a considerable proportion of the federal transfer. The same argument with respect to this issue has been steadfastly pursued by, for instance, the oil rich states of Nigeria.[57] The Russian Federation has approached this problem by sharing the revenue from natural resources with the regions from which the resource is drawn.[58] Even though the objective of federalism is not to perpetuate the difference between rich and poor regions it would promote efficiency and be equitable to allocate or spend some of the revenue on the regions from where the export items originate. Accordingly, it would be appropriate to set a formula for sharing revenue collected from the exported items with the respective regions from which the exported items originate. This is because it could help in pre-empting possible future conflicts between the centre and the region where these tax resources are found.

Income tax

Experiences in many countries have revealed that some have allocated personal income taxes to the central government while others have done so to the regions. In countries like Germany both the centre, the states and the municipalities jointly levy and collect revenue from income tax. In principle the allocation of such taxing power depends on implementing either a scheduler or a global tax system (see these concepts above Section 2). Countries with a global system prefer to allocate the power to the centre. This is because in order to determine the maximum taxable income, the global system requires a flow of information concerning an individual's income derived from different tax bases and also from different jurisdictions. Therefore, it is the central government which is in a better position to acquire all the necessary information. The benefit is not only for administrative convenience but also to reduce the danger of tax evasion.[59] Notwithstanding the above considerations, countries with a global system, for example the USA, also allocate the power to the states. These countries benefit from their development, an advanced system of administration, information on the taxpayer at his/her residence and coordination between the local governments concerning the tax levied against an individual.[60] If, however, a scheduler system is used, a tax may be levied at a local level, the source of which lies in its jurisdiction.

The FDRE Constitution does not exclusively assign income tax to the federal government or to the states. The power to levy and collect taxes from income is assigned to both tiers of government. Each of them is conferred with power over

[56] Interview with OPDO member, January 2003, confidential.
[57] The oil-rich states of Nigeria have recently argued for the share of fifty percent of revenue from oil. See Kingsley Kubeyinje, 'Nigeria: Can handpicked elite group reform the federal system?' (Ontario, Federations: forum of federations, vol. 4 No. 4, 2005), p. 13.
[58] Norregaared, *op. cit.*, p. 68.
[59] Teresa Ter-Minassian, 'Intergovernmental Fiscal Relations in a Macroeconomic Perspective', in Teresa Ter-Minassian (ed.), *Fiscal Federalism in Theory and Practice* (International Monetary Fund, Washington D.C., 1997), p. 10.
[60] *Ibid.*

the other.[50] And the FDRE Constitution does not explicitly limit the power of the states to alter the tax rates or to influence the tax bases. However, it provides general 'directives on taxation' in Article 100 which they must consider exercising their taxation powers. Both the states and the federal government have the obligation to ensure that any tax is related to the source of revenue taxed; that tax should be determined upon proper consideration and the tax imposed by them should not adversely affect their relationship.[51] If any tax imposed by a state affects interstate commerce, the central government intervenes as this power is reserved for central government. In practice, however, tax legislation is uniform throughout the country. At present, as will be discussed in the next Chapter (section 4), this is for practical reasons since most of the regions do not have the expertise to deal with the impact of imposing different tax rates.

The FDRE Constitution provides exclusive revenue sources under the title 'federal power of taxation' and 'state power of taxation.'[52] In general, the division of revenue-raising power in Ethiopia is mainly structured according to the categories of taxpayers or particular things as a source of revenue. The exclusive domain of each government is not the tax base but the tax source. Thus, it does not result in taxing the same income, transaction or thing by both levels of government. However, customs duties including import/export taxes are exclusively reserved for the centre. The revenue sources assigned by the FDRE Constitution to the two tiers of government can be classified as import/export taxes, income tax, sales and excise tax, property taxes and charges and fees. Hereunder, they will be discussed in this order.

Import and export taxes and dues

In fact, it seems universal that import duties are exclusively given to the central government.[53] The trend is also the same with export taxes. The same is true in Ethiopia so that import and export taxes and other dues are exclusively levied and collected by the federal government.[54] Tax on foreign trade is a major source of revenue in Ethiopia. For example, it accounted for 32 percent (in the 1998/99 fiscal year) of the total revenue generated at both the federal and regional level.[55]

In countries like Ethiopia, the nature and type of export items are few in number and they may also originate from specific regions. The major export items are coffee, skin and hides and some raw materials. Of these, coffee is the major source of revenue, especially generating hard currency. Coffee is mainly

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[50] Art. 50 (8) of the FDRE Constitution.
[51] Art. 100 (1 & 2) of the FDRE Constitution.
[52] Although the titles refer to the 'power of taxation', strictly speaking, they do not only deal with taxes. They prescribe provisions that refer to fees, charges, rents and other sources of revenues. Thus, it should be understood in a broader context to include other non-tax sources.
[53] There are many reasons why such power is exclusively retained by the central government. A country may have to fulfil international obligations by reducing its tariffs or to impose restrictions on unfair trade practices imposed by other countries, to protect the sudden influx of imports of specific types of items (anti-dumping measures), to control importation or exportation of prohibited items, etc. (The Articles of General Agreement on Tariffs and Trade, GATT, now WTO)). In order to protect trade distortions within a country and for efficient tax administration the power is usually assigned to the centre.
[54] Art. 96(1) of the Constitution provides that the 'federal government shall levy and collect customs duties, taxes and other charges on import and export.'
[55] See MOFED, 'The countrywide budgetary expenditure for the fiscal year 1998/99,' (Archive, unpublished).

specific sources. Accordingly, with regard to personal income from employment, the Constitution has classified taxpayers as employees of the federal government, employees of states, employees of public enterprises, employees of international organizations, and other private employees. Exclusive federal taxation applies to the income of employees of the federal government, of public enterprises owned by the federal government and of international organizations. Income from the remainder of employees[61] is subject to the exclusive authority of the states. The levying of tax from personal income is primarily for the purpose of providing local public goods and infrastructure. It is therefore recommended to assign the levying of income tax from employees of federal public enterprises and NGOs to the regions in order to enhance their revenue capacity and thereby to ensure the efficient provision of public goods.[62]

The exclusive tax power also extends to income from sources other than employment. The allocation of tax on business profit follows the ownership of public enterprises or the size of the business. Income or profits of federal public enterprises are taxed by the federal government, while those owned by the regional governments are taxed by them. Profit or income from small business activities and sole proprietorships (the nature of business activities determined by the commercial code) is left to the regions. The taxation of larger business companies, however, is left to joint taxation (see the next section). Income from individual farmers or cooperative associations, income from water transport services provided within the regional boundary and rental incomes from properties owned by the regional government are exclusively taxed by the regional government. The federal government likewise exercises exclusive power over income arising from rail, air and sea transport, and income from chance winning from national lotteries. Income obtained from leasing its own property and houses are subject to federal taxation .[63]

The centre can levy tax on several forms of income, of which personal income tax is one of the major sources. The term income has not been defined in the Constitution. It is rather broadly defined in the federal income tax legislation, and refers to 'any form of economic benefit including non-recurring gains in cash or in kind, from whatever sources derived and in whatever form paid, credited or received.'[64] The income tax law, which is applied uniformly throughout the federation as regions have voluntarily incorporated the federal tax legislation,[65]

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[61] In this regard, the collection of tax from the employees of private enterprises may not create any inconvenience if the enterprise is resident in and engages in trading in a particular state. If, however, the enterprise is mobile in several states it requires some kind of cooperation between the states and the federal government since tax on the income of the enterprise is administered by the federal government (Art. 98 (2)). The deduction of such payments from wages and salaries and other payments from income (in order to determine the amount which is subject to business profit tax) requires proper administration and a flow of information to the centre.

[62] The federal government retains exclusive power due to the general principle (as applied in federal countries) that imposes a tax limitation on each level of government to tax income from the respective property and income of their employees. However, this should be reconsidered in cases where states retain a very limited tax power.

[63] Art. 96 of the FDRE Constitution.

[64] Art. 2(10) of the Income tax Proclamation, No. 286/2002.

[65] Art. 58 of the Federal Financial Administration Proclamation No. 57/1996 requires that the tax systems at the federal and regional levels have to be harmonized and should have standardized tax bases. Without formally adopting separate tax legislation, the Amhara and the Oromia states' financial regulations have referred to the incorporation of federal tax legislation. For instance, see the Financial Administration of the Amhara National Regional State, *Zikre Hig*, Proc. No.18/1997.

enumerates different sources of income.[66] For the purpose of determining the tax rate the different income sources are again classified into four different schedules: income from employment; income from the renting of buildings; income from business or trade activity as recognized by the commercial code; and income derived from other sources. The listing of sources of income is not exhaustive, but any form of economic activity that derives income as per the definition given above becomes subject to tax law.

The problem, however, is that the Constitution does not mention all the sources of income and tax bases, nor does it contain a statement reserving such sources to either level of government. The federal income tax proclamation, on the contrary, enumerates several tax sources which are not mentioned in the Constitution. For instance, income derived by self-employed persons (musicians, entertainers, artists), income from interest paid by a government or an individual, or interest income on deposits, and income from the transfer of shares. The main issue that may arise here is whether the legislature, at the federal or regional level, can proclaim legislation imposing tax on whatever rationally considered income. In principle, it can do so only after a decision is made by a joint meeting of the Federal Houses as to which level of government will have the power of levying taxes which are not assigned by the Constitution, as we shall discuss it below in Section 4.4.

The accrual of tax from some of the sources, either to the federal or regional government, may not seem difficult. For example, income derived by an entertainer or musician from self-employed activity can easily be collected by a government/administration at the place of residence. But according to the FDRE income tax legislation, this may not be the case. Taxes are paid to the taxing authority by a withholding agent[67] who is also a payer of the cost of a particular transaction. But neither the Constitution nor the income tax legislation have specifically dealt with how the withholding agent pays taxes to the centre or to a state. It is only clear where the withholding agent pays tax on its own income to the federal government or to a state. The following example shows how income earned by the same person can be taxed and paid to different levels of government at the same time. For example, Mr. X performs a show in Addis Ababa, at the National Theatre, and at the City Hall. The National Theatre belongs to the Federal government, while the City Hall belongs to the city administration. When Mr. X receives royalties from the National Theatre, the latter may withhold and pay to the federal tax authority. The City Hall, on the contrary, may withhold and pay to the Addis Ababa administration. The withholding agent must be clear as to which level of government has the power to collect that specific tax from the taxpayer.

The division of the income tax power which the FDRE Constitution follows is aimed at creating a stable source of income for governments by minimizing the

[66] Some of the sources mentioned under the income tax legislation, Art. 3(6), include income from employment, from business activities, income derived by an entertainer, musician, or sports person from his personal activities; income from entrepreneurial activities, income from the use and alienation of movable property, income from any form of use of immovable, livestock and agriculture; dividend income, profit shared by business partners, income from interest, royalties, lease payments and other license fees.

[67] Art. 2(8) defines a 'withholding agent' as any person with a tax collection obligation as stated under the proclamation. The obligation of a withholding agent with regard to income from employment is relatively clear and easy to administer. But in the case of withholding income tax from company profits and dividends there should be close cooperation between the tax authority and the withholding agent due to tax evasion problems.

factors that may lead to complexities in its structure. The federal tax legislation provides a specific tax rate for each tax base, and the allocation follows a division of tax sources to each level of government. Normally, complexities are related to cases where a taxpayer derives income from more than one state, where a person lives in one state but works in another, and when income derived from different sources is subject to a progressive taxing system. Germany, for instance, avoids the complexities by adopting a tax-sharing scheme where the revenue accrues to the federal government, but is finally shared with the Länder on the basis of an agreed formula. In Australia, a uniform income tax system applies as the power is assigned to the commonwealth government.[68] In India, taxes on all incomes other than income from agriculture are left to the central government (Union List No.82).

In Ethiopia, although income tax is assumed to be one of the major sources of revenue, it is income tax from employees that accrues a substantial amount of revenue. For instance, in 2000/01, if we compare it with other direct taxes, it accounted for 25 percent of the total direct taxes collected at the centre and in the regions. At the federal level, most of the personal income tax from employment is collected from government employees, i.e., from civil service employees and employees of government-owned enterprises. However, as there are no state-owned enterprises, the regions can levy employment income tax on civil servants only.[69] In the 2000/01 fiscal year, for instance, revenue from personal income tax accounts for 30.4 percent of the total revenue of all regional governments. If we extend the share of this tax source on a state by state level, in Tigray it accounts for 28.3 percent of its revenue collected in the same year, SNNPR 23.3 percent, Amhara 21.4 percent, and Oromia 17.55 percent.[69] In general, there should be a concerted effort in collecting income tax from all other sources. For instance, income tax from employees of private enterprises is insignificant, for at least, two reasons: a limited number of taxpayers from the private sector, and inefficient tax administration in the regions. It is, however, expected that the accrual of tax from the employees of government-owned enterprises will shift from the federal government to the states as a result of the ongoing privatization programme. However, this transfer will be limited to Addis Ababa and the surrounding areas, as most of the enterprises reside there.

Sales and excise taxes

The area of sales and excise taxes is divided between the centre and the states. The FDRE Constitution assigns exclusive power to the federal government to levy and collect sales and excise taxes in so far as they pertain to the sale, production or services of public enterprises owned by the federal government (Article 96 (1)). The same pattern is followed as the power of the states: they can levy these taxes against public enterprises owned by them (Article 97(7)). In addition, the states can also levy and collect sales and excise taxes from individual traders within their jurisdiction (Article 97(4)). However, the exclusive power of the states is restricted in some cases since some of the individual traders are subject to federally administered VAT law. (Sales and excise taxes that pertain to companies are treated under concurrent (joint) taxes below).

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[68] Although the Australian Constitution does not limit the states from levying income tax, the federal government succeeded in withdrawing the power of the states from levying income tax during World War II in return for grants. See Wheare, op. cit., p. 111.

[69] The computation is based on the data available in the MOFED, 'Countrywide budgetary expenditure for the fiscal year 2000/01', (Archive, unpublished).

Sales and excise taxes can be imposed upon a variety of commodities. The tax base of sales tax is the price of goods and services, but for excise tax it can be the act of importation or the local production of items specified by legislation.[70] Sales tax is imposed upon the price of commodities. It can either be special or general depending on the legislation specifying items which are subject to tax. It can also be classified as single or multi-stage depending on the impact of the payment of tax at one point or in several stages. Retail sales tax is a case of a single stage whereas value added (VAT)[71] and turnover taxes are multi-stage. Excise tax is imposed upon the production or importation of selected and specifically stated items. It can be imposed for reasons other than raising revenue. It can be imposed to discourage the consumption of some commodities such as alcoholic and tobacco products. It also has an income distribution objective when imposed upon luxury goods. In most cases, items such as alcoholic drinks, tobacco, perfumes and personal automobiles are subject to excise taxes.[72]

It is important to identify the type of tax imposed on a certain item. A tax paid on the purchase of a raw material for the production of a commodity is a sales tax. But a tax imposed on the production of a commodity using raw materials could be excise tax (if the product is subject to excise tax). When a manufacturer sells his products, the payment of tax is classified as sales tax since the payment refers to the act of selling not the production. Thus the same commodity can be subject to an excise and a sales tax if it falls within the area of excise legislation. Both excise and sales taxes have similar effects in the sense that the actual incidence of these taxes is dependent on the consumer.

The concept of sales and excise taxes has been subject to differing meanings in different systems. Sometimes the difference lies in determining the taxable amount of the manufactured item.[73] In other cases, it relates to determining which level of government has jurisdiction over the taxes. For instance, excise tax has been interpreted widely in the USA, Australia and Canada where the assignment of taxing power is mainly based on the classification of direct and indirect taxes. In the USA, before the XVIth Amendment of the Constitution, the federal government had a wider right to impose indirect taxes (excises and imposts) compared to the power to impose direct taxes.[74] This is because while indirect taxes (all excises) were required to be uniform throughout the United States, direct taxes were levied in proportion to census or enumeration. The federal government was levying succession tax, corporate income tax, and even general income tax by considering these taxes as excises.[75]

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[70] See Art. 5 of the Excise Tax Proclamation No. 307/2002.
[71] VAT has recently been introduced in Ethiopia (effective since Jan. 1, 2003). There has been a difference of opinion on the introduction of the VAT. The government has argued that it is an effective means of raising government revenue. Others have argued that as tax is paid at every stage of a transaction, it increases the price of commodities which the purchasing power of the people cannot afford. Further, there is a danger of evasion.
[72] See, for instance, the Ethiopian Excise Tax Proclamation No. 307/2002.
[73] *Ibid*, (Art 2(7), 6(2, b)).
[74] See Art I Sec. 8 (clause 1), Art. I Sec.2 (clause 3) and Art. I Sec. 9 (clause 4). The XVIth Amendment reads: 'Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.'
[75] A.T. Mason and D.G. Stephenson, *American Constitutional law*, 11th ed. (Prentice Hall, 1996), p. 273.

A wider meaning of excise also exists in Australia. The Constitution of Australia (Section 90) debars states from imposing excise taxes. By interpreting excise tax in a wider sense as a tax on goods, the states are precluded from levying many taxes on the sale, use or consumption or production of certain items which are characterized as excises.[76] But following the tax reform in 2000, the states will be entitled to the share of the goods and services tax (GST) which replace most of the sales and excise taxes administered by the centre.[77]

In Canada, the states, or often called as the provinces, have the power to impose direct taxation for provincial purposes (Section 92 of Canadian Constitution). They are excluded from levying indirect taxes. But as Laskin noted, the Privy Council interpreted direct taxes as any tax paid by the person on whom it is levied and if it is not passed on to someone else, it would not be an indirect tax.[78] Accordingly, this wider meaning of direct tax enables the provinces to levy sales tax by making the purchaser pay the tax and the retail seller serve as a withholding agent.[79] This conclusion, therefore, makes a distinction between direct and indirect taxes only based on the convenience of the tax administration and not on the nature of taxes as to where the burden lies.

The Indian Supreme Court, however, has a contrary view to the Canadian approach by considering excise tax as an indirect tax, whether it is collected from the manufacturer himself or at any stage from the consumer, so long as it is imposed on the production of a specific item.[80] In India the area of excise tax is divided between the centre and the states, and it is imposed on items produced in the country.[81] In Ethiopia, at present, such a problem seems to be avoided since the division of tax powers follows the source, not the type of tax. But there is a somewhat similar problem of delimiting the scope of designated taxes in the context of the question of what are residual tax powers. We discuss this below, Section 4.4.

Property Taxes

The types of taxes on property depend on how the tax legislation defines the categories of property subject to taxes. For taxation purposes, properties can be categorized in a variety of ways.[82] They can simply be categorized according to their nature such as real property, personal property, tangible or intangible property. Taxes on property may include several types such as real property taxes on land and buildings, annual taxes on the value of land, or land transfer or conveyance taxes payable when real property is sold.[83] Special levies or taxes

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[76] Cheryl Saunders, 'Fiscal Federalism - A General and Unholy Scramble', in Gregory Crave (ed.), *Australian Federation: Towards the Second Century*, (Melbourne University Press, 1992), p. 110 -111.
[77] See Saunders, 'Federal Fiscal Reform and the GST,' (11 Federal Law Review, 2000).
[78] As quoted by M. P. Jain, *Indian Constitutional Law*, 4th ed., reprint, (Wadhwa and co. law pub. India, 1998), p. 297.
[79] *Ibid.*
[80] As quoted in Jain, op. cit., p. 296 (J.R.G. Mfg. Ass v. India, AIR 1970 SC 1589.)
[81] Union List, No. 84 - The centre has the power to impose excise duties on tobacco and other goods manufactured and produced in India, except those items listed under the State List, No. 51.
[82] Daniel Shaviro, *Federalism in Taxation: The Case for Greater Uniformity* (AEI studies, Washington, 1993), p. 36; Douglas H. Clark, 'Assessing Provincial Revenue-raising Capacity for Transfers,' in Ehtisham Ahmed (ed.), *Financing decentralized Expenditures: An International Comparison of Grants*, (Edward Elgar, UK, 1997), p. 22.
[83] Shaviro, op. cit., p. 36.

on the exploration of natural resources are in most cases considered as property taxes. Fees for the registration of automobiles and trucks could be considered as levies on property. In some tax regimes, though a different type of tax, called 'inheritance tax', is imposed, it is levied on the value of the estate of a deceased.[84] Whatever the type of category, Shaviro argues that it is the subjectivity of tax assessment that distinguishes property taxes.[85] This is because the amount of tax paid is mostly determined by the estimation of the value of property by tax authorities. And it is also 'case specific' in the sense that the value subject to the tax rate is determined in each case.

The Ethiopian Constitution gives the states a power to levy property taxes upon houses which are privately owned, land which is used by the *usufractuaries* and royalties[86] from the use of forests. The states are also empowered to levy and collect tax and royalties on small-scale mining activities.[87] It is easier to administer the levying and collection of royalties directly from the owner or the usufructuary. The amount levied is not based on the value of each property, but rather on the size of and the area in which the property is found. However, a problem could be encountered when property taxes are levied indirectly in the form of income and capital gains taxes.[88] The assessment of capital and property values based on the market price and other technical measurements are exposed to corrupt practices. This is because there is a lack of information on the true price of a property.

In general, the fixed nature of real property makes it easier to administer by the subnational governments. But there are exceptions. Mineral taxes and royalties are in most cases assigned to the centre. This is because natural resources are unevenly distributed between the states. Thus, if the taxation of minerals is assigned to local governments, it may aggravate horizontal imbalances.[89] In Ethiopia, however, the states have the power to levy tax and royalties on small-scale mining activities. But they have failed to generate revenue from local mining activities. It was recently reported that the country loses $30 million from illegal mining which is neither regulated nor taxed by the local, state or central governments.[90]

One of the most important revenue sources for the regions could be revenue from land lease payments from investors, since according to the Constitution, land is publicly owned.[91] It creates a potential for setting different rates which

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[84] Some call this inheritance tax (Australia), others estate duty (India).
[85] Shaviro, *op. cit.*, p. 36.
[86] A royalty is a payment made by a leaseholder of land containing minerals or resources to the owner of the land usually expressed as a percentage of the production sold. A royalty may also be paid to the owner of a patent or copyright by others who used for gain the patented or copyrighted work.
[87] Art. 97 (2, 6, &10) of the FDRE Constitution.
[88] A capital gains tax was introduced for the first time in Ethiopia by Proc. No. 108/1994 for the Payment of tax on gains. It was levied on the increase in value upon the sale of shares and bonds, and urban houses. But, later on, urban houses were excluded from the list by the new income tax law, Proc. No 286/2002.
[89] Peter Mieszkowsky, 'Energy Policy, Taxation of Natural Resources and Fiscal Federalism', in McLure (ed), *Tax assignment in federal countries* (ANU, Canberra, 1983), p. 129.
[90] Report by the Ministry of mines and energy, http://news.bbc.co.uk/go/pr/fr/-/2/hi/business/2888777.stm accessed on 27/03/2003
[91] According to the Constitution, Art. 40 (3 & 6), 'The right of 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... The government shall ensure the right of private investors to the use of land on the basis of payment arrangements established by law.'

may in the end lead to influencing the flow of capital between the regions. Those offering maximum benefit to investors may obtain higher revenue by attracting many investors. Negotiations for leasing out lands and determining the rate of payment are in principle within the power of states, but it is currently highly influenced by the centre. Thus, it is hardly possible to conclude whether the nature of lease contracts has influenced the flow of investment into a particular region.[92]

Fees and other charges

The Ethiopian Constitution lists the power of collecting fees, charges and stamp duties together with the tax entries of the respective governments. The taxation powers listed for the federal government and for the states also have provisions authorizing the collection of fees and charges on licenses issued and services rendered by the governments.[93]
Fees and charges are collected by different units of government and each level of government retains exclusive power if the service falls in the respective jurisdiction. The fees and charges are no different from taxes in serving as a revenue source for each level of government. However, there are some differences between tax and fees and charges *stricto sensu*.

The first difference between tax and fees concerns the phrase empowering the government to impose tax or fees. Whereas tax can be levied only on cases where the type of tax and its sources are indicated in the Constitution, fees can be levied on sources which are generally considered as the powers and functions of a government.[94] A tax cannot be levied outside the types enumerated in the three categories of state, federal, and concurrent powers of taxation. But a fee, which is included in the powers of the federal and state governments, can be collected from the services rendered by the organs of the respective governments. For instance, someone initiating litigation at the federal court could be subject to a federal court fee. A fee may also be collected from an activity relating to the imposition of tax. For example, the imposition of a licence fee does not exempt the levying of tax on profit or payment of sales tax. So, why must a fee be paid? The payment of fee has two general features: it is paid in consideration of service rendered by the government to the person who pays the fee, and the payment is in principle intended to cover the cost of providing the service, not for generating profit.[95] In this regard it is important to draw attention to the FDRE Constitution which requires that each level of government must ensure that the rates of its levies and the amount raised are commensurate with the services they help deliver.[96]

A tax is the compulsory exaction of money by a public authority for public purposes to meet the general expenses of the state without reference to any special benefit to be conferred upon the taxpayers. The taxes collected are

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[92] For further discussions see the next Chapter, section 4.
[93] Art. 96 (7) and 97 (9) of the FDRE Constitution.
[94] See Arts. 96 (7) and 97 (9) of the FDRE Constitution.
[95] Jain, op. cit., p. 311; It can also be used to have a deterrent effect by making it more onerous for the payer.
[96] This is one the directives set forth under Art. 100 (2) of the FDRE Constitution. It reads '...the rate and amount of taxes shall be commensurate with services that taxes help deliver.' However, this phrase seems to make sense if it refers to 'fees and charges,' but not to tax in its strict sense.

merged in the general revenue and are applied for general public purposes. Fees, on the other hand, are payments for some special service rendered, or some work done for the benefit of those from whom payments are demanded. Thus, in the case of fees, there is always an element of *quid pro quo* which is absent in tax.[97]

The quid pro quo relation cannot be expressed in terms of arithmetic equivalence, but the service rendered must give some kind of advantage to the fee-payer. This may lead to other issues concerning whether persons who receive the same service should be charged the same fee. Or, conversely, whether persons charged the same fee should be entitled to the same degree of service. The answer depends on the nature and type of services rendered by a government agency. For instance, if a service is rendered in order to deposit a marriage certificate in a public registry, an absence of uniformity may not be expected (of course service outside working hours may increase the charge). Depending on the cases and the type of services it may be reasonable to charge fees according to the paying capacity and not necessarily according to the service rendered to each individual.

It is generally agreed that for the sake of convenience stamp duties, fees and service charges shall be collected at the place where the service is rendered. If a licence is given or a specific service is rendered to the beneficiary at a federal office, the federal government will levy and collect the payment. Similarly the Ethiopian Constitution (Article 96 (7 & 9)) has given such powers to the federal government provided that the organs of the federal government render the services in question. Parallel to the federal government states are also empowered to determine and collect fees and other charges for services rendered by the state organs (Article 97(9)). In the 1999/2000 fiscal year the federal government collected fees and charges amounting to 122.43 million *birr*.[98] The revenue from fees and charges had increased substantially from 61.53 million in the 1994/95 fiscal year. In general, fees, charges and stamp duties are the major source of revenue for the federal government. They accounted for 38.3 percent of the total revenue generated by the centre in the 1999/2000 fiscal year.[99] Their contribution increased to 38.3 from the 33 percent of the federal revenue in the 1995/96 fiscal year. They have also become the major source of revenue for the regions. There is a tendency to generate a considerable amount of revenue through fees, charges and stamp duties because the levying of such taxes follows the principle of the 'user pays' which is easy to administrate.

4.2 Concurrent power of taxation

It is appropriate to begin by elucidating the concept of 'concurrent power' in other systems. Conventionally, the concurrency of power signifies that the centre as well as each state has the right to enact laws concerning the subject-matter under its jurisdiction. This occurs when a general power of taxation is conferred on each jurisdiction where the actual assignment of particular taxes is left to each jurisdiction to be sorted out in practice. This system follows the general

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[97] Jain, op. cit., p. 312.

[98] The figures indicated in this section are computed from the data available in the MOFED, 'Countrywide budgetary expenditure for the fiscal years 1995/96-1999/00', (Archive, Unpublished).

[99] The terminology used at the ministry of finance is 'non-tax domestic revenue' mainly referring to fees, charges and stamp duties. It does not refer to foreign aid or assistance.

division of legislative power including the division of broad and general tax powers between the federal government and the states.[100] As we observed above, the USA presents a typical case of concurrent powers. In this case, both the centre and the states are free to impose the same type of tax upon the same subject of taxation. Or, as appears in the German Basic Law, the Länder exercise legislative power on concurrent matters only when the federation has not exercised its legislative powers. But in the Ethiopian case the title 'concurrent power of taxation' may mislead readers since it is different from its application in other systems. At present, it gives the states only the power to share revenue from concurrent sources.

When the FDRE Constitution came into force several issues arose regarding the exercise of the concurrent power of taxation which is the object of Article 98 of the Constitution. The text of the Constitution provides 'The federal government and the states shall jointly levy and collect...' The main issue raised is how can both the centre and states jointly levy and collect taxes at the same time? Is it similar to the concept of concurrent power of legislation? Would it enable each state to enact its own tax law on sources listed under concurrent taxation? Do all states benefit from these taxes irrespective of the place where the sources of the tax are located? The power of taxation comprises of two specific powers: the power to set a tax rate and the power to collect the tax paid. The federal government and the states exercise an independent power to determine the rate and to collect the tax paid in areas exclusively assigned to each level of government. If we pursue this principle, a concurrent power of taxation likewise presupposes the determination of the rate and collection of taxes to be decided independently by the federal government and the state concerned. This could have led to tax competition between the federal government and the states. But when there is a conflict between the two, the main issue is which law prevails? As the Constitution does not address the issue of the supremacy of federal laws (even in the case of concurrent legislation) it could have raised the issue of constitutional adjudication.

On the other hand, the literal interpretation of the provision (Article 98) 'the federal government and the states shall jointly levy and collect' would mean that legislation would be enacted by a joint meeting of the federal and state legislatures. Such a meeting would be held with each region at different circumstances involving only one region. For instance, a specific type of mining operation may be found in one region. So, in order to enact tax legislation and setting royalties, a joint meeting would be held between the federal and a state legislature. Such an approach may in principle lead to the adoption of different tax rates. As a consequence, the same taxpayer may become subject to different rates if income is generated from different states. From the point of view of tax collection, a single taxpayer becomes subject to two bodies, the federal and state offices. When the same tax source is subject to both levels of government it requires close cooperation and an adequate exchange of information between the two. Otherwise, it can lead to tax evasion.

The concurrent power of taxation, as it originally has appeared in the constitution, would have led to inter-jurisdictional competition (centre-state, or state-state) or conflicts concerning a better control of taxes. It might have as well created a serious inconvenience to the taxpayers, a greater possibility of tax evasion and inefficient administration which may have a dire consequence

[100] Saunders (2002), op. cit., p. 7.

upon the low and limited revenue source of the country. In most cases, countries that do not have a developed tax administration system avoid this complicated approach by allocating the power to the central government only.

Finally, it is said that the Constitution has been amended whereby the power is delegated to the federal government.[101] The provision has been interpreted in such a way that those tax sources listed under concurrent power have to be levied and collected by the centre but the proceeds are compulsorily shared with the states. As a result of this interpretation the central government has become fully empowered to levy and collect taxes on the mentioned sources and to retain the proceeds and dispose of them based on the decisions of the HOF.

This interpretation seems logical for two reasons: it follows the precedent set during the transition period,[102] and it is consistent with the method of assigning taxing power as adopted by the Constitution. A specific tax imposed on a specific source is levied and collected either by the centre or by a state. Following the amendment, the tax sources listed under the concurrent power are levied and collected by the centre while the states retain the power to share the revenue generated from these sources. However, this approach may pose at least two problems. First, as the centre controls the power of tax legislation and its administration over concurrent taxes the states are devoid of any participation in setting tax bases and rates. Second, as the concurrent taxation power centralizes there will be a greater need to ensure a satisfactory share for the states, but a greater difficulty in doing so. Should the revenue be divided according to specific formula bases or other criteria, or should it be included in the grant subsidy were the major issues which were subject to discussion.[103]

The Ethiopian Constitution provides the sources of concurrent taxes under its Article 98. These are:

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

Let us convey the substance of the constitutional provision quoted above in a detailed manner.

Tax on joint enterprises

The above provision seems to refer to those enterprises to be established jointly after the incorporation of the federal system.[104] However, the direction of the government's policy is towards market liberalization and its withdrawal from the

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[101] The amendment of the provision, rather the interpretation, follows Art. 9 (1) of Proc. 33/1993 which defined the sharing of revenue between the central government and the regions during the transition period. Art. 9 (1) states 'Central government revenues and revenues jointly owned by the central government and regional governments shall be levied and collected by the central government revenue collection organs. However, whenever deemed necessary the collection of such revenues may be delegated to regional governments.'

[102] The power of levying and collecting revenue from sources listed under the concurrent power reside in the federal government whereas the states retain the right to share the revenue collected from these sources.

[103] See Chapter VII, (2.1.) for a discussion of revenue sharing.

[104] Thos public enterprises which exist in different parts of the country are named 'Share Companies' where their total share is fully owned by the Federal Ministry of Finance. Thus, taxes from these public enterprises belong to the federal government as provided under Art. 96 93).

market. Thus, the federal government is aggressively engaged in privatizing state-owned enterprises rather than establishing new public enterprises. So, practically speaking, no revenue is being generated from this source.

Tax on companies and dividends

Taxes imposed upon companies are relatively mobile among several regions. This mobility factor reflects the fact that their economic activities involve a multitude of factors from different jurisdictions. That is, factors of production (capital, labour, land) may be used from several states and products and sales are going back to these regions. The power of taxation with a huge factor of mobility is suggested to be allocated to the centre.[105]

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

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

A case can also be made for distinguishing between different tax bases with respect to the activities of companies. Income tax on companies and businesses in general are payable on the total income earned. With respect to tax on dividends countries' practices do vary, some directly assign to the states while others leave it to the central administration but distribute it to the states through a revenue-sharing mechanism.[106] In Ethiopia, the central government levies such tax according to a flat rate of ten percent.[107]

Tax on Natural Resources 1142 1147

In most federal systems disparities concerning the fiscal capacities of states are also intertwined with their wealth in natural resources. Tax on natural resources is therefore not exclusively reserved to the states, because it may aggravate the

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[105] Ter-Minassian, op. cit., p.10.
[106] This is the practice in India. See for instance, M. Gavinda Rao, 'Fiscal Decentralization in India', p.10.
http://www.imf.org/external/pubs/ft/seminar/2000/fiscal/rao.pdf retrieved on 14 May 2002.
[107] Income Tax Proclamation No. 286/2002.

gap between resource-rich and poor states. Thus, federal governments deal with the unequal distribution of natural resources through their revenue transfer mechanisms.[108] In Ethiopia, too, issues concerning the equitable distribution of revenue generated from natural resources will be a challenging task when it plays a significant role in the national economy.

In Ethiopia, the revenue from taxation on income from large-scale mining and all petroleum and gas operations and on royalties collected from both operations are shared between the federal government and the regions.[109] Thus, the administration of incomes and royalties from all petroleum and gas operations is the task of the federal government. However, mining operations are qualified as large-scale and small-scale operations, where royalties, land rentals and income taxes from small-scale operations are left to the regions.[110] It is the Minister of Mines and Energy, who designates a mining activity as large or small-scale.[111]

At present royalties and income taxes from mining operations are not significant. But mining operations are a potentially large revenue yielding area which is contingent upon the exploration of minerals. Hence, there should be an appropriate revenue-sharing mechanism that can address at least two contending interests. First, the region where the mineral/natural resource belongs may at times raise a sense of entitlement with secessionist rhetoric. On the other hand, the exploration activity may impose additional costs in the region such as on the environment or security (spillover effects). Thus, there will be a need to compensate these claims. Second, all the regions and peoples of Ethiopia have a vested interest in the income generated from mining operations, as the Constitution confers ownership rights on natural resources to the state and to the peoples of Ethiopia.[112]

The whole argument refers to deciding what proportion of the income from the above revenue sources could go to the regional or local governments where the resources are found. For instance, the oil-rich regions of south Nigeria initially argued to retain all the taxes and only pay royalties to the federal government. But recently they argued for the increment of their share from 17 percent to fifty percent of the royalties from oil collected by the federal government.[113] The above two contending issues remind us that the sharing of revenue from mining operations will require appropriate formula.

VAT

Sales taxes such as value added tax (VAT) and turnover tax (TOT) are multi-stage whereas retail sales tax is a case of single-stage taxation. VAT was recently introduced in Ethiopia at the rate of 15 percent of the value of the

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[108] C. Mclure, *Fiscal Federalism and the Taxation of Natural Resources*, 1983, p. 8.
[109] Art. 98 (3) of the FDRE Constitution.
[110] While Article 98 (3) reserves large-scale mining operations to the federal government, Art. 97(8) assigns the states with the power to levy and collect taxes on income derived from small-scale mining operations and royalties on such operations.
[111] Proc. No. 52/1993, A Proclamation to promote the development of mineral resources. It indicates that the use of mineral waters, non-metallic construction materials, artisan mining essentially of a manual nature, are considered as small-scale mining activities.
[112] Art. 40 (3) of the FDRE Constitution.
[113] See Kingsley Kubeyinje, 'Nigeria: Can handpicked elite group reform the federal system?'(Federations: forum of federations, vol. 4 No. 4, 2005), p. 13.

taxable transaction.[114] VAT is paid by and collected from every person whose annual taxable activity exceeds 500,000 Ethiopian birr (~ $ 60,000),[115] and by everyone who engages in import activities, unless the taxable transaction otherwise involves a supply which is exempt under appropriate laws. The exempted items are those considered to be basic supplies and the imposition of VAT would be considered an unfair burden on low-income families. The VAT replaced the sales tax on those taxable transactions. As a result of the new law, the power of levying and collecting the VAT is assigned to the centre. Hence, the administrative competence of the states with regard to VAT payers (sole proprietors)[116] has been reassigned to the federal administration. But this administrative power is expected to respect the taxation power of the states and the federal government is expected to transfer the revenue from the VAT to the respective state based on a derivative principle.

In general the most important issue in allocating joint taxes is how to share the total revenue between the centre and the regions and as between the regions. For a detailed discussion of the revenue sharing scheme, see Chapter VII, Section 2.1.

4.3 Local taxation

Federal constitutions primarily provide for the distribution of revenue-raising powers between the centre and the states. This enables both tiers of government to have the power to legislate and levy taxes assigned in terms of their respective powers. But the powers of a state could be further decentralized to the lower levels of administration within its territory. However, the assignment of powers to local governments may not be the concern of federal constitutions. For instance, the Constitutions of the United States, Australia and Canada deal only with the powers of the centre and the states. State governments are constitutionally assigned with a number of taxes, fees and charges. Local governments may therefore retain some of the sources assigned to the states.

However, there are some trends to constitutionally allocate taxation power to the local governments. For instance, the German Basic Law assigns taxation power to local governments, including setting tax rates such as levying taxes on real property and trades.[117] The Swiss Constitution also recognizes the taxation powers of the municipalities, and provides that they have the power to levy direct and indirect taxes unless specifically reserved for the centre.[118] In India it is through the 73rd and 74th amendments of 1992 that the Constitution recognized the assignment of revenue sources to the local governments. In Nigeria, the Constitution recognizes local governments, some revenue sources

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[114] Value Added Tax Proc. No. 285/2002, enacted on July 4th 2002, but it only entered into force on 1st Jan. 2003.

[115] As per the exchange rate, December 31, 2004.

[116] The VAT paid by those sole proprietors (with a taxable capacity exceeding 500,000 Eth. Birr) should be transferred to the region where the taxpayer belongs.

[117] It also guarantees the accrual of income taxes paid by the inhabitants, revenue from turnover tax, and tax on consumption and expenditures to the municipalities based on the legislation and apportionment formula adopted by the federation and the Länder (Art. 106 of the Basic Law).

[118] See Arts. 2, 129, 134 of the Swiss Constitution (2002).

and their right to receive a share from the national as well as the state revenue.[119]

In Ethiopia, as we have seen in the preceding chapter, the federal Constitution leaves the decentralization of power within a state to the respective states, but emphasizes the importance of local governments having adequate power. Thus the allocation of revenue sources to local governments is a state matter. Most of the states are organized at the zonal[120], wereda and kebele levels of administration below the regional government. Accordingly, revenues are collected through the finance bureaus organized at the regional, zonal and wereda levels where the latter collect taxes, and they accrue to the state treasury. The weredas have had no autonomy to spend the revenue they collected.[121] Also, the regional governments have been determining the local budgets. Even though the 2001 amended Constitutions of Oromia and SNNPR provide that the *wereda* shall have the power to utilize revenue sources other than those allocated and administered by the regional government, all the revenue sources constitutionally assigned to the states are reserved to the regional governments.[122] The actual local tax power is expected to be determined by the respective state laws. The major obstacles to delimit local tax powers and which the regions have expressed are the wide local disparities in tax sources and local administrative capacities.

Normatively speaking, from among the types of taxes assigned to the states, those attached to real property can effectively be administered at the local level if the human resource capacity is put in place. Taxes on employment income, agricultural income and rural land use fees, rental income tax, charges and fees and tax on the sale of real property can be assigned to local governments.[123] The local governments can also share the revenue they have collected with the regional government according to a certain agreed percentage. Since the type of taxes assigned to the states mainly follow the taxpayer's category they can be administered effectively. The major problem witnessed in the tax collecting capacity of weredas is the lack of skilled labour and the uneven distribution of tax sources between the weredas.[124]

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[119] See Second Schedule part II of the 1999 Constitution of Nigeria; G. Rao, op. cit.; The major criticism in India and Nigeria refers to the lack of assigning meaningful revenue sources so that the local governments have failed to execute important developmental schemes.

[120] According to the government proposal, since the 2002/03 fiscal year, perhaps zones have remained with a limited power compared to the weredas. See Ministry of Capacity Building, 'Wereda Decentralization Study', (unpublished 2002).

[121] The wereda and kebele administrations collect some taxes, fees and other charges but they have to channel them to the central treasury of the state.

[122] See Art. 79 of the Oromia Constitution (revised) and Art. 93 of the SNNPR Constitution (revised). Also see Art. 49 of the Oromia Constitution (revised) and Art. 45 of SNNPR Constitution (revised). The provisions may refer to charging fees for the services provided by the local governments and municipalities.

[123] They have also generated a considerable amount of business profit tax, which accounted for 19.5 percent of the total revenue of the states. But they are only collected in few weredas in each region. Data computed from the data available in the MOFED, 'Countrywide Budgetary Expenditure for the fiscal year 2000/01', (Archive, Unpublished).

[124] In general, sector offices at the wereda level have generated considerable amounts of taxes. Besides the rural land use and agricultural income tax, which are fully administered at the wereda and kebele levels, other types of taxes are also collected at the local level. For instance, during the 2000/01 fiscal year, personal income tax from employees of state and private enterprises accounted for 30.4 percent of the total revenue of regional governments, out of which almost half was collected at the wereda level.

However, an effort should be exerted to maximize the administrative capacity of local governments and to secure their autonomy to administer and collect specific types of taxes. In principle, the establishment of local council and local governments is meant to enable them to implement their own expenditure responsibility by collecting certain local taxes. If local taxes are identified, it will be easier to determine taxes to be shared by the local and regional governments. It is also important to determine what form of intergovernmental fiscal relations should be established in the regions. If revenue sources and the form of fiscal relationship at the local level are identified, the local governments will play a significant role in executing expenditure responsibilities, and in promoting good governance, local participation and efficiency.

4.4 Residual taxes

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

It has to be noted that the joint session of both Houses is to determine which level of government can exercise the power of taxation. The Constitution allocates independent powers of taxation to the states and the centre, and taxes shared by both levels of government. The joint session therefore determines the residual tax to be shared by both levels of government or to be assigned to either of them. Therefore, the power over residual taxes is not linked to residual powers of legislation.

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

Sometimes the issue of residual taxes may arise with regard to the problem in demarcating the precise scope of the constitutionally assigned tax powers. For example, Article 97 (6) mentions the power of a state 'to levy and collect taxes on income derived from private houses and other properties within a state'. Does

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

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

From the above analysis, capital gains tax, royalty from the use of patent and copy right, income from interest on deposits, surtax and VAT can be argued to be residual taxes, despite the presence of some of them in the existing tax laws. A joint session of the Federal Houses was held for the allocation of the latter two types of taxes before the centre levies them.[125]

Similar issues may arise in Ethiopia because of the difficulty to comprehensively list all tax sources and tax bases. In making decisions regarding the assignment of undesignated tax powers, the Federal Houses should consider both the national and state interests. Presumably they have to take into consideration the existing division of powers between the centre and the regions, as is also implied under Article 95 of the Constitution which prescribes that the federal government and the state shall share revenue, taking the federal arrangement into account.

Another issue that may arise with regard to the matter of residual tax is whether its allocation to the centre could result in regulating the residual legislative competence of the states, or vice versa. This has to be thoroughly studied before a decision is made by a joint session on the allocation of a residual tax. This issue may not arise in other systems where the residual tax follows the allocation of residual legislative powers. In that case the general problem would concern the issue of regulating powers beyond one's purview through taxation powers. For instance, in India the problem is minimized since residual legislative and tax powers are allocated to the centre.[126]

In sum, because of the mode of the division of tax powers, there is a greater possibility of having undesignated tax sources and that the states will hang on to the decision of the joint meeting of the Federal Houses. The study on residual

[125] To supplement the defence budget during the war with Eritrea, ten percent surtax was imposed on selected imported items from 14 December 1999 to 1st January 2001.
[126] *Ibid.*

taxes will also consider the overall tax performance, changing economic conditions, and examining the existing division of taxes. These functions do not seem to be solely and properly addressed by the Federal Houses. This is because these functions require professional competence and the need for a forum that can consider the interests and arguments of the states' executives. It is therefore recommended that such tasks be assumed by an intergovernmental institution that submits its findings and recommendations to the decision of the Federal Houses.

4.5 Raising revenue from government-owned enterprises

In most federal systems, both the central and regional governments generate revenue from property, public enterprises or business undertakings and monopolies that the respective government owns. For instance, the postal service is monopolized by the central government in all federations. In some federations the central government monopolizes railways (Swiss), while in others (for example, India) the states also own their own railways. Both levels of government also generate revenue from the land and buildings they own. Although the extent of their ownership varies, both the federal government and the states may generate income from their own investment. The income that accrues to a government is determined by the net income which an enterprise generates. In most cases such income remains under the independent control of each government. However, the amount that a government generates can be influenced by the extent of the immunity which the enterprises enjoy.[127]

In Ethiopia, public enterprises and commercial undertakings monopolized by the federal government are not only a major source of income for the government but also one of the primary sources of personal income tax, excise tax, and business profit tax. The federal government's income from taxes related to its agents and enterprises accounts for the third largest source of revenue.[128] This consists of income from the national bank, rent from government property, and residual surpluses from various public enterprises that the government monopolizes. The latter source includes enterprises such as Banks, Insurance Companies, the Telecommunications Corporation, the Electricity Company, the Petroleum Corporation, Sugar Industries, and state farms. The revenue generated from these sources mainly supports the huge investments they undertake throughout the country. However, it should be noted that not all government-owned enterprises are successful in generating revenue for the government. For instance, the textile industries have remained in the market because of huge investment support from the government. The government also has lost a massive amount of revenue because of the inefficient loan administration of the banks and tax arrears on bankrupt public enterprises.[129]

However, the amount of income generated from public enterprises may decline due to the privatization process. As a result of the free-market economic system adopted in the post-*Dergue* era, the government has engaged in a privatization process to transfer the government-owned enterprises to the private sector. It is

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[127] For an analysis of tax immunity and the limitation of taxation, see infra 5.
[128] World Bank, 'Ethiopia: Review of Public Finances', 2000, p. 46.
[129] The other reason for the failure to collect the revenue is the loans granted to agricultural cooperatives which ceased to exist after the demise of the *Dergue* regime in 1991. Recently, a draft proclamation to transfer the uncollected bank debts to the government has been submitted to parliament.

reported that the gross receipts of the government have reached 1.1 billion *birr* (~$130 million). But this amount could not be a net receipt as the enterprises were capital assets and there were unreported outstanding liabilities related to these state-owned enterprises. The liabilities include debt obligations (bank loans), arrears on taxes, and compensation claims by the previous owners of the enterprises nationalized by the *Dergue* regime.[130] The receipts that accrue from the privatization process are allocated to an independent account called a 'Sinking Fund'[131] and are used to finance regions and activities deemed necessary by the Ministry of Finance. As a whole it is important to determine the net receipt from this privatization process. This is because the deposits into and withdrawals from such funds are treated as budgets in the federal financial account.

5 LIMITATIONS ON TAXATION POWER

The division of tax powers to each layer of government entails a limitation that each of them be restricted to the type of tax allotted to them. For instance, states are restricted in imposing customs duties as this power is exclusively allotted to the federal government. Similarly the power of a federal government is limited when imposing the type of taxes exclusively assigned to the states. This section considers other types of limitations found in many federal constitutions, and whether they have a place in the Ethiopian Constitution. Generally, there are three types of such limitations on taxing powers and they will now be discussed: prohibition of discriminatory tax laws, prohibition of extraterritorial state tax laws and tax immunity.

5.1 The prohibition of federal discriminatory tax laws

The first limitation imposes a prohibition on the federal government from dealing with tax between the states or other levels of government in a discriminatory manner.[132] This explicit constitutional limitation is found in the American and Australian Constitutions. Article I Section 8 and the XVIth amendment of the American Constitution requires all Duties, Imposts and Excises, and income taxes to be uniform throughout the United States.[133] The Australian Constitution also provides that the federal power to impose tax on any sources must not be exercised 'so as to discriminate between states or parts of states' (Section 51, ii). This approach helped to avoid the problem encountered in the US before the XVIth amendment and helped to achieve the uniformity requirement.[134]

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[130] For instance, in 2004 the federal government agreed to pay $1.5m to Nestle co., which was a shareholder in a horticultural company that was nationalized in 1975.

[131] Unutilized funds and receipts from the privatization process are deposited in the sinking fund. See Sinking Fund Establishment, Council of Ministers' regulation number 39/1998.

[132] Saunders (2002), op. cit., p. 8.

[133] Originally, the difference between Sec. 8 and Sec. 9 (4) of Art. I of the Constitution led to the conclusion that indirect taxes (Duties, Imposts and Excises) should be uniform throughout the US, while states should be subject to different direct tax (income tax) treatment depending on the variation in census or enumeration. The variations depicted in these two provisions forced the adoption of the XVIth amendment of the US Constitution which subjects income tax to the same requirement under Art. I Sec. 8 that no discriminatory income tax be enforced.

[134] As indicated in the preceding footnote, before the XVIth Amendment of the US Constitution the uniformity requirement was subject to the difference between direct and indirect taxes. According to court decisions, taxation of income derived from property (i.e. from rents, dividends and interest) was held to be direct and was not subject to the uniformity requirement. And taxation of income derived from activity (profession, trades, employment)

The significance of this kind of limitation upon the federal government is apparent for the main reason that people of different states should not be exposed to unfair treatment by the centre on the pretext of the inequality of states. It is also attributed to the equal constitutional status of the states.[135] The limitation prohibits the imposition of different tax rates and different tax privileges between the states. But in some federal systems, the asymmetry between the constituent units of a federation cannot be overlooked. Rather, it calls for a prudent approach which guarantees a need for assisting the neediest states without varying the tax rates. In practice, a relatively simple measure of discriminatory treatment towards an underprivileged region may enhance the financial capacity of that region.

The tendency of many other federal constitutions is not to explicitly regulate the uniformity of tax laws so as not to close all possible avenues for providing otherwise. In Ethiopia, the asymmetry between the regions is a glaring fact. The Constitution, therefore, requires the governments to provide special assistance to those regions which are least advantaged in economic development. One of the measures taken with regard to taxation is that of the provision of different tax holidays for income from different regions. For example, persons who invest by establishing new enterprises in regions such as Gambela, Benishangul-Gumuz, Somali and Afar are granted an exemption for a period of five years, but if the investment activity is in the remainder of the regions the period of exemption will only be for three years.[136] The greater tax incentive is to attract investment in the above mentioned least developed regions. However, the limitation must be understood as requiring the federal government (and even the states) to abstain from taking discriminatory tax measures which may provide undue preferential treatment to a specific region.[137]

5.2 The prohibition of the extraterritoriality of state taxes

The second limitation is the prohibition of the extraterritoriality of taxes imposed by the constituent units of a federation. The impact of those taxes which by their very nature are extraterritorial can be assigned to the centre, as in the case of customs duties. The Canadian Constitution (Section 92. 2) explicitly provides for the limitation of tax power by requiring provincial tax legislation to be used for 'the raising of revenue for provincial purposes'. This limitation is partly an inherent aspect of some of the tax powers allotted to the constituent jurisdictions, for example, those types of taxes embedded in a 'geographical tax base' such as different types of property taxes. The purpose of this limitation, however, is for preventing certain types of taxes from shifting beyond the territorial boundaries of the constituent jurisdictions. This is because such taxes may have an impact outside the geographical boundaries by imposing burdens upon the economic and trade activities of another state, or they may result in a

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was indirect and subject to the requirement of uniformity throughout the US. However, according to the XVIth Amendment, all federal income taxes are subject to the requirement of uniformity throughout the United States. See Laurence Clause, 'Budgetary Federalism in the United States of America', a paper Presented at the International Academy of Comparative Law, XVIth Congress, Brisbane, 14-20 July, 2002, p. 9-13.

[135] Saunders (2002), op. cit., P. 8.

[136] Council of Ministers' Regulation to Provide for Investment Incentives No. 7/1996.

[137] On the other hand, Laurence Clause says, 'The evil which the uniformity clause precludes is discrimination by reference to state's political lines and state's policies'. Clause, op. cit., p.11-12.

duplication of taxes. Such problems can be mitigated by the constitutional provision which stipulates that the federal government 'shall regulate interstate and foreign commerce'.[138]

The need to preserve the free flow of goods, services and capital is one of the considerations for the imposition of this constitutional limitation on the power of taxation. Non-discrimination is also at the core of this consideration.[139] A problem could be anticipated if a state imposes a different and burdensome tax upon those who are engaged in trading not only in the state but also outside the state. In other words, an issue may arise if a state imposes more burdensome taxes upon those who intend to export to other regions. This could be sought to lower prices for resident consumers by not allowing exports to other states, or by imposing burdensome taxes on items coming into the region. The purpose of the prohibition of the extraterritoriality of taxes is to limit the state's taxes on trade within its territory without discriminatory effects. That is, the states should desist from taking decisions that discriminate between goods on the ground of origin. But perhaps more important in the Ethiopian context, the states should not enact tax laws that discriminate among taxpayers on ethnic grounds. For example, income tax rate structure or assessment that discriminates against taxpayers whose ethnic origin differs from that of its inhabitants must be avoided.

The problems with regard to tax that affects the trading activity involving two or more states can be primarily addressed through regulations on interstate trade and commerce by the centre. They can also be addressed by avoiding conflicts between laws enacted by the various jurisdictions by establishing a relationship between the subject-matter and the law of the state concerned, or through effective intergovernmental cooperation. A power is mostly reserved for the federal government to regulate interstate trade and commerce in order to limit the impact of extraterritorial legislation. The limitation can be effective in Ethiopia since the states' taxing powers are by and large enforced on territorially-limited tax bases, and the power of regulating interstate trade is given to the federal government.

5.3 Intergovernmental tax immunity

The third limitation concerns the capacity of each tier of government to tax each other.[140] When there are several tiers of government, a question arises as to whether it is proper for one level of government to pay tax to the other. In a federal system, the two tiers of government having autonomous functions and taxing powers are deemed to operate in parallel so that one level of government cannot interfere with the power of the other. In practice, however, it is hardly possible to avoid the possibility of intervening in the working of one government by the other. In order to ensure that a level of government operates without unduly interfering in the operations of the other the doctrine of intergovernmental immunity has developed in the area of taxation. We first look at the notion of tax immunity as it developed in the USA, Australia, Canada and India.

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[138] Art. 51 (12) of the FDRE Constitution. For the analysis of the 'commerce clause' restricting state tax power in the US, see Ferdinand P. Schoettle, 'Commerce Clause Challenges to State Taxes'(75 Minnesota
Law Review 907, 1991): 907-932.
[139] Saunders (2002), *op. cit.*, p.9
[140] *Ibid.*

The doctrine of tax immunity, which finds its source in *American federalism*, is not explicitly mentioned in the US Constitution, but has developed through judicial review. The concept was first introduced in the decision in McCulloch vs. Maryland.[141] US Congress had enacted a law incorporating a bank and the Maryland state levied a tax on that bank. The Supreme Court declared the state's tax law to be unconstitutional, and introduced the doctrine of immunity by stating that the state had no power 'by taxation or otherwise to retard, impede, burden or in any manner control the operation of the constitutional law enacted by Congress to carry into execution the power vested in the federal government.'[142] The Supreme Court also continued to provide a reciprocal benefit to the states: the states' functions would be protected from central taxation as well.[143]

The federal government as well as the states are entitled to immunity from tax imposed by one against the other. Jain explains that the immunity concept as it exists today in the US embodies two important concepts.[144] First, it prohibits the imposition of discriminatory taxes against the states which is an important restriction on interfering in their performance essentially expressing their autonomy. Second, a state function is not necessarily immune from central taxation, nor does the federal government become immune from state taxation. The immunity must be confined to a function with a purely governmental character. Clarifying the second concept, Laurence Clause explained that states' employees can be subject to federal income tax, and federal employees can be subject to a state's payroll tax. Similarly, taxes on business enterprises may not automatically be immunized unless the 'legal incidence of the taxes' finally reaches the federal or a state government.[145]

L. Clause describes that the US Supreme Court has considered in several of its decisions whether a particular state tax had legal consequences for the federal government, or merely for persons with whom it dealt.[146] He goes on to explain that, according to the court, the scope of this immunity covers a prohibition of state taxes from being imposed directly upon the federal government, or indirectly by imposing discriminatory taxes upon those persons having a relationship with the federal government which ultimately impairs the tax capacity of the centre.[147] State immunity from federal taxation also requires an absolute prohibition of discriminatory federal taxes and taxes that would impair their existence or capacity to function.[148] The major objective of granting immunity is to protect the revenue-raising capacity from being seriously impaired

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[141] 4 Wheat. 316 (1819), as discussed in Mason and Stephenson, op. cit., p. 270-271.
[142] Chief Justice Marshal as quoted in Mason, A.T. and D.G. Stephenson, *op. cit.*, p. 271.
[143] *Ibid.*
[144] Jain, *op. cit.*, p. 327.
[145] Laurence Clause, 'Budgetary Federalism in the United States of America', paper Presented at the International Academy of Comparative Law, XVI th congress, Brisbane, 14-20 July, 2002, p. 4.
[146] For instance, see (as quoted in Clause op. cit., p. 6) New York V. United States 326 U.S. 572 (1946); Oklahoma Tax Commission v. Texas co., 336 U.S.342, 362-366(1949); Washington v. United States 460U.S.536 (1983).
[147] Clause, *op cit.*, p. 6-7.
[148] Clause, *op. cit.*, p. 6. In this regard, he noted that the Supreme Court recently decided in favour of a state tax imposed exclusively on the sale of building materials to contractors engaged in construction projects on federal land. The court argued that the net result was that for federal projects but the legal incidence of the tax fell on the contractor rather than the landowner-the federal government.

by the imposition of tax so that they perform the tasks independently assigned to each of them.

In *Australia*, Section 114 of the Constitution provides a restriction on both the federation and the states from levying taxes on the property of each other. However, this provision was later narrowly construed to make a distinction between properties of a state within the commonwealth and those movable items imported or acquired in transactions. Consequently, taxes on the holding of property within the commonwealth are covered by the immunity clause whereas property acquired in a transaction is subject to taxes. So, customs duties are imposed on imported items based on the argument that the tax is not on the property, but on the act of importation.[149]

A similar provision in the *Canadian Constitution*, Section 125, prohibits the taxation of land or property of one government by the other. Like the interpretation given in Australia, it is also held in Canada that the provincial importation of goods is not immunized from customs duties.[150]
The principle of intergovernmental tax immunity is also included in the *Indian Constitution*.[151] The benefit of tax immunity towards the Union applies to the states, but with one basic difference. Jain says that the difference lies on Article 285 which is interpreted in such a way that Union property can be immunized even in the case of use for commercial purposes, whereas state property is not subject to a similar exemption from Union tax.[152] However, according to this interpretation the immunity does not apply to property that belongs to a company which has a personality of its own, although the total share might be owned by the centre. The central government can impose customs duties on goods imported or exported, or excise duty on goods produced or manufactured by a state government irrespective of whether it is used for business purposes.[153]

In *Ethiopia*, the directives on intergovernmental tax immunity can be traced from Article 100 (3) of the Constitution. It reads: 'Neither states nor the federal government shall levy and collect taxes on each other's property unless it is a profit-making enterprise.' Before we conclude the extent of benefits the federal government and the states might obtain from this tax immunity, let us determine the scope of application of the given provision. First, what does 'a profit making enterprise' signify in the given provision? Second, what does 'property' mean? The third issue refers to the incidence of tax.

With regard to the *first* question, the provision implies that it is not the status of public ownership that matters; rather, it is the purpose of the enterprise. Thus, any public enterprise engaged in profit-making would not be subject to immunity. For instance, since land is public property in Ethiopia its use is subject to lease contracts. Thus, public enterprises engaged in profit making (e.g. federally owned industries and hotels) will be subject to the payment of fees for

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[149] Att. Gen. of N.S.W. vs. Collector of Customs, 5 CLR 818, as quoted in Jain, op. cit., p. 328.
[150] Jain, *op cit.* p. 327.
[151] Art. 285 (1) and 289 (1) of the Indian Constitution. 'Art. 285 (1) The property of the Union shall, save in so far as Parliament may by law otherwise provide, be exempt from all taxes imposed by a State or by any authority within a State.
Art. 289 (1) The property and income of a State shall be exempt from Union taxation.
(2) Nothing in clause (1) shall prevent the Union from imposing, or authorizing the imposition of, any tax...'
[152] Governor General Council v. Corporation of Calcutta AIR 1948, and The Corporation of Calcutta v. The Governor of St. Thomas School, AIR 1949, as quoted in Jain, *op. cit.*, p. 329.
[153] Ibid, p. 329

land use, while federal executive agencies will benefit from tax immunity, according to Article 100(3) of the Constitution. At this juncture it is important to take note that the above provision gives a wrong impression as if each level of government can tax the profit which the enterprise of the other makes. This should, however, be examined in light of the scheme of distribution of revenue-raising powers adopted by the Constitution. As discussed in the previous section, the taxing powers of the states and the federal government are limited to the subjects, including their respective enterprises, specifically mentioned as their exclusive sources. Accordingly, the federal government and the states levy and collect income, profit, sales and excise taxes on enterprises owned by the respective governments.[154]

The *second* question refers to the meaning of property. The word property can be construed to refer not only to corporeal movable and immovable things, but also to incorporeal (intangible) things. Thus, income from dividends or interests will be part of a state's property. Here the meaning of property clarifies the issue as to whether an income of a state government deriving from its enterprises, if there are any, would be immune from federal taxation. As a result, a state's income derived in the form of dividend from state's enterprise or from income derived from interests will be exempt from federal taxation. In this case, the principle of intergovernmental tax immunity protects the financial capacity of the regional government. The Ethiopian federal income tax proclamation followed the same line of interpretation by exempting the revenue obtained from dividends and interest from deposits by a state government.[155]

A related issue is from what kind of tax can a state property be immune? To be more specific, can a state property be subject to customs duties? Before providing a conclusive answer we can better look at whether a state can engage in import or export activities. A department of state government such as the education or health bureau may import educational and research materials, or health equipment from abroad. In such a case a state may argue that the Constitution immunizes the importation of goods. The federal government, on the other hand, may argue that customs duties are paid on 'the process of importation' but not on 'the property of a state,' and it may also affect the revenue capacity of the central government. It should be noted, however, that as customs duties are indirect taxes they finally fall on the consumer. Thus, in our case it is a state which would become the consumer and could therefore be burdened with the tax. This would seriously impair the financial capacity of a state. As long as the importation is not for making a profit, it will be covered by the directives on tax immunity. The practice is also consistent with this interpretation, as the federal Ministry of Revenue has issued a directive to this effect.

The *third* question relates to the incidence of sales or excise taxes: can the federal government confer immunity on individuals or companies dealing with a state? If a discriminatory tax is imposed on those dealing with a state, the tax can be challenged since it increases the burden of the state. If the immunity is requested in order to discharge the dealers from paying a federal tax, it goes beyond the whole doctrine of intergovernmental tax immunity. The need to

[154] See Arts. 96 (3) and 97 (7) of the FDRE Constitution.
[155] Income Tax Proclamation No. 286/2002, Art. 30(2) exempts the revenue obtained by the federal, regional, local governments, and the National Bank. The Amharic version of the same legislation extends the exemption to every department or administrative agency of a government.

impose a restriction on the government is not to unduly benefit private individuals. Rather, it is to preserve the taxing capacity of a government. In practice, if a government acquires things in an ordinary market, the above issue of tax immunity does not arise due to practical reasons. In Ethiopia, if a person dealing with a state were to be immunized from a federal tax, that person would not be subject to state taxation either. This is because the assignment of taxation power which the Constitution follows curtails the possibility of reserving tax power to a state when there is a federal taxing power. Although tax immunity is related to the government property or function, in Ethiopia with regard to tax on income from employment of a government, reciprocal tax immunity exists by virtue of the constitutional division of taxation power.[156]

In sum, the issue of intergovernmental tax immunity is limited in Ethiopia for two main reasons: it is explicitly recognized in the Constitution and other appropriate legislation, e.g. income tax law, and due to the constitutional method for the division of taxation power. However, the challenge that may arise concerning tax immunity and privilege would be to unfairly utilize the benefit accorded to state governments. This requires to prevent the benefit from being unfairly utilized for personal gains through corrupt practices, and as we have discussed in the preceding Chapter, to effectively address issues spinning around the status or benefits of party (or state) affiliated business organizations.

6. ASSESSMENT

The Constitution of Ethiopia stipulates that the federal and state governments have to finance those functions that are assigned to them. With this objective revenue sources have been assigned to each level of government by the Constitution. The scheme for the allocation of revenue sources reflects some important features of its own although it shares most of the characteristics of taxation in developing countries. The scope of taxation and the taxable capacity is limited in Ethiopia as in many developing countries. Because of a shortage of broad-base tax sources the revenue structure is dominated by foreign trade taxes. The revenue capacity is limited not only because of tax base constraints but also because of inefficient collection and a poor infrastructure.

In the following paragraph, we summarize the main findings of tax assignment as adopted by the Ethiopian Constitution.

a) The allocation of taxation power and the collection of taxes are made in relation to the centre and the states only. The allocation of taxation power and the sharing of revenue below the state level have not been addressed by the federal Constitution. They are matters to be dealt with by the respective states; they should be determined by appropriate legislation.
b) The major tax sources are assigned to the centre. Revenue from customs duties and from certain sources which are unevenly distributed such as income, sales and excise taxes from public enterprises, and from air and rail transport are reserved for the federal government. However, revenue sources which could be administered conveniently and increase the financial capacity of the states should be identified and reserved to the latter. In this regard, income tax from employees of public enterprises and NGOs could be assigned to the states. The mobility factor of companies should also be considered. If companies (like laundry services) are not

[156] Arts. 96 (3) and 97 (1) of the FDRE Constitution.

engaged in business in several states, it is important to assign the levying of taxes to the state where they reside.

c) Taxes on sources or economic activities which are unevenly distributed, or those mainly touching on interstate trade or commerce are assigned to the centre but the revenue is shared with the states. Different types of taxes imposed upon the products or income of companies, and also taxes on mining, petroleum and gas operations fall within this category. The main reason for allocating these sources to the centre is administrative convenience.[157] Nonetheless, in a situation where major revenue sources or export items are found in a specific region, it is important to set an appropriate formula for sharing such revenue or alternatively there should be federal spending in the region where the revenue sources are situated. This is because otherwise this situation could be a major source of conflict since there may develop a sense of entitlement to the resources.

d) The nature of tax assignment which the FDRE Constitution has adopted aims at avoiding the problems associated with 'tax overlapping' and 'multiple taxation'[158] that arise in some other federations. These problems arise when both levels of government levy the same kind of tax on the same tax base, for example when both the centre and the states can levy personal income tax on the same person. This may happen when there is no rigid separation of the type of tax and its base between the levels of government, or when the Constitution confers general concurrent power of taxation on each jurisdiction.[159] The primary approach of the Ethiopian Constitution is a rigid separation of the taxation power of the centre and the states, where a particular type of tax (on a specific source) levied by the centre cannot be subject to the taxation power of the states. This approach helps to minimize conflicts of interest between the states and the centre, or between the states themselves.

However, the following two points should be taken care of. First, although there is a formal constitutional division of taxing power, there are also instances for the allocation of undesignated taxation power. This requires not only a careful analysis of the proper levying and administration of taxes but also determining the scope of the existing taxes.

Second, the processes of intergovernmental cooperation for proper administration of taxes are also important. In this regard, the participation of states in the collation of concurrent taxes and local governments in the administration of states' taxes is vital. The tax administration should also clarify issues related to the responsibility of a withholding agent as to which level of government has the power to collect taxes from the taxpayer. These general issues have implications for the financial capacity of each tier of government, which will be addressed in the next chapter.

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[157] Minutes of the meeting of the HOF on the proposal for the Amendment of Art. 98 of the FDRE Constitution.

[158] Tax overlapping arises when central and state taxes operate simultaneously on the same tax base (federal-state). Multiple-taxation arises when several states levy similar taxes on the same tax base (state-state). Some authors (as Oates) argue that tax overlapping may not be condemned unless it results undesirable consequences.

[159] In such cases (e.g. the USA), the elaborated division of taxes has been organized through practice where both levels of government have engaged in a series of negotiations to determine the character of taxes at the centre or at the state level, and the effect of inter-jurisdictional competition. In general, the centre and the states concurrently levy income tax in most federal systems. But the centre usually dominates this tax either through negotiations or through the supremacy clause.

e) The Ethiopian Constitution follows a similar trend as that of India by its 'rigid' allocation of tax sources which follow the principle of administrative convenience. Although the type of taxes and the details concerning tax bases assigned to each level of government vary, they depict a similar approach for having specified not only the type of tax but also its source (tax base). The Indian Constitution categorizes income tax into agricultural and non-agricultural, where the former is assigned to the states and the latter to the centre. The Ethiopian Constitution classifies income tax levied from different sources such as from air, water, and rail transport, income from federal property, personal income from the employees of the federal government and international organizations. The Indian Constitution, for example, categorizes federal excise taxes to be imposed on tobacco products and other goods produced in India except alcohol and opium products. The items excluded fall under the states' power. In Ethiopia, excises on imported items and products of federal enterprises belong to the centre, whereas excise on products of state enterprises is left to the states. Excise on the products of private companies is levied by the central government but shared with the states. The main difference between the two constitutions is that the Ethiopian Constitution is very concise and its description of tax bases seems incomplete, as some tax sources that were in use even before the coming into force of the Constitution are not addressed there in.

The Ethiopian Constitution also shows some similarity with the German Basic Law by providing for 'shared taxes', levied by the centre but shared with the constituent units. The German Constitution is transparent in providing the share of the Länder and the local governments. But, in Ethiopia, the apportionment of revenue that accrues from shared taxes has neither been provided in the Constitution nor in Acts except the HOF's decision in the 2003/04 fiscal year (see Chapter VII).

There are criticisms against the tax assignment system which the Ethiopian Constitution follows. The pattern of the tax assigned to the centre, to the states or to be shared amongst the centre and the states is incomplete. The Constitution has reserved the system of assigning residual taxes to the joint meeting of the two Federal Houses. Often residual power refers to cases not foreseen during the drafting of a federal constitution. The Ethiopian Constitution, however, does not make any reference to some tax bases which were already in use before its introduction in 1995. There are taxes already included in the income tax proclamation which the Constitution should have referred to, such as capital gains tax, income tax on savings, income from self-employed persons or professionals. Where there is a rigid separation of taxation power, where the possibility of residual taxes is high, and where the contribution of taxes to the economy is expected to grow, it is imperative for the Constitution to entrust an institution to study tax related issues and to submit its recommendation to the Federal Houses for timely consideration.

A disadvantage of the division of income tax to different levels of government is the inability to impose progressive taxation upon income of an individual from several sources. Income is subject to progressive taxation for the objective of equity and income redistribution by following the principle of the ability to pay. As per the Ethiopian Constitution, income from profits, income from dividends, income from the sale of property or income from other sources could be subject to different levels of government or could be subject to different tax laws.

Implementing progressive taxes upon the sum of income is an arduous task since it requires the effective use of information concerning the income of an individual from different sources. However, the Ethiopian income tax law partly addressed the problem by imposing a progressive rate upon income from some of these sources.

Another problem lies in the assignment of taxes on profit, sales and excise taxes upon products of enterprises owned by a state to the respective states. Presently these taxes do not create a problem, as states at present do not own enterprises. But when they are put into use, the taxes may have an impact upon interstate trade or may conflict with the economic objective of taxes. For instance, taxes imposed upon such items produced by state-owned enterprises may easily transport to other states, or if the products are primarily to be exported to other states the taxes imposed at the place of origin will discriminate against other states. Or a state (the owner of the enterprise) can impose sales tax on items produced in its territory, while other states may also tax these items as sales take place within their jurisdiction. This may affect interstate trade and commerce as consumers whose items have passed through several states could be subject to multiple taxation. At some stage it may become necessary to devise a mechanism to avoid such problems. In this regard, the limitations of tax power are of greatest significance for the ethnic-based Ethiopian federation. Accordingly, they have to be understood as prohibiting discrimination not only between states but also between individuals of different ethnic origin. Moreover, they are also for securing a fair treatment of individuals (traders) from other states and for matters of protecting interstate trade from state taxation.

5 Budgetary Relations between the States and the Federal Government: Fiscal Imbalances

After the discussion in the foregoing chapters on the assignment of expenditure responsibilities and revenue-raising powers, it is now possible to conduct a numerical analysis of the budgetary relationship between the levels of government. The analysis focuses on a mismatch between expenditure responsibilities and revenue capacity, which refers to fiscal imbalances between the federal government and the states, between the states themselves as well as at an individual level of government.

In the present chapter we begin our discussion by giving an overview of the governments' spending referring to functional classification, spending problems and the percentage share of revenue sources at the national level in Section 1. The next Sections, 2 and 3, examine the 'vertical' and 'horizontal' fiscal imbalances in Ethiopia respectively. In this discussion, the main emphasis will be on identifying the extent of the problems in measuring the fiscal imbalances as well as the extent of the disparities between the levels of government and their causes. The concepts of vertical and horizontal imbalances are also illustrated in Tables. After analyzing these issues, we proceed to Section 4 to briefly discuss whether governments compete to enlarge their tax capacity, as this can influence the budgetary relations and fiscal imbalances between the levels of government. The assessment under Section 5 brings us to the importance of correcting the imbalances through intergovernmental revenue transfer mechanisms which will be studied in Chapter VII.

1 OVERVIEW OF FEDERAL AND REGIONAL GOVERNMENT SPENDING AND THEIR RESOURCES

1.1 General trends: 1992-2003

The FDRE Constitution (Article 94(1)) requires that the federal government and the states 'shall respectively bear all financial expenditures necessary to carry out all responsibilities and functions assigned to them by law'. The crucial factor that determines the financial expenditure of the respective governments is the financial capacity which is primarily influenced by the constitutional allocation of revenue sources and the method of redistribution. The financial expenditure is further determined by the underlying economic, social and political conditions. This section examines the share of governments' spending by source and function in order to better understand the imbalances between the governments.

Following the introduction of the devolution process in Ethiopia, the central government expressed its commitment towards focusing on selected sectoral development programmes and promoting the private sector. Thus, the share of the central government's and the regions' expenditure indicate the increased spending on selected socio-economic activities. For instance, from 1992-1997 the government's budget indicated an increase in spending on health, education and

road sectors while the figures for defence expenditure showed a sharp decline.[1] Defence expenditure was given less attention, unlike during the pre-1991 period. However, when the war with Eritrea broke out in 1998, the spending on defence dramatically increased almost consuming all the budget intended for major capital expenditure in other areas. Its share again dropped in the post-war period (post-2001) but remained higher than the pre-war period (1992-98).

The overall reports concerning the period between 1991/92-1997/98 demonstrate that the total share devoted to capital expenditure increased while the share of recurrent expenditure declined. Recurrent expenditure declined from about 77 percent of the total expenditure in 1992/93 to 63 percent of the total expenditure in 2001/02.[2] However, throughout the given fiscal years wages and salaries constituted 25-30 percent of the budget. In the meantime the total capital expenditure increased from 22 percent in the 1992/93 fiscal year to 37 percent in the 2002/03 fiscal year. The focus on capital expenditure was the consequence of the end of the civil war period (pre-1992) that resulted in a substantial reduction in defence spending. It can also be attributed to the increased donor funds for capital projects. These two factors, *inter alia*, have created a period of reconstruction in some areas and regional reorganization in the new territories. Thus, one could observe government attention being given to reconstruction and development in war-torn zones, and the construction of offices and other development activities in the newly established regions. Moreover, the focus of international donor institutions was in selected capital projects such as the road and energy sectors. However, there will be additional efforts towards recurrent spending in the post-2002/03 period due to an emphasis on capacity building and training, local decentralization programmes, AIDS prevention and control programs, ensuring food self-sufficiency[3], and a decline in the regions' budget for building offices. The public sector is also withdrawing from spending on activities that can be undertaken by the private sector.[4]

When one further analyzes the trends in government expenditure, there is a considerable amount devoted to the transport sector. The capital expenditure for the transport sector (mainly road construction) as a proportion of the expenditure on economic development grew from 6 percent in 1992/93 to 25 percent in 2001/02. There is also an increase in the expenditure on the education and health sectors.[5] However, the World Bank study shows that the per capita expenditure on education and health is still very low compared to other least developed countries.[6] This is mainly attributed to scarce financial

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[1] For the shares of recurrent and capital expenditures by functional classification see Tables 5:1 and 5:2; during the given fiscal years the defence expenditure declined from 18 percent in 1992 to 7.4 percent of the total budget in 1997. However, its budget sharply increased during the following three fiscal years due to the war with Eritrea.

[2] It should be noted that the data in this chapter have not been fully corrected for the rate of inflation. Nevertheless, the data demonstrate the expenditure trends in a functional classification and the overall share of the fiscal capacity of the centre and the regions.

[3] See Ministry of Finance and Economic Development, 'Sustainable Development and Poverty Reduction Program (SDPRP) of the FDRE', Addis Ababa, July 2002.

[4] For instance, see Table 5:2 where the capital expenditure on industry declined from 15.4 percent in the 1991/92 fiscal year to 0.1 percent in 2000/01 of the total budget allocated for capital expenditure.

[5] For a detailed account of the economic reform and the performance of each economic sector in Ethiopia, see Kinfe Abraham, *Ethiopia: The Dynamics of Economic Reforms* (EIIPD press, 2001).

[6] World Bank, 'Ethiopia: Review of public finances', Report No.20810, 2000, p. 11.

resources and the low level of the economy. This implies the need for effective decision making in prioritizing competing public expenditure needs and promoting the participation of the private sector in providing these services.

The federal government accounts for a higher proportion of the total expenditure than the states; this is more pronounced in relation to capital expenditure than recurrent expenditure in certain sectors. This is because large capital investment projects are carried out through federal agencies such as the Ethiopian Road Authority, the Ministry of Defence, the Agricultural Ministry and research organizations, the Aviation Authority and the Electricity Corporation. These five programme areas consume a considerable amount of the federal capital budget. The federal government can spend on anything within its jurisdiction, but focuses on the major development sectors mentioned above. However, direct federal spending in a region to provide services in the above mentioned priority sectors has sometimes led to resentment. The reason is partly related to a lack of transparency in the process of prioritizing geographical areas that can receive the services (e.g. electricity or road construction). As the government cannot provide these services at the same time in all areas needing such services, some ethnic groups feel that the government has paid no attention to their problems. Federal spending obviously has a direct or an indirect impact on interstate disparities since it is intended for improved provision of public goods and services, infrastructural developments and improving standards of living.[7] This issue highlights the need for a 'checks and balances' procedure in the Upper House to monitor federal decisions that may have effects concerning decisions by the House as to the formula for federal grants.

The regional governments, on the other hand, have become responsible for several categories of public expenditure, mainly in the education and health sectors and self-administration. Their role has become significant in both recurrent and capital budgets. The share of the total expenditure carried out by the regional governments has steadily increased throughout the fiscal years studied here.[8] However, the capacity of the regions varies significantly (see the following sections). In most of the regions, performance has been beset by inefficiency and corrupt practices. In general, the increasing importance of the regions in several socio-economic sectors has been welcomed, but their underperformance has necessitated action to strengthen their capacity to budget, implement and evaluate the use of resources at their disposal. In this regard, it is important not only to employ the revenue transfer mechanism but also to engage the governments in effective intergovernmental cooperation which may address the problems of inefficiency.

1.2 Reform of budget control

Although the trend in the allocation of capital expenditure by both tiers of government was welcomed, there was and is a danger of misappropriation of resources at the federal and regional levels.[9] Normally, the growth in capital expenditure would mean a better infrastructure or better public services. But the impact of irresponsible capital spending cannot be ignored when it leads to the

[7] For a detailed analysis of the impact of federal spending, see Chapter III, Sec. 2.4.1.
[8] But in the 1998/99-2000/01 fiscal year (during the war with Eritrea), the regions' shares declined due to an increase in the defence budget.
[9] See, for instance, the reports (unpublished) of the General Auditor to the parliament (from 1998-2001).

purchase of goods that have less of a public purpose, such as vehicles (more than reasonably required) for the government authorities.

Nowadays, it is common knowledge that a higher official (at the regional or central level) has a minimum of two vehicles for his/her official and personal use.[1] It is not difficult to understand the impact of this lavish spending from the government budget. The price of a typical vehicle used by an official is almost equal to the cost of one elementary school or one health centre in a rural area. Furthermore, the method of disbursing capital budgets has paved the way for harmful financial practices. One of the studies conducted by the Ethiopian Economic Association indicates that, unlike recurrent expenditures, which are paid on a regular basis, the budget outlays of capital budgets are made in the last month of the fiscal year. In this regard, the study concludes:[10]

> For the period 1991/92-2001/02, the average share of the first, second and third quarters were respectively, 11.35, 19 and 21.7 percent. Almost half of the activities under the capital budget are accomplished in the fourth quarter. This is clearly a rush to spend the allotted money before the end of the budget year. Such a 'fire buy' is very likely to create all kinds of loopholes for embezzlement of public funds. Even worse, capital projects that are accomplished in such a short period of time are susceptible to quality problems leading to lower economic and social returns. It is not uncommon to hear that some payments are effected at the eleventh hour lest the budget expires and returns to the federal treasury.

The most worrisome issue has been the absence of an effective mechanism to make the decision-makers accountable. However, in order to manage public resources in an efficient and effective manner, the overhaul of the legal instruments and reform of the financial system has been part of the government's commitment. Accordingly, a reform targeting 'expenditure management and budget control'[11] has been geared towards improving the public expenditure management system in Ethiopia. The reform covers a wide range of issues such as the legal framework, management, reporting, procurement, and internal and external audits. The necessary legal instrument has been proclaimed and it has entered into force at the federal and regional levels.[12] The improved financial laws target the proper use of public funds, including reporting, purchasing, auditing and legal responsibility. Anti-corruption commissions have been established at both the federal and regional levels to curb corruption in general, and to investigate corruption cases and to prosecute individuals suspected of committing the crime.[13] However, the sluggishness of the reform process has remained troublesome. Although there are reports of massive dismissals and demotions of authorities, there is also tolerance of economic corruption mainly for reasons of political expediency. This is, according to Merera, due to the fact that both the regional officials and the persons to whom they are accountable are primarily corrupt and inefficient.[14] Maimere argues that no matter how corrupt and inefficient the officials are, they still remain in power since it is their ethnic identity not their merit that matters

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[10] The Ethiopian Economic Association/ Ethiopian Economic Policy Research Institute, 'Quarterly Report on the Macroeconomic Performance of the Ethiopian Economy', Vol. 1 No. 1, November 2003, p. 16.

[11] Ministry of Economic Development, 'Expenditure management and control reform programme', March 1998, Addis Ababa.

[12] The proclamation and the regulation came into force in 1997. Federal Government of Ethiopia Financial Administration proc. No. 57/1996, and Councils of Ministers Financial Regulation No. 17/1997.

[13] See Proclamation No. 239/2001 for the establishment of Anti-Corruption Commission.

[14] Merera Gudina, *Ethiopia: Competing Ethnic Nationalism and the Quest for Democracy, 1960-2000*, (Chamber Printing Press, Addis Ababa, reprint 2003), p. 141.

Table 5:1. General Government (Fed +States) **Recurrent expenditure** by functional classification, 1991/92-2002/03: Percentages of total recurrent expenditure. *
Ethiopian fiscal year ending July7.

	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03
General Services	32.6	33.9	30.8	31.8	34.9	33.4	44.3	54.7	61.3	49.5	44.3	34.59
-O/w defence	19.49	19.82	15.07	14.12	13.82	15.03	27.20	41.16	49.84	31.67	24.76	17.31
Econ. Services	7.5	9.8	10.1	10.9	11.1	11.7	9.0	7.5	6.1	9.1	9.9	9.82
-O/w Agric. & Natural resources	4.15	5.05	5.69	6.46	6.78	7.28	6.22	4.93	3.97	6.09	6.41	5.4
Social services	24.3	27.9	27.5	26.9	25.5	26.1	23.7	18.2	15.4	21.4	26.6	23.53
-O/w Educ. & training	15.07	17.59	16.84	16.56	16.86	17.95	15.58	11.97	9.78	14.44	16.86	16.83
-O/w Public Health	4.66	5.51	6.38	5.95	5.88	5.93	5.43	4.36	2.94	4.48	4.95	3.89
Pension payments	6.0	6.6	6.2	5.3	5.2	5.3	4.3	0.2	0	0.2	0	
Interest and charges	9.4	15.4	21.8	16.1	16.5	16.0	12.1	9.5	8.9	10.3	9.5	9.01
Subsidies	1.8	0.2	1.9	2.9	3.1	2.2	0	0	0	0	0	
External assistance	12.5	3.9	1.2	4.1	2.6	4.6	5.1	9.3	7.9	9.4	9.5	21.36
Misc.	5.83	2.33	0.42	0.92	0.86	0.74	1.4	0.48	0.48	0.14	0.07	1.69
Total expend. (in millions birr)	3253.6	3434.5	4399.7	5215.5	5582.2	5750.4	7190.5	10533.1	13676.5	10441.2	10541.1	13527
Percentage of current exp. compared to total (R+C) exp.	77.37	65.8	62.02	62.3	61.04	57.42	66.6	71.8	78.01	66.35	63.2	68.2

* Source: Ministry of Finance and Economic Development, Policy Analysis Department, accessed in January 2004.

Table 5:2. General Government (Fed +States) **Capital expenditure** by functional classification, 1991/92-2002/03: Percentages of total capital expenditure.*

	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03
Econ. Develop.	88.4	4.1	73.3	77.5	73.5	75.3	67.4	70.4	63.4	56.3	54.3	52.9
-Agric.	25.8	19.2	13.9	9.3	10.0	8.4	8.1	16.9	14.2	10.9	12.9	12.08
-Natural resources.	15.6	16.6	12.9	14.7	11.9	13.3	13.2	10.3	8.2	6.8	4.9	4.75
-Mining & energy	14.7	8.2	9.3	8.5	10.7	18.5	10.4	10.2	7.2	7.6	6.1	8.34
-Industry	15.4	17.4	9.8	10.4	10.0	6.7	2.5	0.9	1.1	0.4	0.1	0.51
-Road Construction	6.4	11.0	15.4	23.7	19.0	19.0	25.9	24.8	25.9	24.9	24.9	24.9
-Transport & communicatio	7.1	7.8	9.7	5.9	6.1	9.2	5.3	7.1	6.3	5.7	5.4	2.23
Social Dev.	9.6	11.4	23.0	16.1	20.0	17.5	22.1	19.6	15.7	19.7	16.2	21.08
-Educ.	4.0	5.0	9.5	8.5	12.4	9.9	11.0	10.7	7.5	11.4	8.8	12.56
-Public Health	3.9	3.7	2.5	3.8	4.3	5.7	7.0	4.3	4.3	5.6	4.5	4.7
-Urban Dev. & Housing	1.4	1.4	6.0	3.5	2.8	1.5	3.4	4.1	3.1	2.4	2.7	3.33
General Dev.	1.6	4.3	3.0	5.9	6.1	6.8	10.1	9.6	10.4	11.1	11.3	7.04
Source, Total Cap. Exp. (%)	100	100	100	100	100	100	100	100	100	100	100	100
-Central treasury	48.9	51.7	71.2	71.3	75.6	76.2	74.3	59.3	53.2	49.1	44.8	51.7
-Ext. Assistance												
-Ext. Loan	14.3	15.5	4.4	5.9	4.0	3.8	3.7	6.2	10.5	12.7	18.2	18.9
	36.9	32.8	24.4	22.9	20.4	20.0	22.0	34.5	36.4	38.2	37.1	29.4
Total Capital Exp. (in millions birr)	951.8	1784.9	2694.3	3156.5	3562.6	4264.5	3608.3	4144.2	3855.1	5296	6134.1	6312.7
Percentage of Capital exp. compared to the total (R+C) exp.	22.63	34.2	38	37.7	39	42.6	33.4	28.2	22	33.7	36.8	31.8

- Source: Ministry of Finance and Economic Development, Policy Analysis Department, accessed in January 2004.

most to the government (to both the centre and the regions).[15] These problems require the governments to aggressively implement the recently launched 'capacity building program' and political commitment to restrict areas that need political appointments in the civil service.

1.3 The figures: an overview

In general, an overview reveals that the national financial sources are tax and non-tax sources (in the strict sense), loans (foreign and domestic) and foreign assistance. As can be observed from Table 5:3, the domestic revenue sources (tax and non-tax) account for only up to 62.8 percent of the total national revenue. Of the principal domestic revenue sources tax from foreign trade accounts for 30 percent of the federal revenue.[16] A sum of national borrowing (foreign and domestic) and foreign assistance on the other hand account for an average of 35 percent of the total national revenue. In general, about 17 percent of the total national revenue is allocated to the states in the form of grants which account for up to 70 percent of total state spending (see Table 5:6). This implies that the bulk of the states' revenue is comprised of grant-subsidies from the centre. Since a considerable amount of the states' and the federal revenue come from loans (foreign as well as domestic) and foreign assistance, sharing the 'national cake' also means sharing the revenue from loans and aid. However, dividing 'the cake' is not an easy task since the financial capacity of the regions varies tremendously, as they differ in their performance of the fiscal tasks assigned to them by the Constitution.
Thus, in order to understand budgetary relations in general, we need to analyse the causes and effects of vertical and horizontal fiscal imbalances in Ethiopian federal system.

Table 5:3: Percentages of the domestic and foreign sources of the national revenue for selected fiscal years. *

Fiscal year	Total expenditure (federal+ states)	Foreign loan and aid	Domestic loan and capital receipt	Domestic Revenues		
				Tax revenue	Non-tax revenue	Total Domestic revenue
	In Million Birr	%	%	%	%	%
1998/99 (actual)	*15,244*	*13.72*	*25.28*	*36.31*	*26.38*	*62.69*
1999/00 (actual)	*18,033*	*14.52*	*30.12*	*33.99*	*21.36*	*55.35*
2000/01 (actual)	*17,821*	*32.7*	*7.62*	*38.75*	*20.93*	*59.7*
01/02(pre Actual)[17]	*16,675*	*22.2*	*15*	*47.53*	*15.29*	*62.8*

* Source: Ministry of Finance and Economic Development, 'The Federal Government of Ethiopia Countrywide Budgetary Revenue and Expenditure', fiscal years 1998/99- 2000/01 (MOFED archive, unpublished).

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[15] Maimire Mennasemay, 'Federalism, Ethnicity and the Transition to Democracy', (Horn of Africa, V. XXI 2003), p. 88-114.
[16] Computed from 'Countrywide Budgetary Expenditure for the 2000/01 fiscal year', (MOFED archive, unpublished).
[17] The term 'Actual' refers to the final expenditure and revenue data consolidated by the Central Accounts Department of MOFED. The process of collecting reports, verifying, consolidating and subsequently publishing the data for each fiscal year usually takes three years and more. Those provisional data available at the Economic Policy and Planning Department of MOFED are labelled as 'Pre Actual'.

2 ISSUES OF VERTICAL IMBALANCE

In most federal systems, there is a mismatch between the expenditure responsibility and the revenue capacity of regional governments. This imbalance between the revenue-raising ability of subnational governments and their expenditure responsibilities is usually called vertical fiscal imbalance.[18] The problem of vertical imbalance is also evident in the Ethiopian fiscal arrangement. This vertical imbalance is primarily generated by the constitutionally assigned expenditure and revenue responsibilities. That is, while both tiers of government have significant expenditure responsibilities, the major revenue sources remain concentrated at the centre.[19]

2.1 Measurement

One way to measure the vertical imbalance is to examine what share of regional government expenditures is financed with revenue sources under the control of the regions. The corollary of this is the share of regional government expenditures financed with revenue sources controlled by the federal government.

The second way to examine the imbalance is to measure the share of revenue generated by the regions as a percentage of the total national revenue raised by all tiers of government.[20] The imbalance measured in these two ways demonstrates that the states remain with limited revenue sources and with a small percentage of the total revenue. The total revenue generated by the states, including the Addis Ababa administration and the Dire Dawa council, accounts for only a maximum of 15-17 percent of the total national revenue.[21] As can be seen from Table 5:4 the centre collects 83-85 percent of the total revenue.[22] The overall share of the states' revenue is considerably lower than their expenditure. For example, in the 1996/97 fiscal year the states' own taxes (excluding Addis Ababa) accounted for only 11.4 percent of the total revenue, and covered only 37 percent of their total expenditure.[23] Even though the revenue collected by the

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[18] See, for instance, Ehtisham Ahmad and Jon Craig, 'Intergovernmental Transfers,' in Teresa Ter-Minassian, (ed.), *Fiscal Federalism in Theory and Practice*, (IMF Publication 1997), p. 73-79; Anwar Shah, 'The Reform of Intergovernmental Fiscal relations in Developing and Emerging Market Economies' Policy and Resources Series 23, World Bank, 1994, p. 1-2; Jennie Litvak, Ehtisham Ahmad and R. Bird, 'Rethinking Decentralization in Developing Countries'(Sector studies series, the World Bank, 1998); Ehtisham Ahmed (ed.), *Financing decentralized Expenditures: An International comparison of grants*, (Edward Elgar, UK, 1997).

[19] *Ibid*; Ronald Watts, *Comparing Federal Systems*, 2nd ed. (Queen's Univ. Kingston, Ontario, 1999 a), p. 46.

[20] A measurement for the 'coefficient correlation' is one of the formulas widely used by economists. $VI=[(R^S/R_T)/(E^S/E_T)]$, where R^S =states revenue; R_T=total revenue (S+F); E^S= states expenditure; E_T=total expenditure (F+S). By this measurement a coefficient of zero implies low level of imbalance and states are sufficiently autonomous while a coefficient close to one indicates absolute dependence on federal transfer. See also Eshetu Chole (1994) for various formulas to measure VI

[21] See below the Tables 5:4 and 5:6.

[22] *Ibid*.

[23] It should be noted that the figures released by MoFED at different circumstances are not consistent; In comparative terms, R. Watts gives the following data on federal transfer (both general and specific) as a percentage of state revenue for 1993-1996. The proportion of federal transfer in Australia constituted 40.7 %, India 39.4, USA 29.6, Canada 19.8, Switzerland 18.9 and Germany 18.3. R. Watts, *The Spending Power in Federal Systems: A comparative study*, (Institute of Intergovernmental Relations, Queen's Univ., Kingston,

regions increased progressively from 695.3 million *birr* in 1994 to 1,736.5 million in 2000, it is the central government which collects the major portion of the country's revenue.[24]

If we compare the states' total revenue with their recurrent expenditure, it only covered about 41 percent in 1994 and about 55 percent in 2000.[25] It is apparent that the remaining percentage of recurrent expenditure and the full cost of capital expenditure were covered by the finance transferred from the centre.

2.2 Expenditure and revenue aspects

The fiscal problem faced by the regions has two aspects: revenue is low while expenditure needs are high. To begin with revenue: the dominant and lucrative sources of revenue are reserved for the federal government under its exclusive jurisdiction, or through the concurrent powers on the basis of which it has the ultimate power to levy and collect the taxes. The major sources of revenue, such as customs duties and other charges on imports and exports, which account for up to 33 percent of the total revenue generated in the country,[26] are placed under the exclusive jurisdiction of the federal government. The centre has also been levying and collecting other taxes, such as corporate taxation which is concurrently assigned to the centre and the states.[27]

On the other hand, tax sources which yield only a limited amount of revenue have been allocated to the states. The sources of revenue held by the states neither generate a substantial amount of taxes nor reveal signs of growth relative to the total revenue and their expenditure needs. This can be observed from the lower amount of revenue generated by the regions. The regional governments generate a small amount of tax from trade activities and indirect taxes such as sales tax. The regions' revenue receipts are mainly from those types of sources which are easier for the administration, such as employment income tax,[28] pension contributions and charges and fees for services rendered by government offices. For the regions, the source of tax which is easiest for the administration is personal income tax paid by government employees.[29] The

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Ontario, 1999 b), p. 53. In Nigeria, between 1995 and 1999 the states and local governments collected 18.3 and 11.8 percent respectively, while the remaining 67.7 of the states and local revenue transferred from the center. Ayodele Jimoh, 'Fiscal Federalism the Nigerian Experience,'(paper presented for Ad-hoc Expert Group Meeting, Economic Commission for Africa, 7-9 October 2003, Addis Ababa), p. 12.

[24] See Tables 5:6 and 5:7.

[25] Computed from data available at the Ministry of Finance and Economic Development, 'Federal Government of Ethiopia Countrywide budgetary Revenue and Expenditure, for fiscal years 1995/96-2000/01'(MOFED Archive, unpublished).

[26] *Ibid.*

[27] As we have seen under Chapter IV, the major reasons for assigning taxes to the centre are for the development of a customs union and for securing one economic union. However, the federal government has retained a wider power over sources which may not always fit into these reasons.

[28] See, for instance, Table 5:5; see also Chapter IV, Sec.4.1.

[29] However, even the federal government did not properly administer the collection of personal income taxes from employees of private enterprises, and from employees of NGOs and international organizations. Most of these employees never paid tax until mid-2002 although the income tax legislation clearly provides otherwise. The mayor of the Addis Ababa Administration discussed the matter with those employees in order to convince them to pay taxes starting from the 2002/03 fiscal year while promising to waive the uncollected taxes. This fact implies that there was also a lack of initiative and political accountability, and an inefficient tax administration.

insufficient revenue of the states is not only the result of limited tax bases, but also of tax administration incapacity and taxpayers' unwillingness or inability to fulfil their obligations.

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

The above figures depict the fact that the fiscal capacity of the regions and the centre vary considerably. As Ronald Watts propounds, the vertical imbalance continues to exist and requires regular adjustment. This is because, according to him, 'no matter how carefully the original designers of the federation may attempt to match the revenue sources and expenditure responsibilities of each order of government, over time the significance of different taxes (such as income taxes) changes and the costs of expenditure vary in unforeseen ways.'[30] Revenue from agricultural income tax and land use fees is a case in point in Ethiopia. The revenue from these sources always varies and, for example, the total amount fell sharply during the 2001/02-03 fiscal years because of the famine which affected millions of people dependent on land.

The vertical imbalance may also be attributed to the fact that the factors determining the assignment of expenditure and revenue-raising responsibilities are usually considered independently. The underlying reason for assigning both powers to the subnational governments is to bring a government closer to the people so that the governments can better address the people's needs. But with regard to assigning taxation powers there could be additional reasons which may lead to the growth of a vertical imbalance. There are at least two reasons: capacity in tax administration and the need to secure equitable distribution of finance among the regions. This is because, for example, for reasons of efficient and effective tax administration some tax sources will be assigned to the centre. Similarly revenue sources which are unevenly distributed between the regions or concentrated in few regions could be retained by the centre. Unless they are retained by the centre and later on redistributed to the regions on equitable grounds, there could be a huge disparity between the regions. However, there will be a vertical imbalance between the expenditure responsibilities and the revenue raising capacities of the states which requires an effective transfer mechanism. Thus, when a greater portion of the revenue accrues to the centre, the major task of the central government will be to redistribute it equitably to the regions.[31]

The levels of the vertical fiscal imbalances in some developed federal systems have demonstrated a lesser revenue capacity on the part of the states, while the centre collects funds in excess of its expenditure needs.[32] When we analyse the

[30] R. Watts, 'The Distribution of Powers, Responsibilities and Resources in Federations', in Ann L. Griffths (ed.) *Hand Book of Federal Systems*, (Forum of Federations, Canada, 2002).
[31] For a detailed analysis of the reasons for the division of taxation powers see the previous chapter.
[32] The Australian federal system has been described as typical of this case. That is, the amount of revenue collected by the Commonwealth government has been in excess of the money needed for the expenditure of its exclusive responsibility. Jon Craig, 'Australia', in Teresa Ter-Minnasian (ed.) *Fiscal Federalism in Theory and Practice* (IMF Publication 1997), p. 175; see also Brian Dollery 'A Century of Vertical Fiscal Imbalance in Australian Federalism,' working paper series No. 2002-6, School of Economics, University of New England, 2002.

Ethiopian federalism (the assignment of expenditures and the revenue-raising capacities) and its vertical imbalance, caution is required. The vertical imbalance is not a result of an assignment of power that enables the central government to collect funds in excess of its expenditure needs. Although the amount of revenue that accrues to the federal and state treasuries varies tremendously, the federal revenue is not sufficient to cover the federal expenditure. The central government does not generate revenue in excess of its expenditure needs. It is only when we compare the capacity of the central and the regional governments that the vertical imbalance is evident from the flow of a large amount of taxes to the centre. If we see it in terms of fulfilling financial requirements, then neither the centre nor the regions cover their expenditure from domestic revenue sources. All the revenue generated by the federal government through tax and non-tax sources accounts for up to 65 percent of its total expenditure. The bulk of the expenditure needs are covered by finance flowing from domestic loans as well as foreign sources such as loans, aid, and counterpart funds. These sources account for up to 35-40 percent of the total national expenditure.[33]

2.3 Implications

Whatever the causes may be, the vertical imbalance in Ethiopia provides evidence that the centre dominates the fiscal power of the federation. The imbalance is also higher than in many other federal systems.[34] As we have seen above, the subnational revenue share in Ethiopia is a maximum of 17 percent, compared to India 28, Brazil 24.3, Germany 24.5, Australia 28.2 percent and Nigeria 32.3 percent.[35] In this regard, the main issue will be what does this imbalance imply?

First, it could lead to problems of inefficiency. As it will be further argued in the next chapter, 'because the costs of public expenditure are not fully internalized by the regions and are supported by transfers from other parts of the country, there is a reduced incentive to provide public services in an efficient manner.'[36]

Second, a very low level of vertical imbalance generally implies that the states vigorously exercise their decision-making autonomy, as their revenue capacity matches their expenditure responsibilities to a great extent. In contrast, a higher degree of vertical imbalance implies that the states' autonomy is dependent on the transfer of revenue controlled by the centre. When the states remain with a small amount of revenue in comparison to their expenditure needs, they will be prone to central influence. However, the extent of the central influence will be dependent on the mode and extent of federal transfers. If the nature of the transfer system emphasizes federal preferences or conditions, there will be too much influence on the autonomy of the regions. The practice in Ethiopia does not appear to reflect a challenge to secure regional autonomy, since the ruling party and its allies control both the federal and regional governments. However, this trend may change if strong opposition parties control regional governments. In such a case, the degree of maintaining regional autonomy will be dependent on the nature of the revenue sharing and the transfer system.[37] The revenue transfer system requires, at least, an independent and efficient financial

[33] See Table 5:3 above.
[34] World Bank, 'Ethiopia: Regionalization study', Report No.18898, 2000, p. 25.
[35] *Ibid*; for the Nigerian data see Jimoh, op. cit., p.12.
[36] *Ibid*.
[37] For a detailed analysis of the revenue transfer system in Ethiopia, see Chapter VII.

institution, a check and balance mechanism (through the Upper House) and a transparent transfer formula. Otherwise the federal government may harass or restrict the states' autonomy through fiscal instruments.

2.4 Corrective measures

The problems of vertical imbalance can in principle be addressed through several corrective measures: by reassigning some of the major expenditure responsibilities to the centre, by introducing new taxes or reallocating tax sources to the states, or by implementing effective intergovernmental transfer mechanisms. There is a dilemma in recommending the first option because it may require constitutional amendments and the preferences (expenditure responsibility) of subnational governments vary. In any case, the revenue capacity of the regions should increase at a higher rate than the centre in order to reduce the present degree of imbalances. In this regard, first, the joint revenue levied from concurrent taxes should be distributed by following objective criteria. Second, as was indicated in Chapter IV, the tax system could evolve to introduce new tax bases which can be efficiently administered at the regional or local level. Third, the vertical imbalance is usually redressed through intergovernmental transfer mechanisms. Transfer mechanisms will be effective if objective criteria based on the efficiency of revenue raising and the variation in the costs of expenditure needs are applied. But if regions rely only on revenue transfer, it could be a disincentive to revenue raising and may even have a negative impact, actually increasing the vertical imbalance.

Apart from focusing on revenue sources, reducing the existing imbalance itself requires far reaching administrative and political measures to tackle the problems. Some of these measures could be the following: increasing efficiency in tax administration so that the regions can tap the full potential of the assigned taxes, promoting awareness among taxpayers to fulfil their obligation, securing financial accountability, fighting corruption, and engaging in effective intergovernmental cooperation. This also requires a political commitment to enhance the capacity of subnational governments by refraining from acts which hinder the movement of skilled labour and capital.

Table 5:4: Percentage of revenue collected by the federal and regional governments*

Fiscal year	Total		Federal		Addis Ababa		All Regions	
	Amount in millions	In percent	Amount in millions	In percent	Amount in millions	In percent	Amount in millions	In percent
1993/94	3938.8	100	3240.3	82.3	184.68	4.69	510.82	13
1994/95	5912.8	100	5026.24	85	262.26	4.4	624.24	10.6
1995/96	6966.09	100	5836.8	83.79	348.77	5.0	780.53	11.2
1996/97	7882.54	100	6524.97	82.8	463.28	5.86	894.3	11.34
1997/98	9562	100	7967.11	83.32	682.01	7.13	912.88	9.55
1998/99	9569.2	100	8017.87	83.78	669.89	7	881.5	9.22
1999/00	10083.64	100	8315.25	82.46	731.13	7.25	1037.26	10.29
2000/01	9950	100	8075	81.56	802.75	7.67	1072.75	10.77
2006/07+	16,753.6	100	15133	90.3			1620.6	9.7

* Source: Computed from 'The Federal Government of Ethiopia Countrywide Budgetary Revenue and Expenditure', (MOFED archive, unpublished).
+ Source: 'The New Federal Budget Grant Formula' HoF, 2007, p. 3

Table 5:5: The percentage of revenue collected from employee income tax as a percentage of the total tax revenue (excluding non-tax revenue) generated by the regions. *

Fiscal Year	Fed. Gov't	Tigray	Afar	Am-hara	Oromia	Somali	Ben. Gumuz	SNNPR	Gam-Bela	Harari	A.A[a]	Dire Dawa
99/00	5.6	34.8	61	28.4	17.02	31.4	54	24.8	67.7	32.5	27.6	23
00/01	6	31.5	52.6	20.6	18.5	24.8	53.14	25.03	70.2	34.8	29.2	25.6

* Source: 'The Federal Government of Ethiopia Countrywide Budgetary Revenue and Expenditure, for the fiscal year1999/00 and 2000/01', MOFED. If we add pension contributions, which are easier to collect, the total percentage increases and this implies a lesser effort to collect tax from trade and other economic activities.

a: (The share of Addis Ababa. will be higher after the 2002/03 fiscal year since the levying of income tax from employees of international organizations, NGOs, and embassies has been assigned to it.

Table 5:6: Revenue collected by the regions, contributions in percentages of the total domestic revenue: *

	1995/96	1996/97	1997/98	1998/99	1999/00 (Pre-actual)	2000/01 (Pre-actual)	2006/07 +
Tigray	86.22	104.98	95.35	81.37	86.419	97.72	194.9
Afar	11.103	14.692	13.973	10.6	16.721	13.96	38
Amhara	135.22	160.12	180.69	183.4	192.87	203.74	380.3
Oromia	331.65	378.04	386.86	380.72	485.27	511.62	624.3
Somali	40.03	39.13	33.32	24.67	22.51	28.42	31
B-Gumuz	5.47	6.88	8.58	9.92	14.72	14.07	22.1
SNNP	143.43	157.57	164.45	154.7	171.6	163.66	262.8
Gambela	4.90	7.23	7.01	9.54	9.45	9.3	12.4
Harari	7.74	7.72	8.36	9.64	10.45	9.91	20.5
Addis Ababa	348.77	463.28	682.01	669.8	731.13	802.75	
Dire Dawa	14.77	17.93	14.79	16.97	27.26	19.09	34.3
Regions Total	1129	1357.57	1595.39	1551.33	1768.39	1875	1620.6
Contribution in % (excl. A.A)	11.2	11.4	10	9.22	10.29	10.77	9.7
Contribution % (inclu. A.A)	16.2	17.3	19.01	16.22	17.54	18.44	
Federal	5836.80	6524.97	7967.11	8017.87	8315.25	8075	15133
Federal in %	83.8	82.7	80.9	83.78	82.46	81.56	90.3
Grand Total	6966.09	7882.54	9562	9569.2	10083.64	9950	1620.6

* Source: Ministry of Finance, Policy Analysis Department.
+ Source: 'The New Federal Budget Grant Formula' HoF, 2007, p. 4

3 THE CUASES AND IMPACT OF HORIZONTAL IMBALANCES

One of the objectives of the fiscal arrangement is to ensure that individuals residing in different regions or localities have equal access to the use of public goods and services. However, these subnational governments may not have equal fiscal capacity to provide public services to people residing in their territory, although they are assigned with the same revenue sources. They usually have different capacities owing to the fact that a single tax base may not generate the same amount of money in different places. This leads us to another problem of fiscal imbalance which is related to the fiscal disparities between the states, usually referred to as horizontal fiscal imbalance. The problem of horizontal imbalance occurs 'when the revenue capacities of different constituent units vary so that they are not able to provide their citizens with services at the same level on the basis of comparable tax levels'.[38] This problem is related to the varying fiscal capacities of the individual member states of the federation.

In Ethiopia, all the regions have fiscal deficits and they also have widely divergent revenue-raising capacities. This disparity can primarily be attributed to the fact that regional governments at the same nominal level vary considerably in their skilled manpower, financial capacity, as well as in population size. Just two regions, Oromia and Amhara, account for 60 percent of the total population and one third of the territory of the country, while three regions (Harari, Gambela and Benishangul-Gumuz) do not have more that one percent of the population.[39] They also have variations with regard to the management and administrative capacities as a result of relative variations in infrastructure, skilled manpower and the characteristics of urbanization. They also vary in their economic environment for private as well as public investment. This asymmetry causes problems in measuring the imbalances between the jurisdictions.

3.1 Measurement

A formal regional fiscal imbalance is measured as the ratio between a region's own revenue and the total revenue generated by the regions. The total revenue collected by the regions is very much concentrated in a few regions. Just four states account for more than 80 percent of the total revenue generated by the states. For instance, in the 1999/2000 fiscal year Oromia's share of the total revenue raised by the regions (including Addis Ababa) was 27.45 percent, but Benishangul-Gumuz had only 0.83 percent. They accounted for 30 and 6 percent of their respective financial expenditures.[40] The largest revenue item in these regions is employment income tax. Their capacity to effectively raise revenue from business-related taxes such as sales, excise, and business profit taxes is very much limited.

A better indication of the horizontal fiscal imbalance is given by the percentage of revenue raised by each region relative to the respective expenditure. Table 5:7 shows that the Oromia region has the highest percentage of revenue raised when compared to its own expenditure (excluding Addis Ababa). The lowest

[38] Watts (1999a), op. cit., p. 46.
[39] See Table 1:1, and FDRE, The 1994 Population and Housing Census of Ethiopia: Results at Country Level, Vol. II Analytical Report (Office of Population and Housing Census Commission, Central Statistical Authority, Addis Ababa, June 1999).
[40] Computed from data available at MOFED, 'Federal Government of Ethiopia Countrywide Budgetary Revenue and Expenditure for the fiscal year 1997/98', (Archive, Unpublished)

percentage is recorded in the Afar region. The variation in the revenue capacity is a reflection of the available revenue sources. The lowest percentage of revenue compared with own expenditure is recorded in Afar, Gambela, Benishangul-Gumuz and Somali regions. This implies that they have the least revenue-generating capacity. The data also show that Addis Ababa and Dire Dawa generate the highest percentage of their own revenue compared with own expenditures, accounting for 94 and 56 percent respectively. Tigray, Amhara, SNNPR and Harari showed about 20 to 30 percent, while Afar, Somali, Benishangul-Gumuz and Gambela regions were able to account for less than 10 percent of their expenditure. The shares of Tigray, Amhara and SNNPR have remained relatively constant. But the figures were not constant in all regions. For example, the ratio of Oromia region has changed from 42 in 1999/2000 to around 30 percent in the subsequent years.

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

3.2 Expenditure and revenue aspects

As observed in Table 5:7 the regions vary in terms of per capita revenue and per capita expenditure. In cash terms during the 1999/2000 fiscal year the lowest amount of revenue raised per person was about 6 birr in Somali and the highest was about 85 birr for Dire Dawa respectively, if one were to exclude the Addis Ababa administration. The next highest per capita revenue was raised in the Harari region (65.8). The highest per capita revenue raised in Dire Dawa and Harari is a reflection of the higher level of economic activity as they are urban centres and have a smaller population size. Although Tigray, Amhara, Oromia and SNNPR are in the same group of relatively developed regions, the latter three regions, with large populations and territory, have lower per capita revenue and per capita expenditure than the middle-sized region of Tigray. This demonstrates, among others, that the average size does matter in the per capita distribution of revenue.

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

have a higher public expenditure need owing to the relatively low level of development.[41]

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

The degree of financial imbalances can also be influenced by imbalances in the expenditure needs. The need for public services of different types can differ between states and the cost of providing them may also differ. As Watts emphasized, this is 'because of variations in... population dispersion, social composition and age structure, and the cost of providing services affected by such factors as the scale of public administration and the physical and economic environment.'[42] The imbalance of expenditure needs between regions and local governments should be measured. Thus, the measurement should focus on the cost of the provision of basic services in the regions and the size of the population with similar expenditure needs due to remoteness or poverty or lack of public services.

As has been observed above, the general understanding is that the least developed regions have been historically marginalized and, therefore, they have a higher expenditure need. However, this comparison is difficult because the total number of people living in extreme poverty in Oromia, Amhara and SNNPR is higher than the total size of the population living in the remainder of the regions.[43] Measuring the expenditure needs should also target the vulnerable population that live in the so-called developed regions. As a whole, in the Ethiopian case, measuring the imbalances could be feasible if the existing asymmetry pertaining to demography and size is reduced by territorial reorganization. It is argued that efficiency and accountability is better promoted in regions with a relatively manageable size.

Table 5:7 The share of revenue collected by each regional government compared to own expenditure during the 1999/00 fiscal year- Actual (excluding foreign direct aid and grants)*

region	Pop* (,000)	Expenditure	Per capita expenditure	Domestic Revenue	Per capita revenue	Percentage of revenue compared to own expenditure	Percentage of the state revenue compared to the domestic national revenue)
Tigray	3,694	300,269,462	81.3	86,405,931	23.4	28.8	0.965
Afar	1,216	259,885,709	213.7	16,717,304	13.75	6.43	0.187
Amhara	16,295	806,245,088	49.5	192,865,113	11.84	23.9	2.154

[41] However, the recent effort to improve the level of development may take a long time unless it is supported by additional efforts such as mobilizing labour from other regions, effectively curbing financial embezzlement and effectively supervising the implementation of projects.
[42] Watts (1999a), op. cit., p. 46-47.
[43] See Table 7:9 and Table 1:1.

Oromia	22,354	1,136,239,978	50.83	485,269,071	21.71	42.7	5.42
Somali	3,698	270,432,595	73.13	22,514,250	6.09	8.33	0.252
Benish-Gumuz	537	159,679,560	297.35	14,723,848	27.4	9.22	0.165
SNNPR	12,515	623,299,938	49.8	171,597,768	13.71	27.53	1.92
Gambela	211	108,483,647	514.14	9,044,709	42.87	8.33	0.101
Harari	160	49,559,938	309.75	10,447,298	65.3	21.1*	0.117
Addis Ababa	2,495	772,461,695	309.6	731,131,004	293	94.6	8.166
D.D.	318	48,797,421	153.5	27,255,127	85.7	55.9	0.304

* Source: Computed from the data available at the Ministry of Finance and Economic Development, 'Federal Government of Ethiopia Countrywide budgetary Revenue and Expenditure for the fiscal year 1999/00', (Archive, Unpublished).

3.3 Intrastate imbalance

If we continue the comparison, the imbalance exists not only between the regions. There is also an imbalance between zones and local administrations within a region or in comparison with those in other regions. In other words, the horizontal fiscal imbalance refers not only to interstate but also intrastate imbalances between the subregional governments. In order to analyse the actual imbalances of revenue-generating capacity vis-à-vis the expenditure share there should be a clear assignment of sources and responsibilities. Although the powers and responsibilities of the subregional administrations are not constitutionally delimited, the zone and wereda administrations have, in practice, expenditure responsibilities. Hence, the following analysis is based on the past performance of the zones and weredas.

Table 5:8 Amhara national regional government: zonal revenue capacity and expenditures.*

Bureaus and Zones	Fiscal year 1998/99 Percentage of revenue contribution compared to the state's total revenue	1998/99 Percentage of own revenue compared to own expenditure	1999/00 Percentage of revenue contribution	Percentage of own revenue compared to own expenditure	2000/01 Percentage of revenue contribution	Percentage of own revenue compared to own expenditure
Bureaus **	16.59	11.79	9.87	8.26	9.32	5.33
North Wollo	6.64	26.06	7.01	31.32	6.97	27.47
Wag Hemra	1.34	13.28	1.3	17.62	1.35	16.12
South Wollo	14.52	29.30	15.38	32.25	16.43	29.12
Oromia zone	1.69	15.21	2.03	23.5	2.0	20.78
North Gondar	11.76	29.13	14.47	35.44	14.87	33.54
South Gondar	7.89	25.26	8.54	32.15	8.18	27.03
North Shoa	10.93	29.14	11.24	30.57	10.73	27.00
East Gojam	11.28	32.80	11.06	35.34	10.70	29.76

West Gojam	*10.55*	*32.27*	*11.41*	*37.96*	*11.22*	*33.04*
Awi	*4.20*	*25.72*	*4.6*	*28.88*	*4.61*	*25.9*
BahirDar Special Zone	*2.64*	*38.09*	*3.08*	*41.57*	*3.61*	*50*

*Source: Computed from the annual budget report, 1998/99-200/01, Amhara National Regional Government Finance Bureau. The use of the Amhara region is due to the data accessibility to the author.
**The major revenue source of the Bureaus is direct foreign aid. Most of the expenditures, which account for more than 30 percent of the total regional expenditure, are made through the sector bureaus.

Zones

If we see the Amhara region, the zones, as can be gathered from Table 5:8, vary in their contribution to the region's total revenue and in the percentage of revenue compared to own expenditure. For instance, during the 2000/01 fiscal year the smallest contribution was made by *Wag-Himra* zone raising about 1.4 percent of the total revenue and covering 16 percent of its own expenditure. The highest contribution came from the South Wollo zone raising about 16 percent of the region's total revenue and covering 30 percent of its annual expenditure.
If we continue the comparison in the Oromia region, a few zones within the region are the major contributors to the region's revenue capacity. For example, the recurrent expenditures of East and West Harerge zones are completely covered from locally collected revenue.[44] The economic dynamics in some of the zones indicate that most of the tax bases accrue to the regional and to the federal government (i.e. not local government). For instance, Eastern Oromia is an industrial zone and has a better possibility of attracting investment due to its better infrastructure. Some other zones have a potential for natural resources and agricultural investment. However, most of the revenue from large investment accrues to the central government. If these economic potentials are exploited and properly regulated, it may be assumed that there will be significant contributions to the region, zone or to the local government.

Weredas

If we turn our comparison to the weredas, during the 2000/01 fiscal year, out of the 89 weredas in the SNNPR, 18 weredas were able together to generate more than half of the total business profit tax collected in the region. 45 weredas together generated less than 10 percent of the total business profit tax.[45] During the same fiscal year the weredas in the Tigray region varied tremendously in their revenue-generating capacity. Out of the total 34 weredas, 2 weredas were able together to generate a major portion of the sales tax collected in the region. These sketchy figures indicate the overall picture and the extent of the imbalance between the weredas.

[44] From data available at the Oromia Finance and Economic Development Bureau; also an interview with Ato Ahmed Mohammed, head of the planning and programming department at the Bureau, December 2002.
[45] Ministry of Capacity Building, 'Revenue Assignment between Levels of Regional Governments: Region, Zone and Wereda'(Unpublished document in Amharic, Addis Ababa, May 2002).

3.4 Impact of the black economy

One of the main challenges in measuring the horizontal imbalance between the states, between zones or between local governments is the impact of the 'black economy'. This makes itself felt at local level. The black economy is related to unregulated business, cross-border trade and smuggling. In some places the smuggling of goods into and out of the country forms the major economic activity of the people. However, the expansion of contraband trade and the dumping of cheap foreign products on the local market have been major setbacks to the growth of the industrial sector in general.[46] In general, contraband is rampant in many of the localities in the Somali, Harari, Benishangul-Gumuz and some Oromia zones, whereas at the moment regions like Amhara and Tigray have little opportunity to 'benefit' from such a black economy. For instance, it has been reported that the country loses up to 400 million birr due to live animal smuggling in the eastern and southern part of the country.[47] The impact of the black economy in the regions mentioned above cannot be ignored. Besides its impact on the national economy, it can contribute to imbalances between weredas, zones or regions as the case may be. It can also influence the per capita income of the people in a specific zone or wereda. It has been recounted by the residents of Dire Dawa that economic movement in the city is hampered since the federal government imposed serious customs control. They complain because the economic activity in the city is forced to move to neighbouring zones where administrative and customs controls are lax.

3.5 Some additional remarks

The fiscal issues may be related to the objective of the EPRDF: tackling the socio-economic problems by treating all nations, nationalities and peoples equally. As ethno-linguistic factor is the basis of organizing regional or subregional levels of government, there is also a tendency to scrutinize the fiscal imbalances through the same principle of equality of the groups irrespective of the level of government to which they are represented. An attempt to compare the financial packages of each nation, nationality and people, however, will not address the real financial disparities between the levels of government. Of course, these groups vary in terms of several factors, ranging from population and geographical (physical structure) size to the available manpower and administrative capacity. However, the fiscal imbalance can only be measured by comparing the revenue and expenditures across the territorially-defined jurisdictions. Thus, recently there is a tendency to devolve power to the weredas, thus making them the relevant budgetary unit which then makes it possible to measure the fiscal imbalances between them. As a result, the Oromia, Amhara and Tigray regions have started in the 2003/04 fiscal year to devolve a large share of revenue and spending powers to the weredas. Nevertheless, the difference at the local level is also a reflection of the disparity between the regions and it is likely that the disparity between the weredas would be the same. This is so because the disparity observed at the regional level is also a reflection of the disparities at the local level. Furthermore, tracing the exact

[46] Of course, the government is undertaking several measures to curb contraband activities in places which are well known for hosting the smugglers and serving as connecting areas to the centre. Consumer bias against local products is also a great problem despite the availability of comparable or even better local products.

[47] For related news, see http://www.waltainfo.com/wicfind.asp, accessed on September 20, 2004

degree of imbalances and the precise calculation of the share of revenue requires a careful analysis. Thus, a comparison between local governments is equally problematic as it reveals tremendous variations in financial capacity, expenditure demand and skilled labour. Thus, to measure effectively the local fiscal imbalance, it is important at least to reduce the territorial asymmetry between the regions (see also Chapter VII, 2.2).

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

4 THE IMPACT OF FISCAL COMPETITION ON BUDGETARY RELATIONS

One of the factors that may result in budgetary differences between governments is the ability/inability to generate more taxes from a given tax base. The financial capacity of each level of government is determined not only according to the allocation of tax sources but also according to the ability to compete in generating more taxes compared to others. This intergovernmental tax competition exists between governments of the same level (horizontal), and it may also exist between different levels of government (vertical). Vertical tax competition exists when different levels of government tax the same base, or if the lower level is credited in proportion to the amount collected by the higher level in its jurisdiction.[48] Horizontal competition, on the other hand, refers to competition between governments of the same level when taxes are imposed on the same base. Normally, governments enter into competition if each one of them is free to set its own tax rates for the assigned taxes. In both cases of vertical and horizontal competition the level of competition is measured in terms of the impact of the tax rate in attracting more taxpayers and maximizing the revenue capacity. It is assumed that the rates determined can influence the decision of an individual to reside or invest in a particular region.

As one of the bases for implementing decentralized expenditure and revenue-raising responsibilities, several economists mention the theory of Tiebout's model.[49] This theory suggested that in order to provide goods and services to the residents, subnational (regional) governments should raise sufficient revenue so as to cover the cost of the expenditure. On the other hand, consumers choose a jurisdiction that can maximize their utility by efficiently providing the services with a lower comparable cost. Yet to address these demands governments compete with each other by offering an attractive taxation system. Thus, according to this theory, competition between the levels of government becomes one of the important features. However, not all types of taxes are subject to government competition. Each jurisdiction competes with regard to the types of taxes in which it can determine the rate and /or tax base, and concerning those areas where they can decide on the spending priorities. Moreover, experience

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[48] Ricardo Versano, S. G. Ferriera and J. R. Afonso, 'Fiscal Competition', in Raoul Blindenbacher and Arnold Koller (eds.), *Federalism in a Changing World – Learning from Each Other: Scientific Background, Proceedings and Plenary Speeches of the International Conference on Federalism 2002* (Montreal & Kingston, McGill-Queen's University, 2003), p. 412-419.

[49] Wallace Oates, 'Public finance in a federal system,' in Collections of Wallace Oates, *Studies in Fiscal Federalism* (Edward Elgar Pub. UK, 1991), p. 10-15.

suggests that a variation in the tax rates cannot be the sole factor influencing the decision of an individual to reside in a particular place.

The nature of competition depends on several factors such as the method of allocating taxation power, the nature of intergovernmental cooperation, the disparity between governments, and the efficiency of the local administration. Although governments may not engage in competition by lowering tax rates, they do compete in attracting investment and creating jobs by providing basic infrastructure and services, by avoiding bureaucratic bottlenecks, by offering an efficient and effective administration, and by minimizing unnecessary costs. The most common is to promise incentives such as subsidies and the provision of services (infrastructure) to a specific taxpayer. Evidence from many developed federal systems (the USA, Canada and Switzerland) shows that central and regional governments engage in competition by varying tax rates or by employing various incentive mechanisms even when tax harmonization steps are taken.[50] However, the impact is said to be insignificant compared to countries in transition economies and developing countries. For instance, it is said that competition has increased inequalities between governments in Brazil and Argentina.[51]

A further issue concerns which form of competition is desirable for enhancing financial capacity. Economic theories respond that it is neither possible to conclude that vertical competition is more damaging than its horizontal counterpart, nor to emphasize that competition in general benefits the federal system.[52] Fiscal competition, whether vertical or horizontal, has its own merits and demerits. Competition should not exacerbate regional inequalities and any harmful competition should be curbed. Governments should not enter into competition which may result in higher administrative costs. On the other hand, governments may harmonize their taxes, but the outcome also depends on other factors. In practice, an efficient tax administration, the field of public spending and government accountability may also affect private decisions and thereby the revenue capacity of each level of government. Thus, simply lowering tax rates may not bring about the intended result: attracting more taxpayers and retaining higher revenue.

The above factors show that interstate and intrastate competition seems inevitable. Any command from the centre that eliminates competition between the levels of governments would be against the objectives of decentralization and the autonomy of governments. Thus, after defining the objective of competition, appropriate fiscal measures should be designed in order to reduce the harmful effects of competition without completely undermining the autonomy of governments. In this regard, the role of law that secures transparency and the complete accountability of decision makers for their decisions should be the first step to secure healthy competition.[53]

It is not an easy matter to adduce conclusive evidence (nor is it the aim of this section) concerning all issues involving fiscal competition in Ethiopia.

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[50] Ricardo Versano *et al*, *op. cit.*, p., 424-426.
[51] Richard Bird *et al*, 'Assignment of Responsibilities and Fiscal Federalism', in Raoul Blindenbacher and Arnold Koller (eds.), *Federalism in a Changing World – Learning from Each Other: Scientific Background, Proceedings and Plenary Speeches of the International Conference on Federalism 2002* (Montreal & Kingston, McGill-Queen's University, 2003) p. 366
[52] *Ibid*, p. 365-66.
[53] *Ibid*, p. 366.

Nonetheless, it is possible to infer from the laws and the present economic environment that it is unlikely that a regional government can influence the conditions prevailing in other states and attract more taxpayers by varying the tax rates. This is because, during the transition period, the Ministry of Finance was authorized to ensure that regional governments harmonized the implementation of tax laws and the policies of the central government.[54] After the adoption of the federal Constitution, each level of government is empowered to set its own tax rate on bases assigned to the states. But, in practice, in order to avoid harmful tax competition, the states generally follow the guidelines set out under a variety of federal legislation. The federal financial administration law requires the federal and state tax laws and policies to have harmonized and standardized bases.[55] The states have also declared, through their constitutions and laws, that they will implement federal legislation and enact laws which are consistent with federal legislation.[56]

Currently, the only major departure from applying harmonized tax laws is the taxation of agricultural income and the imposition of land use fees.[57] This is an area which the Constitution exclusively allocates to the states. It has a low risk of tax competition since agricultural activity is highly influenced by factors other than tax-related promises. Also, currently, it has little impact since land is not privatized. However, its implication for the emergence of commercial farming and the location of agricultural activities should not be underestimated.

The other area which may lead to competition is urban land lease holdings. The federal law requires that land cannot be sold or possessed indefinitely. Urban land can be possessed for a fixed period through lease agreements. However, the lease price is dependent on the amount offered by the potential lessee. In order to attract investors some states may offer low prices, others may grant concessions, still some others may offer land free of charge. For instance, the basis of the lease price for industry is higher in Addis Ababa and its environs and Dire Dawa than in other regions. The lease price for agricultural investment is higher in Oromia than in other regions.[58] Thus, potentially, states may compete in offering urban/rural land lease agreements in order to maximize the benefits that can be generated from private investment.

Fiscal competition is also influenced by the constitutional allocation of revenue sources. The regions have complete authority to levy taxes on businesses owned by individual proprietors. However, if an individual decides to run a business in the form of a registered company it will be subject to a federal tax. Unless a

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[54] Art. 8(1) of Proclamation No. 33/1992, A proclamation to define the sharing of revenue between the central government and the national/regional self-governments.
[55] Art. 58 of the federal government financial administration proclamation No.57/1996.
[56] See for instance, The Revised Constitution of SNPPR; Proc. No. 18/1997, for the financial administration of the Amhara National Regional State. However, although the same rate applies throughout the states, the actual tax capacity of the states can be influenced, *inter alia*, by the administrative capacity and method of assessing the sales and profits of individual proprietors and incomes derived from private property.
[57] See, for instance, Southern Nations, Nationalities and Peoples Regional Government rural land use rent and agricultural activities income tax proclamation No. 4/1996, Debub Negarit Gazeta.
[58] As reported by the Chamber of Commerce, indicative land lease base prices (in birr) for industrial activity in Addis Ababa is 284/m^2, in Oromia 0.16/m-0.81/m, in Amhara 1/m, in Tigray 0.3/m-0.75/m (reduced to 0% in 2004), in SNNPR 0.15/m-0.80/m. For agriculture, it is 135/hectar in Oromia, but could be given for free by concession in other regions. http://www.addischamber.com/aboutethio/info.asp,accessed on February 15, 2004.

business is very small in nature it is the choice of an individual that matters as to which level of government the payment of tax is subject to. For instance, several business activities which seem to be very local in nature, such as laundry services or beauty salons, are subject to federal taxes because they are registered as Private Limited Companies. An official[59] at the Ministry of Revenue has said that there are also instances where some retail outlets change their licences to a federal licence (registered PLC) in order to avoid supervision by the regional tax authorities. Since the Federal Inland Revenue Authority (FIRA) does not have offices in all urban centres they are not frequently supervised for the purpose of tax administration. The regional finance bureaus which are delegated with the power of collecting federal taxes do not give due attention to federal taxes and they do not consider that it increases their revenue capacity. This has been considered as the major drawback of the lack of intergovernmental cooperation to prevent any possible tax evasion. According to the above informant, one of the tax reform programmes is to create awareness among the regional authorities that their participation in the collection of federal taxes also upgrades their revenue capacity since the amount they obtain from shared taxes is dependent on the amount collected in the respective region or locality.

As we have seen above, the prevailing socio-political, economic and administrative situation in the regions may also affect the decision of taxpayers to change their place of residence. It is clear that in Ethiopia the decision of consumers and potential taxpayers does not only seem to be easily influenced by tax-related promises, since other political factors play a major role. The impact of ethnic and language factors, a fear of lack of fair and equal treatment as compared with indigenous residents, and, in general, the danger of ethnic favouritism must not be underestimated. Furthermore, it is a widely observed phenomenon that subnational governments make little effort to increase their tax capacity as they rely very much on vertical transfer (grants). The tax capacity of regional and local governments is small, as the major tax sources are centralized. Above all, large taxpayers such as companies and enterprises are subject to the federally administered taxes, not to the states, except the payment of employees' income tax. However, in the long run it is possible to envisage the possibility of potential horizontal fiscal competition to maximize the share from concurrent (shared) taxes, but this depends on the method and procedure for distributing shared taxes. If the sharing procedure follows a residence principle, states may compete to attract the head office of companies that are subject to concurrent taxation.[60]

In general, the movement of individuals due to tax rates is very limited. But business firms or companies are very likely to be influenced by tax competition since they are mobile by nature. The regional governments cannot influence business firms by changing the tax rates, as the tax bases related to these enterprises are subject to the federal government. Interregional tax competition can exist in limited cases where the regions can set the tax rates. Such cases may exist through the use of lease agreements, agricultural income tax and rural land use fees. The regional governments may also enter into 'passive competition' aiming to attract investment to their respective territory. This can be done through expenditure competition or enacting favourable regulatory instruments.
Since regions cannot vary tax rates in an attempt to attract business investment,

[59] Interview, Ato Zeru G/Selassie, secretariat of the tax reform programme, Ministry of Revenue, January 2004.
[60] See Chapter VII, the discussion on 'revenue sharing'.

they may resort to the provision of public goods which are specific to the business, or the use of relaxed regulations that fall within regional competence.

However, it is difficult to predict the impact of these instruments since the federal government usually determines most regulations that can influence the location of investment. Furthermore, because of the assignment of revenue sources which has left little room for competition, the existence of some constitutional provisions promoting cooperation and the centralized party system, tax harmonization is in practice the norm, rather than competition. However, competition, despite the little impact it may have, exists irrespective of coordination and harmonization efforts between the levels of government since it is highly intertwined with the existence of several jurisdictions. Thus, it may exist in forms other than the lowering of tax rates, such as the method of estimation and assessment of taxable income, and the tax administration capacity. Moreover, the manifestation of fiscal competition could be the outcome of instruments other than purely economic factors. Also, the impact of political competition between ethnic political activists to maximize the revenue share of the territories they represent should not be underestimated. In whatever form competition may take place, any laxness on the part of governmental authority or instruments that may have destructive consequences need to be effectively controlled.

5 CONCLUDING REMARKS

In general, when there is a higher horizontal disparity there will be a need for a stronger redistributive role by the centre. The net impact of this role should be to increase the income of poor states in order to provide comparable public services. This could be one of the roles that should be adopted as a correcting measure. The horizontal and vertical disparities described above mainly depict the numerical analysis of the existing financial capacity. But there are also disparities in their economic dynamics which might have an impact on the overall revenue capacity of the regions. Certain factors may influence the financial capacity of a region in one way or another such as potential reserves of oil and minerals, and an environment conducive to agriculture and investment. Actually, the assignment of certain tax sources to the centre limits the financial capacity and the potential of a region to derive a larger share of revenue autonomously. However, when the impact of surrendering such tax sources to the centre only touches upon a few regions, they expect a proportional share of the revenue they have indirectly contributed to the federal government. If they feel that their contribution flows disproportionately to other regions, it can be used as an agitational weapon against the federal system. There is such a tendency in the Oromia region where some opposition political organizations argue that their resources flow disproportionately to the northern part, despite the fact they are the major contributors to the national treasury.[61] There is a similar tendency in the Gambela region after the federal government provided a concession for oil exploration to a foreign company.[62] Thus, a key factor in the federal financial arrangement and its related effect would be to work strongly to obtain the advantages of economic union, and to forge solidarity among the constituent units of the federation. Otherwise, the trend of uncertainty and even resentment

[61] See, for instance, Merera, op. cit., p.175.
[62] For a detailed discussion see Chapter III, Section 2.4.5.

as to what a fiscal union could or should entail may lead to economic and political destabilization.

In order to redress the horizontal imbalances so that the regional governments can provide goods and services which are comparable to each other, an effective mechanism has to be discovered. Its implementation must have the aim of ensuring that the governments have sufficient resources to provide the necessary public goods. Various federal systems have implemented diverse approaches to meet the problem. Some of them (such as Australia and Canada) have adopted a general equalization scheme for transfers from the centre to the regions. Some others implement different types of grants to address the problems of both horizontal and vertical imbalances at the same time. Still others (Germany) follow a different approach of equalization payments between the regions where the rich regions transfer to the poor ones according to a special formula based on per capita income. Ethiopia also needs not only equalizing the revenue capacity of the states but also allocating grants for specific selected development projects.

The details of the transfer mechanisms and the Ethiopian approach will be dealt with in the following chapters. However, the situation in Ethiopia requires measures in addition to the formal correcting instrument (intergovernmental revenue transfer). The major policy implication of the studies in this chapter is the need for a political commitment, on the one hand to reduce factors that can aggravate the disparities between the regions, and, on the other, to introduce policies that can enhance revenue capacity. In this regard, reducing the disparities attributed to socio-demographic and territorial asymmetries is important. This could be reorganizing the territories of the constituent units by creating smaller regions out of the large ones or by merging small and neighbouring territories so that the disparity in absolute territorial or population size is reduced. Introducing a separate financial and administrative autonomy for municipalities and urban centres is also important. Other policy measures that can enhance the movement of labour, capital and confidence in the private sector are also vital.

6 Correcting the Imbalances (I): Principles of Intergovernmental Revenue Transfer

The outcome of the overall greater regional disparities and fiscal imbalances has led to the implementation of the transfer system that can be considered as the major revenue source of states in many federations. The implementation of the transfer system in Ethiopia since its adoption in the 1992/93 fiscal year is therefore the focus of this study. The transfer system in Ethiopian federation operates within its local context. However, before we delve into the study of the Ethiopian system in the next chapter, the present one elaborates the principles of intergovernmental revenue transfer that one observes in other federations in the following five sections.

In the first section we discuss the rationales and objectives of the transfer system.

Section two discusses the forms and extent of transfer in general. It deals with revenue sharing arrangements and the nature of different types of grants.

Section three focuses on the methods of equalizing the revenue capacity of states adopted by different federations for particular fiscal years.

The next sections, four and five, consider the impact of data in the transfer system and the institutional mechanisms responsible for revenue transfer decisions. The concluding section highlights some of the issues which may have importance in the Ethiopian context.

1 THE RATIONALES AND OBJECTIVES OF REVENUE TRANSFER

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

Revenue transfer has the main objective of addressing the states' financial constraints in executing their expenditure responsibilities, which we have already discussed in the preceding chapter as vertical imbalance. But narrowing the gap between revenue capacity and expenditure need may not be sufficient to ensure that state governments will be able to provide comparable public goods and services. The revenue of the state governments may vary also between them, which affects their ability to provide (access to) services. Therefore, in addition

to correcting vertical imbalances there will also be the objective to correct existing horizontal imbalances between the states.

The process of adjusting the horizontal as well as vertical imbalances is known as 'the fiscal equalization system'.[1] This process is required, as Saunders observes, because 'large differences in economic circumstances between regions are likely to threaten the social cohesion of the federation, and to distort federal policy making and the operation of the internal market.'[2] However, the processes, extent and nature of transfer to reach the desired level of equalization varies widely across federations. For instance, as we shall discuss below, in Australia, the process of adjusting the imbalances between the states takes into account not only of the difference in revenue capacity, but also of the difference in expenditure needs. Notwithstanding the great variety, the general assumption which is common to most federations concerning the objectives of equalizing the revenue capacity of states is principally to address the vertical and horizontal imbalances.[3]

Addressing financial disparities between governments is sought for equity reasons and for promoting an economic union.[4] The interest of an economic union at the same time necessitates an equitable revenue transfer system and collaboration between the constituent units of a federation. The system of revenue transfer is related to the economic role of the responsibilities and revenue sources of government. This federal principle leads to a certain expectation that each state should have a broadly comparable level of resources so that it can provide the same standard of services. However, the states may end up with different capacities to provide public goods and services to their residents. This results in two main problems: different tax capacities and different expenditure needs. Consequently, as economists say, 'identical persons will be treated differently by the public sector according to the [states] in which they reside.'[5] Thus, in the process of revenue transfer there is also a need to consider, to the extent possible, for the equitable distribution of income between individuals.[6]

The disparity in the capacity (of revenue raising and expenditures) of the states also raises the question as to how to balance their role in the interest of the

[1] For instance, see Paul Boothe, 'Taxing, Spending and Sharing in Federations: Evidence From Australia and Canada', in Paul Boothe (ed.), *Fiscal Relations in Federal Countries: Four essays*, (Forum of Federations, Ottawa, Canada, 2003), p. 13.
[2] Cheryl Saunders, 'Constitutional Arrangements of Federal Systems' (Publius: The Journal of Federalism, Vol. 25 No. 2, 1995), p. 70.
[3] For an analysis of the objectives of transfer in specific jurisdictions, see Ehtisham Ahmad (ed.), *Financing Decentralizæd expenditures*, (Edward Elgar, UK, 1997); Teresa Ter-Minassian (ed.), *Fiscal Federalism in Theory and Practice*, (International Monetary Fund, 1997). For general economic rationales, see Anwar Shah, 'The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Market Economies,' World Bank, Policy Research Series, 23, June 1994.
[4] Wallace Oates, *Fiscal Federalism* (Harcourt Brace Jovanovich, 1972), p. 78.
[5] Robin Boadway and Frank Flatters, 'Fiscal Federalism: Is the System in Crisis?', in Brown Banting and Courchene (eds.) *The Future of Fiscal Federalism* (School of Policy Studies, Queen's University, Kingston, 1994), p. 31.
[6] However, in the process of revenue transfer, there is always tension between the equitable distribution of financial resources between governments and between individuals. Wallace Oates argues that just distribution of income requires distribution at the individual level. This distribution of income at the individual level has to consider individual income, cost and tax rate variations, employment opportunity and even access to education. W. Oates, *op. cit.*, p. 78-81.

economic development of the federation as a whole.[7] Inefficiency in some constituent units can have an impact upon the capacity of the federal government, on the one hand, and on efficient execution of responsibilities by the states, on the other. This is because the disparity consequently requires the shifting of resources from efficient to inefficient states. The financial imbalance between the states requires an equitable transfer which can address two opposing interests: enhancing the ability of states with less reliance on their own source of revenue and promoting the role of the efficient ones in achieving the objective of equitable distribution without weakening the financial benefit derived from fiscal decentralization.[8] Therefore, the other objective of revenue transfer is to reduce, if not to eliminate, financial imbalances and inefficiency across the states.

The other rationale of revenue transfer is to compensate for local spending which provides significant extra-territorial benefits but has unrecognizable local benefits, or increases the local burden due to the goods and services provided for the neighbouring state or local territories.[9] For example, local spending on schools and health centres could in fact mean the provision of services to people coming from neighbouring local governments. Unless these external benefits given to the other communities are compensated, the quality of goods and services to the local community remains below standard or the local government will be forced to undertake additional costs. Thus, the revenue transfer system is expected to take this issue into consideration and aim at compensating the spillover effects of local costs.

A federal government may also transfer revenue for local spending on condition that it can be spent on specific services or targeted objectives. This type of conditional transfer will at the same time enable the implementation of federal policies at the state or local level.[10]

The attainment of the objectives of an equitable transfer of revenue might encounter several problems which should be handled with care. For instance, several economists warned that if the transfer solely aims to fill the budget deficit and if subnational governments rely on the amount transferred, it can have a disincentive effect on efficient tax administration.[11] Inefficient local taxation can also reduce accountability and responsibility towards local residents. Thus, transfers should, to the greatest extent possible, reduce the impact of inefficiency and unaccountability. Also transfers may undermine the autonomy of state or local governments if they involve federally set priorities or conditions. So, one should be careful not to create a loss of local or state autonomy.

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[7] Ibid, p. 78-79.
[8] See Watts, *The Spending Power in Federal Systems: A Comparative Study* (Institute of Intergovernmental Relations, Queen's University, Kingston, 1999 b).
[9] This is what economists have mentioned as 'negative or positive externalities or spillover effects'. They are defined as third party effects arising from the production and/or consumption of goods and services for which no appropriate compensation is paid. See, for instance, Wallace Oates (1972), op. cit., p. 46.
[10] See for instance, Lynn A Baker, 'Conditional Federal Spending After Lopez', (95 Colombia Law Review 1911, 1995) on how the US federal government succeeds in using conditional grants for national programmes.
[11] See Richard Bird and Francois Vaillancourt, 'Fiscal Decentralization in Developing Countries: An Overview', in R.M. Bird and F. Vaillancourt (eds.), *Fiscal Decentralization in Developing Countries* (Cambridge Univ. Press, Cambridge, 1998), p. 32-33.

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

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

In general, to ensure efficiency, equity and a healthy fiscal capacity at a subnational government level, Shah recommends considering various guidelines in designing a grant system. Some of these are clarity in grant designs, respecting regional autonomy, equity, transparency, efficiency, simplicity, accountability, etc.[12] However, these criteria may not be consistent with each other. Therefore, each federation has to set clear objectives and select criteria which may help achieve the objectives depending on local circumstances.

2. FORMS AND EXTENT OF TRANSFER IN GENERAL

Although the scheme for the allocation of centre-state taxing powers can be made with many considerations in mind, in most cases it does not create a balance between responsibilities and revenue sources at the state level. Most productive sources of taxation are in the hands of the centre. As a result of this, it is necessary to transfer a portion of the revenue to the states. Thus, most federal systems have sought to create a balance between states' functions and financial resources through transfer mechanisms. While in some federations the power is entrenched through specific interpretations of the concurrent power of the centre and the states, in some other systems a wider transfer of authority is mandated by the constitution. As Roy Bahl remarks 'transfers are at the heart of subnational finances. But designing a transfer system is difficult, not least because of the many goals that such systems might set out to achieve. One system cannot simultaneously achieve all of these ends [see supra section 1], and governments must decide which are the most important.'[13] In general, there are two instruments which are devised for the transfer of revenue from the centre to the regions: revenue sharing and equalization through the allocation of grants. Before discussing the situation in Ethiopia, it is important to gain an insight into the nature and the purposes of these instruments and the practice in other federal systems. First we discuss revenue sharing (Section 2.1), next we discuss grants (Section 2.2).

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[12] A. Shah, 'Introduction: Principle of Fiscal Federalism', in A. Shah (ed.), *The Practice of Fiscal Federalism: Comparative Perspectives* (Forum of Federations, 2007)

[13] Roy Bahl, 'Revenues and Revenue Assignment: Intergovernmental Fiscal relations in the Russian Federation', in Christine I. Wallich (ed.) *Russia and the Challenge of Fiscal Federalism* (The World Bank, Washington DC., 1994), p. 136.

2.1. Revenue sharing

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

i) In some cases, besides assigning independent revenue sources to the centre and the states, revenue sharing applies to specific sources the revenues of which are jointly owned by the federal government and the states;

ii) In other cases, most or all revenue from federally assigned taxes are shared between the levels of government.

Revenue sharing becomes relevant when revenue sources are shared between the centre and the states, but administered by the former.[14] Its principal purpose is geared towards increasing the revenue capacity of states in order to meet their expenditure assignments.[15] This implies, on the one hand, recognizing the autonomy of subnational government for a portion of centrally administered taxes and, on the other hand, retaining the merits of a uniform application and administration of such tax laws. According to Bahl and Linn, the merits of a uniform application of laws are several, such as effective tax administration, reducing adverse impacts on trade and investment, avoiding harmful tax competition, and treating taxpayers in the same manner.[16] But the basic question that needs to be addressed is what proportion of the revenue collected should be allotted to the states (vertical division)?

There are two basic approaches which have been adopted by countries in order to provide an answer to the above question: the sharing of revenue on a tax-by-tax basis or the sharing of revenue pooled by the central government from all the taxes destined to be shared.[17]

The first approach, *tax-by-tax sharing*, implies that the revenue collected by the central government from each tax base is divided between the centre and the regions using percentages set by the constitution or other pertinent legislation.[18]

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[14] While in most countries shared taxes are collected by the centre and are transferred to the subnational governments, in China they are collected and transferred upwards to the state governments and the centre. In Russia, too, there are taxes administered by the states and transferred to the centre. This approach respects the autonomy of regional governments, but it can keep the centre's share subject to the threat of manipulation by the regions. In the former USSR the upward revenue sharing contributed to its collapse since the republics stopped transferring revenue to the centre. See Roy Bahl, 'Revenue and Revenue Assignment: intergovernmental fiscal relations in the Russian Federation,' in C. Wallich (ed.), *Russia and the Challenge of Fiscal Federalism,* (The World Bank, Washington D.C., 1994), p. 129-138; and Roy Bahl, 'China: Evaluating the Impact of Intergovernmental Fiscal Reform', in R. Bird and F. Vaillancourt (ed.) *Fiscal Decentralization in Developing Countries,* (Cambridge University Press, Cambridge, 1998) p. 49-77.

[15] Ehtisham Ahmed and Jon Craig, 'Intergovernmental Transfers, 'in Ter-Minassian (ed) *Fiscal Federalism in Theory and Practice,* (International Monetary Fund, Washington DC., 1997), p. 74-76.

[16] Roy Bahl and Johannes Linn, 'Fiscal Decentralization and Intergovernmental Transfers in Less Developed Countries,' (Publius: the Journal of Federalism, Vol. 24. No.1, CSF Associates, Philadelphia, 1994), p. 8-11.

[17] For the discussion of the two methods, see Teresa Ter-Minasian, 'Intergovernmental Fiscal Relations in a Macroeconomic Perspective: An Overview,' in Teresa Ter-Minassian (ed.) *Fiscal Federalism in Theory and Practice,* (International Monetary Fund, Washington DC., 1997), p. 11-12.

[18] For instance, in Germany and India the scheme for revenue sharing is laid down in their Constitutions and partly in federal legislation.

The German financial equalization scheme is a case in point. The federation and the states have concurrent power concerning revenue from income tax, corporation tax and (turnover tax) VAT.[19] The Basic Law provides that the federation and the Länder equally share the revenues from corporation taxes. The division of personal income tax, on the other hand, is different; the federation and the states take their equal shares of the personal income tax after the allocation to the localities has been determined. And VAT is subject to different criteria where each state receives a different share since it is apportioned on a per capita basis resulting in a better share for the less efficient states.[20]

The Indian Constitution, on the other hand, provides for a sharing of revenue, but without setting a percentage for the share of the centre and the states (Article 270). For instance, the revenue accruing from income taxes (other than corporate and agricultural income) is compulsorily shared on the basis of a percentage recommended by the Finance Commission and decided by the President. It is the Finance Commission which decides the net proceeds of taxes of each state (on a tax by tax basis) and the allocation of grants to states in need of assistance. Actually the Constitution had categorized the taxes shared on a compulsory basis or voluntarily by the centre until the 80th amendment in 2000. This amendment repealed the distinction between the two and broadened the ambit of the sharable taxes to cover all central taxes except those listed in Articles 268, 269 & 271 and enabled states to share in the wider context.[21]

The sharing of revenue on tax-by-tax basis can also be laid down by agreements reached through intergovernmental negotiations. In Switzerland, for instance, different percentages for tax-sharing schemes were implemented in 1992 for three revenue sources; 30 percent of the federal tax on income and profits, 10 percent of the withholding tax, and 20 percent of a tax on exemption from military service were allocated to the cantons.[22] The newly introduced revenue-sharing scheme in Ethiopia follows the first approach (see the next chapter, 2.1), sharing on a tax-by-tax basis.

One of the questions that can be raised is why different share percentages are applied to each type of tax. One reason could be the convenience of locating the source of the tax.[23] For example, when it is difficult to trace the source state, as in the case of tax on companies which are highly mobile, a higher percentage

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[19] Art. 106 (3) of the Basic Law of Germany.
[20] Clifford Larsen, 'States Federal, Financial, Sovereign and Social: A Critical Inquiry into an Alternative to American Financial Federalism', (47Am. J. Comp. L. 429, Summer 1999), p. 440. According to Larson, in 1998 the localities received 15% of the personal income tax, the states as a whole and the federation 42.5% each.
[21] Before the 80th amendment, which repealed Art 272, revenue from excise taxes (other than on medicinal and toiletary preparations) was voluntarily shared on the basis of a percentage prescribed by parliament. The distinction between compulsorily and voluntarily shared taxes was that in the former case the states could claim the share as their own taxes while in the latter the taxes were federal and the sharing depends on the unilateral decision of the Union government. Later, the voluntary transfer refers to the discretionary grants of the central government. See C. Rangarajan, 'Fiscal Federalism: Some Current Concerns', (Indian Journal of Federal Studies 1/2004, Jamia Hamdard, New Delhi); See also M. Govinda Rao, 'India: Intergovernmental fiscal relations in a planned economy', in R. Bird and F. Vaillancourt (ed.) *Fiscal Decentralization in Developing Countries*, (Cambridge University Press, Cambridge, 1998), p. 78-114.
[22] Paul Bernard Spahn, 'Intergovernmental Transfers in Switzerland and Germany', in Ehtisham Ahmad (ed.), *Financing Decentralized Expenditures*, (Edward Elgar, UK, 1997), p. 115.
[23] Ter-Minassian, op. cit., p. 12.

could be assigned to the centre. The cost of administration could also be considered in setting the percentage. It may also be designed to partly address the horizontal disparity in addition to its primary goal of narrowing the vertical fiscal gap. Ter-Minassian recommends, when considerable disparities exist between the rich and the poor states a higher percentage share of the revenue should be allocated to the centre.[24] The centre can then redistribute it to the states subject to certain agreed principles.

In the second approach, the *sharing of the entire pool of the tax* levied by the central government, a single formula may suffice. For instance, had Germany applied this method, revenue collected from corporate tax, personal income tax and VAT would be added together and divided between the centre and the states based on a given percentage. The second approach for revenue sharing has been the major intergovernmental transfer mechanism in Nigeria where the total amount derived from the major tax sources that accrues to the federal account is divided between the centre, the states and the local governments.[25]

In a revenue-sharing scheme (either on a tax-by-tax basis or on the basis of sharing the total tax pool), the actual proportion of tax to be allocated to the respective states is determined by either the *derivation* or the *redistribution* principle.[26]

By a derivative principle is meant that each state receives a share based on the amount of revenue collected in that specific state.[27] It is very much correlated with revenues that are collected by each state on tax sources allocated to them. Of course, it requires an arduous task to identify the amount of income generated by, for example, companies operating in each state. Depending on the type of tax bases, the amount of revenue generated in each state has to be identified. In addition, a different percentage of apportionment of revenue can apply to each type of tax.[28]

The other method of apportioning revenue is by means of a formula based on the *redistributive* principle.[29] In this approach, explains Ter-Minassian, revenue from a specific tax base or from the entire pool retained by the centre will be apportioned to all states, irrespective of their capacity to generate the shared revenues.[30] In this case, revenue sharing is very much like unconditional grants.

Several countries have adopted different criteria to apportion the revenue between the centre and the states. In Germany, for instance, VAT is apportioned

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[24] *Ibid.*
[25] See Art. 162-164 of the 1999 Constitution of Nigeria. Since 1981 the major revenues collected by the federal government accrue to a single pool called the 'Federal Account' and this is then shared among the three tires of government. In 1992, for example, 48.5% of the federally collected revenue was allotted to the central government, 24% to the states and 20% to the local governments. See Olufemi Fanja, 'Three-and-a-half decades of fiscal federalism in Nigeria,' in J. Isawa Ilaigw & R.A. Akindala (eds) *Foundations of Nigerian Federalism,* (series: Vol.3, National Council on Intergovernmental relations, Abuja, 1996), p. 114.
[26] Ter-Minasian, *op cit.*, p. 12-13.
[27] Ibid, p. 12.
[28] According to Art. 106 (5) of the German Basic Law, Personal income tax is apportioned between the federation, Länder and the municipalities. The sharing of revenue from this source between municipalities follows the derivative principle by following the residence of the taxpayers.
[29] Ter-Minassian, *op. cit.*, p. 12-13.
[30] *Ibid.*

on a per capita basis which results in a better share for those states with less per capita revenue. Its objective is essentially to redistribute income. In India, according to Govinda Rao, the formula comprises a combination of equity and efficiency criteria such as income per capita, population size, level of development and the state's own tax effort.[31] In Nigeria, the share of the states and local governments from the Federal Account has to be allocated to each state and local government based on redistributive criteria. For example, one of the studies indicated that in 1992 a formula with the following variables was used: equality of states, population size, geographic size, social development needs, and revenue raising efficiency.[32] In general, several factors have to be considered and approved by the constituent units of a federation when a rule is determined for apportioning the revenue between the centre and the states and among the states themselves. Some of these factors could be the nature of the distribution of the tax base among the states, the amount of revenue collected from a specific tax base, the capacity of the central government, and the role of the centre in allocating grants to relatively poor regions.[33]

In a revenue sharing scheme, there are some arguments that should be considered before which method of distribution is adopted. For instance, some authors argue that revenue sharing on a derivative bases perpetuates the resource disparities between the regions (horizontal imbalance).[34] Others also criticise the case of sharing revenue on tax-by-tax bases since the central government may give priority to those taxes from which it receives a greater share.[35] However, if a central government gives a preference to some types of taxes, it is possible to solve the problem by applying a uniform percentage share to all shared taxes. Making subnational governments active participants in the collection of shared taxes could be another solution.

Revenue sharing is essentially based on efficiency in revenue generation, especially in cases where there is another transfer in the form of grants. So, a proper and transparent system of sharing revenue based on a tax-by-tax system addresses the efficiency considerations of the respective states. Furthermore, as Bahl and Linn noted, the revenue-sharing schemes either explicitly provided in the constitution or through other pertinent legislation should guarantee a specified share. According to them, this makes it different from grants where the grantor predominates the method of allocation and the amount of grants.[36] Revenue sharing promotes partnership, enables the actual share of the centre to be easily determined and, to some extent, reduces dependency. In general, it guarantees the states a certain percentage of annually collected shared taxes, it is unconditional and the states can utilize the taxes according to their local needs. In particular, the sharing of revenue on the basis of the derivative principle promotes transparency and helps to contain secessionist tendencies by

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[31] M. Govinda Rao, 'Fiscal Decentralization in Indian Federalism,'2000 http://www.imf.org/external/pubs/ft/seminar/2000/fiscal/rao.pdf accessed 14 May 2002.

[32] Ovwasa describes 40% of the revenue as being shared equally among the states to meet the minimum responsibilities, 30% based on the size of the population, 10% based on geographic size, 10% based on social development needs and 10% on revenue-raising efficiency. O.L. Ovwasa, 'Fiscal Federalism in Nigeria: A historical analysis,' (Transafrican Journal of History, Vol. 24, 1995), p. 80.

[33] *Ibid.*

[34] Ehtisham Ahmad and Jon Craig, 'Intergovernmental Transfers', in Teresa Ter-Minassian (ed.) *Fiscal Federalism in Theory and Practice*, (International Monetary Fund, Washington DC., 1997), p. 76.

[35] Ter-Minassian, *op. cit.*, p. 12.

[36] Roy Bahl and Johannes Linn (1994), *op. cit.*, p. 8.

giving due consideration to the capacity of a region that contributes major revenue sources.[37]

2.2 Allocation of grants

Apart from systems of revenue sharing, disparities between poorer and richer states are addressed through grants also known as 'equalizing transfers'.

In principle, the objective of allocating such grants is to reduce the horizontal imbalance between the states. It also has the effect of reducing the vertical imbalances by increasing the revenue capacity of the states. Ehtisham Ahmad espouses that by equalizing the revenue capacity, it is anticipated that the states can provide comparable public services for their inhabitants.[38] Each country may also have specific objectives which have to be met by using various grant instruments. The German Basic Law, for instance, stipulates the equalization of living standards as an objective of the system. Whatever the ultimate objective of the transfer of grants may be, its nature is intertwined with issues relating to the division of revenue sources and expenditure responsibilities. Since the states surrender most of the productive tax sources to the centre, the transfer of grants secures a flow of revenue back to the states. But its impact on subnational autonomy in making financial decisions depends on the choice and structure of the grant system. Therefore, let us first study the types and the nature of grants in general.

2.3 Types of grants

Grants can be categorized into three different types.

i) *Unconditional or general purpose grants*[39]
As the name indicates, general purpose grants are allocated to states to spend the money in any area of public purposes designated by them. It is characterized by the absence of significant restrictions on the use of funds, as it is at the region's discretion to spend the money for any preferred purposes.[40] The choice of a general purpose grant not only maximizes the financial capacity, but also broadens the area of spending which may be considered essential by the states.[41] A general purpose grant is widely used as an instrument to equalize the revenue capacity of states. Thus, it should be equitably distributed between the subnational governments. The main characteristic of general purpose grants is the incongruity between imposing the taxation burden on the federal government while benefiting the subnational governments with the liberty of spending the

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[37] Some reasons which arise out of assigning shared taxes between the federal and regional governments in Ethiopia have already been noted in Chapter IV under the section on the concurrent power of taxation.
[38] Ehtisham Ahmad, 'Intergovernmental Transfer - an International Perspective,' Ehtisham Ahmed (ed.), *Financing decentralized Expenditures: An International comparison of grants*, (Edward Elgar, UK, 1997), p. 8.
[39] It is important to note that the term 'grants-in-aid' is sometimes used to refer to general purpose grants and in other cases to refer to federal transfer to states or local governments for particular purpose.
[40] Bernard P. Herber, *Modern Public Finance*, (5th ed. Vikas Pub., India, 1996), p. 340; However, the centre may not be completely deprived of the power of general auditing and surveillance of the spending of grants.
[41] Ahmed and Craig, *op. cit.*, p. 87.

money. This has led to an argument that 'such an 'asymmetry' between the political unpopularity of imposing taxes and the political popularity of spending money is said to foster fiscal irresponsibility. This asymmetry would be avoided, however, if the same government that takes the taxing decision also, in a symmetrical fashion, takes the spending decision.'[42] This argument is typical of the United States which favours conditional grants since the centre can control the recipient through the imperatives attached to the use of the funds. Nonetheless, if the allocation of grants is required to equalize the financial capacity of states, some form of general purpose grant is required.

ii) Conditional or specific purpose grants

These grants are also referred to as categorical grants. They are aimed at spending in a specific sector supported by the central government. The grantor may require, for example, a state to use the funds for a specific activity in the education sector, such as the construction of post-secondary institutions or the purchasing of books, with a possibility of further specifications. As the conditions become more specific, the states will in effect be left with no option but of spending the money in the area specifically required by the centre. Wheare argues, the imposition of such conditions upon the use of grants has to be explicitly or tacitly mandated by the constitution, or the initiative has to come from the states where the state alone cannot finance projects without the assistance of the centre.[43]

Ahmad and Craig claim that the objective of specific purpose grants is to impose conditions on the use of grants in order to maintain nationwide standards for the provision of services such as health and education.[44] However, its objective may go further to address the problems associated with the provision of public goods in the less developed and asymmetrical societies by allocating funds to scarcely endowed areas. Further, it can also play a role in curbing financial embezzlement, inefficiency and corruption, as the federal government retains the power to set conditions, to control and audit the spending. This will be consistent with the principles of financial responsibility and accountability to the taxpayer.

iii) *Matching* and *non-matching grants*

Conditional grants may also be further classified as *matching* (cost-sharing) and *non-matching*.

Non-matching grants are conditional transfers from the federal to the state governments but without any matching requirement on the part of the latter. The states are not required to spend a portion of their income to match the funding by the central government.[45]

Grants are given on a *matching* basis when states commit themselves to sharing the costs in order to receive a grant for a particular programme. In practice it may be difficult to determine the exact share of a state and the central

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[42] Herber, *op. cit.*, p. 341.

[43] K.C. Wheare, *Federal Government*, 3rd ed. (Oxford Univ. Press, London, 1963), p. 118-119. As in the case of India, an independent commission is empowered to study and approve specific projects to be financed by the centre but executed by the states. There is also an instance which is easier for the implementation of specific grants, as in the case of Germany, where there is a division of law making and administrative powers.

[44] Ahmed and Craig, *op. cit.*, p. 87-88.

[45] *Ibid.* Unconditional general purpose grants are non-matching by their very nature. So the need to describe them as non-matching grants is less relevant.

government, but the rationale for granting the money can provide some guidelines. Normally, the greater the degree of the federal interests in the project to be covered by the matching grant, the larger the federal share. The other issue would be whether the states should share the same percentage of the costs or whether the poor states should be favoured. As commented by R. Watts, in the USA where conditional grants are extensively used, there is an attempt of equalization in determining the matching rates.[46] Accordingly, rich states pay a greater share than poor states.

According to Wallace Oates, the main reason for the federal government to introduce matching grants is for the purpose of encouraging states to spend on activities which at the same time benefit the nation at large, and also to economically utilize the scarce federal resources.[47] At the same time, this allocation of matching grants enables the central government to influence the states instead of directly interfering in their autonomy.[48] Furthermore, matching grants have the objective of encouraging recipient states to 'maximize the initiative for self-financing'.[49] Matching grants can be constitutionally entrenched, as is the case in Germany,[50] or unilaterally decided by the federal government as is the case of the USA.

3 THE METHOD OF AND THE MECHANISM FOR THE ALLOCATION OF GRANTS: FEDERAL EXPERIENCES

In the present section, we deal with the main choices which have to be made in designing the transfer system as regards the role of grants. Some of the aspects involved in this issue will be the forms of grants chosen, the nature of equalization formulas and the variables included in the formulas. What types of institutional mechanisms are adopted in federal systems and what type of issues are they mandated to deal with will also be covered.

3.1 The design of grants

Although almost all federal systems experience fiscal disparities between the centre and the states and between the states themselves, they differ in their choice and design of the types of grants. The main choices relate to the amount to be vertically transferred to the states and the relative magnitudes of the use of conditional and unconditional grants and the purpose for which they are destined. The choices made show whether the transfer has the objective of narrowing the 'fiscal gap'[51] or achieving equalization between the fiscal capacities of the states.

The practice in the US, for instance, shows that the main transfer instrument is the allocation of conditional grants with a variety of matching and non-matching

[46] Watts (1999 b), *op. cit.*, p. 13.
[47] Eshetu Chole, 'Issues of vertical imbalance in Ethiopia's emerging system of fiscal decentralization,' in Eshetu Chole (ed.) *Fiscal Decentralization in Ethiopia*, (AAU printing press, Addis Ababa, 1994), p. 176.
[48] *Ibid.*
[49] *Ibid*, p. 176.
[50] Art. 91a of the Basic Law of Germany;
See also Paul Bernd Spahn and Oliver Franz, 'Consensus Democracy and Interjurisdictional Fiscal Solidarity in Germany', 2000, p. 6. A webpage accessed on 10 June 2003, http://www.imf.org/external/pubs/ft/seminar/2000/fiscal/spahn.pdf
[51] 'Fiscal gap' refers to the gap between revenue raised by a state and its annual budget.

requirements directed at specific programmes. Most often, said Watts, it has no specific requirements for equalizing the financial capacity of states through general purpose grants. The federal government (through the consent of congress) decides both on the gross amount vertically apportioned and horizontally dispersed between the states.[52]

On the other hand, Canada uses both conditional and unconditional grants, although the country is engaged in a continuous debate on the use of conditional grants in the absence of explicit constitutional recognition of the use of grants for specific provincial responsibility.[53] Whereas the judicial interpretation of concurrent powers paved the way for the extensive use of conditional grants in the US (and Canada), the degree of participation of the constituent units of the federation at the centre determines the nature of conditional grants, as in the case of Germany. The Länder participate in the decision making for the allocation of conditional and unconditional grants and revenue sharing for equalizing the Länder. The Constitutions of India and Australia have given a wider discretionary power to the federal governments to provide grants for general or specific purposes.[54]

In principle, designing a mechanism for allocating revenue for general purpose grants has to address two major questions: How should the total volume of revenue transferred from the centre (to the states as a whole) be determined? And how should this gross amount be distributed amongst the states?[55]

Concerning the first question, several approaches are used. First, as in the case of Germany, the share is determined on the basis of a constitutionally determined ratio and is secured with the participation of the states at the centre through the Bundesrat (Basic Law, Article104a &106). Second, it can be unilaterally determined by the centre on the basis of recommendations given by the finance or grant commissions, as is done in Australia, India, and South Africa.[56] Third, it can be established by an ad hoc negotiation between the centre and the regions as is practised in Russia.[57] Fourth, the amount set aside for

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[52] Watts, (1999, b), *op. cit.*, p. 10-11.
[53] Douglas H. Clark, 'The Fiscal Transfer System in Canada', Ehtisham Ahmed (ed.), *Financing Decentralized Expenditures: An International Comparison of Grants*, (Edward Elgar, UK, 1997), p. 79. About ninety percent of the total transfer is for three programmes: 'Fiscal equalization programme, Established Programme Financing which is a type of 'block transfer' for health and post-secondary education, and the 'Canada Assistance Plan' which is a shared-cost programme to provide support for persons in need.' In Canada there is a debate which focuses on the extent of the power of federal decisions on such programmes, the influence of the conditions increasing the role of the federal government within the provincial jurisdiction, and the absence of explicit constitutional provisions for conditional grants. Quebec vehemently argued that any form of conditional grant is an intrusion in its autonomy. For a general discussion of the issues of federal spending, see Hamish Telford, 'The Federal Spending Power in Canada: Nation-building or Nation-destroying?'(Working paper, Institute of Intergovernmental Relations, Queen's University, Kingston Ontario, 1999); See also R. Watts (1999,b), op. cit.
[54] See, for instance, Art. 275 and Sec. 96 of the Indian and Australian Constitutions respectively.
[55] Similar issues could be raised in the transfer of revenue at the sub-state level, and similarly the solutions adopted at the federal level could also be used at the state level.
[56] As discussed infra, the Ethiopian case reveals a share of joint taxes determined by the HOF, but the amount transferred from the federal revenue is unilaterally decided by the federal government.
[57] Christine I. Wallich, 'Russia's Dilemma', in Christine I. Wallich (ed.) *Russia and the Challenge of Fiscal Federalism* (The World Bank, Washington DC., 1994), p.

grants can be unilaterally decided by the federal government,[58] as in the case of Ethiopia (but the states participate in its horizontal distribution).

In general, the volume of federal transfer is dependent upon the nature of the distribution of revenue sources and the degree of vertical imbalances. When the vertical imbalance is significant, the volume of grants will be larger. The second question, i.e. the horizontal allocation of grants, will be dealt with in the following paragraphs on various countries' experiences.

3.2 The experiences of countries in designing equalization grants

The main issue in designing the transfer mechanism is the method of apportioning grants among the constituent units of the federation (the second question raised above). Focusing on the principles used for the allocation of unconditional grants and the variables employed we may classify the experiences of federal countries into four categories: equalization through measuring only the financial capacity of states, equalization through measuring both the financial capacity and expenditure needs of states, equalization through grant formulas and through the principle of equalizing the living standards of citizens.

First, in a federation like Canada the allocation of general purpose grants is based on the fiscal capacity of the states, known as provinces. Although the provinces have access to the major tax bases, they have exhibited a vertical imbalance.[59] The equalization programme is intended to address the fiscal disparities among the provinces through a comprehensive assessment of their 'fiscal capacity'. The fiscal capacity of each province is assessed in order to measure the gap in revenue-raising capacity between the rich and the poor provinces. The fiscal capacity of each province is estimated every year using a 'representative tax system' which lists all sources that can generate revenue for a province, ranging from actual taxes, to the sale of goods and services and public enterprises owned by the provinces. According to Clark, who studied the fiscal transfer system up to 1996, the assessment of fiscal capacity is done separately for each of 30 revenue sources and they are finally summed up together to arrive at the fiscal capacity of each province.[60] It also includes revenue generated from shared taxes allocated on a derivative basis. The fiscal capacity of each province is expressed in terms of a per capita basis and it is compared with *a standard* established to compare the highest and the lowest level.[61] Depending on actual performance, those states with a lesser amount compared to the standard will be entitled to a transfer amounting to the difference.

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[58] The fourth method is widely used in unitary decentralized systems. However, it can also be observed in some federal systems besides using either of the other methods. In Ethiopia, it is used in addition to the mandatory sharing of joint taxes listed in the Constitution under the 'concurrent power of taxation.'

[59] Clark, *op. cit.*, p. 79.

[60] *Ibid.*

[61] *Ibid*, p. 81; Clark discusses a question as to whether the standard should be the highest amount or the average of the total amount raised by all the provinces. If the transfer targets the equalization of all the rest with the one which has raised the maximum amount, it may have a daunting effect on the efficient regions. As the Constitution (of Canada) requires the fiscal capacity to be set as *a reasonably comparable level* of taxation the standard has been set (in 1967) as the average per capita revenue raised by all provinces, and in 1982 as the average of the middle-income provinces. The per capita revenue standard was originally set as the highest set is important to compare the fiscal capacity of the provinces.

Administering the assessment of the fiscal capacity of provinces in Canada is considered to be successful as it involves intergovernmental collaboration between the centre and the provinces in order to have an effective system of collecting, processing and preserving data, and to regularly (every five years) update the population statistics.[62] The designers of the system also argue that other conditional transfers are designed to assist provinces in major local expenditures which may help to narrow the disparities between the provinces.[63] The system in Canada, however, is criticized for failing to consider the expenditure need of each province, although the Constitution refers to the provision of goods and services at a comparable level; and the fiscal capacity is measured in relation to the actual revenue generated by the provinces and not the potential capacity to raise revenue.[64] But applying this kind of method (based only on the actual revenue performance) in a less developed system may have the danger of promoting dependency on relatively efficient regions.

Estimating the 'revenue-raising capacity' is an important variable employed in several systems. The related issue is whether it is the potential capacity to raise revenue that should be considered or the actual revenue raised by a state. The problem is that the actual revenue raised may not necessarily indicate the capacity. Measuring the capacity requires an independent assessment of the potential revenue that can be raised using the state's own revenue sources (tax bases and rates) such as property taxes, local business tax, local fees and charges and local contribution to shared taxes. The major issue in using either of the approaches is who should be entitled to the grant: a state making a great effort to raise more taxes or those who do not make an effort to utilize their taxation capacity. If the system rewards less taxation effort, it may lead to inefficiency in revenue generation.[65] Mostly, there is a need to set a national average tax effort.

Second, the Australian system administered by the Commonwealth Grants Commission measures both the differences in the revenue capacity and the expenditure needs of each state to determine the general purpose equalization grant.[66] The grant is transferred in order to overcome horizontal imbalances or to balance the fiscal inequality for funding recurrent expenditures. In assessing each state's expenditure need, according to Rye and Searle, the commission considers the recurrent spending on state matters from sources available from

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[62] *Ibid.*

[63] See footnote No. 52 above for the three program areas where specific grants are allocated.

[64] Clark argues the expenditure needs are very difficult to estimate; costs of provision of public services do not vary significantly across Canadian provinces; and where cost differentials are important..special purpose grants are used to compensate for these differences. Clark, *op cit.* p 81-86; See Ahmad (1997), in Ahmad, *op. cit.*, p. 11.

[65] The tax effort is not about the difference in the actual revenue collected. It is rather defined as 'the extent to which a jurisdiction exploits its tax base, or its taxable capacity.' Thus, according to this definition, 'a poor jurisdiction with a weak tax base might be making better tax effort than a richer one, even though its actual revenue collections are much lower.' Roy Bahl, in Wallich (ed.), *op. cit.*, p. 146.

[66] The general purpose transfers have ensured some state autonomy in their utilization. However, in a country where there exist considerable vertical imbalances the states have no complete autonomy over the size of these transfers. In an effort to address these problems, the Commonwealth and the states have introduced a new GST (goods and services tax, a form of VAT) in 2000. The parties have agreed that, after a transitional period, the proceeds of the goods and services tax administered by the commonwealth should be transferred to the states. See, C. Saunders, 'Federal Fiscal Reform and the GST' (centre for Comparative Constitutional Studies, the University of Melbourne).

the state budget and state public enterprises or direct spending by the centre.[67] By making categories of expenditure the Commission takes into account each public expenditure in the state and sets the per capita expenditure. After setting the per capita expenditure and the available per capita revenue it will be compared with the nationwide standard average per capita expenditure and per capita revenue. Then the system equalizes the different levels of per capita expenditure to that standard.[68] However, since the 2000 tax reform the total size of transfer each state receives from the GST (general sales tax) proceeds is determined relative to the amount of GST that is collected from each state.[69] The Australian Grants Commission has been successful partly because of the availability of reliable, detailed and accessible statistics from the states.

Concerning the estimation of the expenditure need, one of the methods is to design a list of expenditures and their cost, for example, the per pupil cost of education.

The exact cost could vary from one state to another, if not within a state. In theory this approach is persuasive since it attempts to include the need to provide all aspects of public goods and services, and capital and recurrent expenditure. This kind of identifying and standard-setting of expenditure seems to be effective, but is costly both in terms of time and labour. That is why some other countries recommended a method which comprises several variables such as population, per capita income, poverty levels, etc. to arrive at the average expenditure need as the standard. In determining the expenditure need a question may arise as to whether to include the costs of both recurrent and capital expenditures. In this regard, considering the experiences of developed federations Ahmad argues:

> It is generally desirable to avoid large fluctuations in equalization grants over the years. Moreover, large infrastructure projects tend to be financed through user charges and borrowing. For these reasons, large capital expenditures are usually excluded from the equalization process and are generally financed from borrowing or through a system of special-purpose capital transfers.[70]

It is important to note that transfers for major capital expenditure needs are outside the purview of the equalization formula in Australia. However, other forms of transfer such as general purpose capital grants and special purpose recurrent grants also play some expenditure equalization roles. The Australian federation is characterized by the situation that the states assume major expenditure responsibilities, while it has a centralized revenue system (higher vertical imbalance compared to other countries). It therefore has a greater role for equalization through transfers for general purpose recurrent expenditure grants (presently called GST revenue grants), capital expenditure grants and special purpose transfers. Although a higher degree of revenue centralization exists, it has become successful in employing effective equalizing instruments. It

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[67] C. Richard Rye and Bob Searle, 'The Fiscal Transfer system in Australia', in Ehtishan Ahmad (ed.), *Financing Decentralized expenditures: An International Comparison of Grants*, (Edward Elgar, UK, 1997), p. 164-65; See also C. Richard Rye and Bob Searle, 'Expenditure Needs: Institutions and Data,' in Ehtisham Ahmed (ed.), *Financing decentralized Expenditures: An International comparison of grants*, (Edward Elgar, UK, 1997), p. 43-69.

[68] According to Rye and Searle, 'A general purpose transfer is made according to the difference between the standardized revenue capacity and the expenditure need. The standardized expenditures are what the states would need to spend on each function to provide a standard (average) service if they operated at a standard level of efficiency. Standardized revenues are what the states could raise through particular taxes if they applied them at standard (average) tax rates and collected them with standard efficiency.' Rye and Bob Searle, op. cit., p.165.

[69] C. Saunders (2000), *op. cit.* p. 99-105.

[70] Ahmad, in Ahmad, *op. cit.*, p. 13.

has also demonstrated the possibility of dealing separately with recurrent and capital expenditures and the use of special purpose grants with some form of equalization roles.[71] Moreover, it has established the importance of measuring both the revenue-generating capacity and expenditure needs to equalize the states.

If a country like Ethiopia could take into account both the revenue capacity and the expenditure needs, it would minimize issues concerning equitable financial distribution. However, we have partly seen, and will further establish later on in the next chapter, that Ethiopia has encountered the difficulty of measuring expenditure needs due to huge regional asymmetries, a poor statistical record, technical and financial incapacity. But Australia teaches us an important lesson in how to apply it in major and important expenditure areas of the states such as on education, health and regional administration, and addressing other capital projects through conditional transfers.

In the *third* category, we find countries implementing formulas with important need indicators, which can help to show the imbalances between the states and address the intended objective. The selection of appropriate indicators should be highlighted with the corresponding percentage used to divide the available grant pool among the states. The use of indicators varies between countries and is subject to change to respond to the changing circumstances in a country. In India, the use of formulas and variables is extensive. Both the Finance and Plan Commissions use several variables to distribute revenue between the states.[72]

The Finance Commission uses different formulas for distributing joint taxes and allocating 'gap filling' grants mainly for recurrent costs. For distributing the joint taxes - personal income tax and union excise duties - between the states, different percentages of the variables are used. The variables are the local contribution of taxes, the population, per capita state domestic product, the level of underdevelopment and the degree of deficits.[73] For the grants allocated to each state the important criterion is the difference between the projected recurrent expenditure and the total state revenue. The Plan Commission uses a grant formula for 'plan transfers' (or for capital expenditures) from the centre to the states. According to M. Rao, Since 1969 the plan transfer has been made on the basis of a 'Gadgil formula' (named after the person who introduced it), as modified from time to time.[74] For instance, according to the modification introduced in 1991, out of the total amount allocated for transfer 30 percent was reserved for a special category of states, and the remainder - 70 percent - was distributed to the major states on the basis of the following weighted indicators: 60 percent assigned to according to population, 25 percent to per capita state domestic product (out of which 20 percent is allocated only to those states with lower than the average per capita), 7.5 percent to fiscal management and the remaining 7.5 percent to states' with special problem.

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[71] For a detailed analysis, see Rye, and Bob Searle, *op. cit*, p. 144-183; and Jon Craig, 'Australia', in Teresa Ter-Minassian (ed.), *Fiscal Federalism in Theory and Practice*, (International Monetary Fund, 1997), p. 175-200.

[72] For the discussion of the grant formulas used by the two Commissions, see M. Govinda Rao (1998), *op. cit.*, 78-112; See also Bhattacharaya, Harihar 'Federalism, Decentralization and State-building in India: Aspects of Centre-state Fiscal Relations', in R. Bird and Thomas Stauffer (eds.), *Intergovernmental Fiscal Relations in Fragmented Societies*, (Bâle, PIFF vol. 33, Helbing & Lichtenhahn, 2001):247-304.

[73] *Ibid*, p. 101-02.

[74] M. G. Rao, *op. cit*. p.102.

The 1999 Nigerian Constitution is peculiar in that it lists the variables that should be taken into account by the Revenue Mobilization, Allocation and Fiscal Commission in allocating revenue from the 'Federal Account'.[75] The Commission advises the president by adopting a revenue allocation formula taking into account the derivation and other variables including population, equality of states, internal revenue generation, land mass, terrain and population density.[76] The experience of the Nigerian federation displays the vertical distribution of the federal account between the centre, the states and local governments and a horizontal distribution based on some of the variables mentioned above with varying percentages. As we shall see later on in the next chapter, the Ethiopian grant formula that was applicable until 2003 could be grouped within this third category because it attempted to measure the level of development of the states using several variables.

The use of formulas for allocating conditional grants has also been introduced in the USA. In his comparative study, R. Watts classified the application of a variety of conditional grants in the United States into, firstly, formula grants with open-ended reimbursement of costs at a specified rate, and, secondly, formula grants related to specific projects.[77] Since grants are allocated to specific programmes, the variables used to determine the amount of grants vary according to the nature of the program. For instance, grants paid to prisons depend on the prison population. Statskey and Sunley argue that the objectives of using such formulas are to measure the needs of the community, its capacity to provide public services, the cost of providing public services and the tax effort of the community.[78] The use of formulas for conditional grants has been peculiar to the USA.

The *fourth* category refers to the principle of equalizing the living standards and the horizontal transfer of revenue between the Länder in Germany. There are three levels of transfer that determine the equalization effect and the financial capacity of the Lander.[79] The variables used in the three levels also vary.

The first level of revenue transfer follows the assignment of joint taxes. The variable used for the distribution of personal income tax and corporation income tax (shared taxes) is the residence of the taxpayer.[80] For the transfer of VAT, the population and the financial capacity of the states are used. From the total amount of VAT available to the states three-fourths are apportioned to each state according to population size. The rest, one-fourth, is distributed to those with less financial capacity based on average per capita state taxes (exclusive tax sources). Those states with less than 92 percent of the average per capita state taxes will receive a transfer from the VAT. Thus one-fourth of the states' VAT serves as an effective tool to address horizontal imbalances.

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[75] See Art. 162 of the 1999 Nigerian Constitution. For a historical analysis, see Fanja, op. cit., and Ovwasa, *op. cit.*
[76] *Ibid.*
[77] R. Watts (1999 b), *op. cit.* p.13.
[78] Janet G. Stotsky and Emil M. Sunley, 'United States', in Teresa Ter-Minassian (ed.), *Fiscal Federalism in Theory and Practice*, (International Monetary Fund, 1997), p. 368-373.
[79] For a description of the German system, see Spahn and Franz (2000), op. cit.; and Spahn, 'Intergovernmental Transfers in Switzerland and Germany', op. cit., p. 103-143; for the analysis of revenue transfer before Germanys' unification, see Biehl, Dieter, 'Fiscal Federalism in Germany', in Cheryl Saunders and Anne Mullins (ed.), *Economic Union in Federal systems*, (The federation Press, NSW, 1990), p. 152-193.
[80] *Ibid*; The regional distribution of corporation tax requires a formula apportionment of income for firms with multiple regional activities (the residence variable is divided).

The second level of distribution targets horizontal imbalance and comprises some different variables: the average revenue per capita multiplied by the population of each state (population is counted by a factor of 1.35 for city states taking into account urban problems, compared to 1 for the others), and the special burdens of some states such as harbours for the benefit of all. These variables are used to compare the effective financial situation of each state.[81] The arduous task is to arrive at the average revenue per capita. Once the average rate is determined, the states below that average will receive compensation from the above average states. This interstate equalization mechanism, which operates among the states themselves, is unique. This seems to be a reflection of the German cooperative federalism with its strong interregional solidarity. The fiscal experts argue that this system of transfer helps to promote the fiscal capacities of 'weak states' in order to attain at least 95 percent of the average tax capacity.[82]

The third level of transfer plays a vital role in correcting the horizontal disparities by using asymmetrical vertical transfers from the federal government. This includes, according to Spahn and Franz, the unconditional 'supplementary federal grant,' and specific purpose payments.[83] Such grants can be used to assist those with a lesser financial capacity to equalize the provision of infrastructures, or to finance joint tasks. The disbursement of grants for these purposes passes through rigorous federal/state procedures as well as interstate cooperation and negotiation. It is presumed that these grants were considered logical to equalize the eastern German Länder after unification. But as time passes, several comments have been aired concerning the volume of these grants and their impact on efficiency and the need to limit their duration.

4 THE IMPACT OF DATA

The need to equalize the constituent units of a federation should consider all pertinent factors in order to provide public goods and services at a comparable level of tax. To do this requires adequate data that can help to understand the disparities in fiscal capacities and expenditure needs across the regions. However, the problem of a lack of adequate data in many federations is a barrier to implementing an effective equalization system. Some of the problems are related to the lack of harmonized tax polices and time-scales, the existence of greater asymmetries between the regions, the lack of efficient and effective data-gathering institutions, and the problem of data manipulation by subnational levels of government concerning factors that may maximize their share.[84] The shortcomings of grant formulas are usually attributed to the lack of reliable and up to date data, which could be much worse in developing countries. Emphasizing the importance of assessing all relevant statistical information, Clark recommends a relatively independent institution staffed by highly qualified professionals and an effective auditing system.[85] In dealing with data gathering problems related to assessing the revenue capacity of states, Clark recommends to focus on those sources which are reasonably of good quality until such time as acceptable data become available for all other sources.[86] With regard to the

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[81] Spahn and Franz, *op. cit.*
[82] *Ibid.*
[83] *Id.*
[84] Clark, 'Assessing Provincial Revenue Raising Capacity for Transfer,' in Ahmad, *op. cit.*, p. 27.
[85] *Ibid*, p. 36.
[86] *Ibid*, p. 26.

difficulty to assess expenditure needs, Rye and Searle recommend to focus on major expenditure categories and by allocating conditional grants on specific major public services.[87]

5 INSTITUTIONS FOR REVENUE TRANSFER

One of the differences observed in the implementation of the transfer system is the mechanism and processes involved in addressing the two important questions: determining the amount transferred and how it is to be transferred among the states. Although there is a horizontal interstate transfer of revenue in an attempt to equalize the revenue capacity of the states in Germany, most of the issues relating to transfer in all federations are held at the centre through different institutional arrangements. Broadly, four models of institutional mechanisms can be discerned.[88]

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

The Australian Grants Commission is a standing commission established by the federal government[89] whereas the Indian National Finance and Planning Commissions, and the South African Fiscal and Financial Commission are established by the respective constitutions. Since its establishment in 1933 the Australian Grants Commission is well known for its effective equalization instrument by dealing with both the revenue and expenditure needs of the states, and the overall recommendations to reduce both the vertical and horizontal imbalances.[90] It is mandated to deal with the general/unconditional transfer of grants but with time it has been able to influence the federal government in its decisions on the allocation of conditional grants.[91] In India, the revenue transfer is administered by two Commissions: the Finance Commission and the Planning Commission. The Finance Commission, appointed for five years, makes recommendations on the sharing of revenue between the centre and the states and as between the states themselves. The principle it uses mainly focuses on the financial capacity of states, leaving the expenditure need to be determined by the Planning Commission. The latter commission recommends the allocation of special purpose grants for the major developmental expenditures of the states.[92]

The other important institution is the South African Fiscal and Financial Commission which was set up under Article 220 of the Constitution and the Fiscal and Financial Act No. 99/1997. It is an independent body of experts where provincial and local governments are also represented. The principal duty of the

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[87] Rye and Searle, 'Expenditure Needs: Institution and Data', in Ahmad, *op. cit.*, p. 53-54.
[88] For a comparative analysis see R. Watts, 'The Dynamics of Decentralization,' in Bird and Stauffer (ed.) *Fiscal Decentralization in a Fragments States* (PIFF vol. 33, Bâle, Helbing & Lichtenhahn, 2001), p. 15-34.
[89] However, there is an intergovernmental council (Loan Council) established by the Constitution with the task of coordinating public borrowing by the federal and state governments based on a two-thirds majority vote.
[90] R. Watts (1999 b), *op. cit.* p. 21-22.
[91] *Ibid.* p.22.
[92] M. G. Rao, *op. cit.* p.100-105.

commission is to make recommendations with regard to the equitable division of national revenue among the three tiers of government with a view to facilitating cooperative government. The Commission's mandate includes adjustments to both vertical and horizontal imbalances.[93] The Commission assumes a difficult task especially for two major reasons: the provinces' responsibility for providing major public goods and services, and the need to aggressively address the economic disparity attributed to the legacy of apartheid.[94] In Nigeria, too, the importance of an independent fiscal commission has been stressed since independence in order to ensure that revenue sharing is done on a rational basis.[95] Compared to the other commissions mentioned above, its history is marred by interventions or rejections by the military regimes, ethnic and regional competition dominating the fiscal issues, the increasing number of states and the impact of frequent political and constitutional changes that have taken place in Nigeria.[96]

The *second* model is found, for example, in Malaysia (National Finance Council) where the Constitution provides for the establishment of a formal council for intergovernmental cooperation composed of representatives from the federal government and the states.[97]

The *third* model refers to the system of revenue transfers which is decided by the federal government, but there is states' representation at the federal legislature (through the Upper House) for expressing regional interest. This model is followed in many federations including Germany, Switzerland and the USA. However, the role of the states at the centre concerning their interests, particularly the design and approval of revenue transfer is much more constitutionally entrenched in Germany than in other federations. Any federal decision in areas of concurrent or exclusive state jurisdiction is effected through the consent of a majority in the Bundesrat where the Länder are represented. In Switzerland, in addition to the cantonal representation in the federal legislature the cantons can challenge any federal legislation through a referendum.[98] So the cantons are consulted formally through their representation at the centre and through an informal mechanism. In the USA, any decision on the federal transfer of revenue requires the consent of Congress and the president. The Ethiopian situation may be categorized under this third model since the issues of revenue sharing and the grant formula are decided by the HOF (the Upper House).

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[93] The Commission is also allocated specific functions through other legislations, notably the borrowing powers of the provincial governments Act of 1995 and the Intergovernmental Fiscal Relations Act of 1997.

[94] See Brian Dollery, 'An Initial Evaluation of Revenue Sharing Arrangements in the New South African Fiscal Federalism', (Publius: The Journal of Federalism Vol. 28 No. 2, March 22, 1998), p. 129- 154

[95] The major institutions whose recommendations have determined the sharing of revenue in Nigeria since independence were Raisman-Tress Commission (1958), Binns Commission (1964), Dina Interim Revenue Review Committee (1968), Aboyade Technical Commission (1977), Okigbo Presidential Commission (1980), and National Revenue Allocation, Mobilization and Fiscal Commission (1988,1999). For a historical Analysis see Fanja, Olufema *op cit.*; and Ovwasa, O. Lucky, *op. cit.*

[96] See Attahiru M. Jega, 'The Nigerian Federal System: Problems and Prospects', in L. Basta and Jibrin Ibrahim (eds.) Federalism and Decentralization in Africa: The MultiCultural Challenge (PIFF, vol. 24, Helbing & Lichtenhahn, 1999), p.195-220.

[97] Art. 108 of the Constitution of Malaysia.

[98] A referendum can be held on any federal legislation if fifty thousand eligible voters request this, and for constitutional amendment if one hundred thousand propose such an amendment. See Arts. 138-142 of the Swiss Constitution.

However, as we shall see further below, the composition of and the powers conferred on the HOF have made it different from the above countries.[99]

The *fourth* model is typical of Canada where all matters of revenue transfer schemes and tax-related arrangements are determined by the federal government not by any formal independent commission or constitutionally provided institution. However, since the nature of fiscal relations involves extensive regional interests, several extra-parliamentary mechanisms involving officials of the centre and the provinces (intergovernmental cooperation) have been established.[100]

6 CONCLUDING REMARKS

What lessons could be learnt from the experiences of the federal systems discussed in this section? Distributing grants on the basis of some grant formula is a widely used approach in equalizing the fiscal capacity of the constituent units of a federation. In order to equalize regions, the disparity between them must be identified. Therefore, an important question would be what kind of variables should be included in the formula in order to determine the extent of disparities among the regions and by how much could this disparity be reduced. Since the causes of regional disparities are closely related to country-specific factors such as economic conditions, political and historical factors it will be difficult to establish norms for the inclusion of variables. However, there are commonly found variables in many grant formulas, but with differing percentages. These are population, per capita income, territorial size, poverty levels, and the special needs of a state (urban or rural related problems). As the Nigerian Constitution demonstrates, all variables that can address the regional disparities could be relevant but the data-related factors might force us to focus on selected variables. If general purpose equalization grants are used, the formula should be designed to equalize the revenue capacity of subnational governments so that they can provide basic public services such as health care and education. As can be observed in Australia, this can be done by measuring the revenue-generating capacity and the expenditure needs (to measure the cost differences). However, the objective of equitable distribution and measuring all variables in the expenditure needs of the regions may not be met only by the general purpose grants. Thus, projects that require huge investment or special local interests (vulnerability to drought or a natural catastrophe) should be addressed by special purpose grants.

Furthermore, although the transfer of general purpose grants aims to equalize the capacity of regional governments, the experiences of several countries demonstrate the use of several instruments to distribute resources in an equitable and transparent manner and to assist the developmental aspects of each level of subnational government. For instance, some classify the revenue

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[99] For a detailed analysis and recommendation see the next chapter, Section 4.

[100] For instance, intergovernmental fiscal relation is one of the concerns of the new Council of Federations that was founded in July 2003 to deal with all forms of cooperative relations between the federal government and the Provinces and Territories. For further discussions on the relevance of intergovernmental councils and institutions, see R. Watts, 'Intergovernmental Councils in Federations', and Meekison, Peter J., 'Council of Federations: An Idea Whose Time has Come' In: *Constructive and Cooperative Federalism?* (IIGR, Queen's Univ., IRRP, Montreal, 2003, http://www.jigr.ca/browse_publications.php?section=39, accessed on February 15, 2004.

transfer for recurrent and capital grants. In this regard, the experience of India could be important in order to address considerable disparities between the states. A special purpose federal grant (with a clearly set percentage) could be allocated for regions categorized as the least developed regions. However, in a federation where there are considerable de facto asymmetries, it is advisable to reduce the asymmetries (such as size) since it is difficult to address all forms of disparities solely by transferring revenue.

The experiences of various countries also remind us of the importance of an independent commission with the required expertise in order to prevent political exigencies and logrolling, and to promote impartiality.[101] Australia and India, for example, have followed a similar approach of assigning independent commissions but with different applications. The Nigerian Fiscal Commission also has a major task in sharing revenue from the Federal Account between the centre, states and local governments and distributing it horizontally between the states. The very recent constitutional mandate of the South African Fiscal and Finance Commission also indicates the relevance of independent institutions.

In general, the above summary demonstrates to Ethiopia the relevance of the use of specific purpose grants other than the general purpose unconditional grants as a means to administer grand capital projects, the need to address the fiscal problems of the least developed regions, the need to reduce the asymmetry and the relevance of an independent financial institution. With this background we will explore the system of revenue transfer in Ethiopia.

[101] It does not mean that other federations like Canada, Germany and Switzerland have a more problematic model. The federal structure and experiences of these countries have rather helped to secure an effective intergovernmental financial relation. The bargaining position of the provinces in Canada, the role of the Länder at the federal level through the Bundesrat and the significant role of historically independent cantons at the federal level are some of the reasons for the success of these countries. However, as we shall thoroughly discuss it later in the next chapter, we emphasized the importance of independent institution in Ethiopia considering the non-legislative role of the HOF and its composition, the federal structure and the experience of the last decade.

7 Correcting the Imbalances (II): Revenue Transfer and Borrowing in Ethiopia

In the previous chapter we have reviewed the literature as to the importance of revenue transfer from the centre to the regions on the one hand and as between the regions on the other, and the experiences of several federal systems. This comparative analysis is believed to highlight some issues that should be analysed in the Ethiopian situation as presented in the following sections.

As was thoroughly discussed under Chapter V, the constitutional division of revenue sources between the centre and the regions does not create a balance between responsibilities and revenue sources at the state level in Ethiopia. While most of the major revenue sources lie with the centre the states remained with limited sources. Moreover, on the one hand, the economic condition and the level of development prevailing in the states show a huge demand for revenue, but on the other, their revenue-generating capacity does not demonstrate significant progress. The states are therefore dependent on a sizable amount of transfer coming from the centre. In the sections that follow we will be dealing with the Constitution and other legislation devised to address the issues of transfer, and the prevailing practices in Ethiopia. While it is worthwhile comparing these with developments in other countries, the emphasis will be on the manner in which the system of transfer has been practised since the devolution of power in 1992, the nature of the reforms which the transfer system is currently being subject to, and the major problems that still need to be addressed.

The present chapter is divided into six sections.
Section one explains on what legal basis the allocation of grants has been implemented in Ethiopia and its objectives.

Section two thoroughly discusses the operational reality of the transfer system in Ethiopia and focuses on the revenue sharing arrangement and the allocation of grants. It covers various issues related to the arrangement for the sharing of concurrent taxes, the allocation of federal grants and the applicable formulas, the challenges to the grant system, other forms of federal transfer and intrastate allocation of grants from subsections 2.1 to 2.5. This section, while analysing the nature of the forms of transfer as embodied in the Constitution and their implementation, further discusses the real challenges to the successful operation of the transfer system.

Section three attempts to forward a proposal on how to improve the system for the allocation of grants in its bid to narrow the financial disparity between the regions.

Section four discusses the existing institutional framework to administer federal grants in Ethiopia on one hand, and the importance of a non-partisan, professional institution on the other.

Whether the process of revenue transfer in Ethiopia leads to a competitive, cooperative or controlled form of federalism is also analysed in section five.

Section six discusses the methods of regulating regional borrowing in general and examines the trends in Ethiopia in particular.

1 THE LEGAL BASIS OF THE SYSTEM AND ITS OBJECTIVES

To study the complicated system of intergovernmental transfer it is important to consider, first, the constitutional basis of the transfer system and what objectives it intends to achieve.

Intergovernmental transfer is recognized in the Ethiopian Constitution and plays a major role in determining the financial capacities of the regional governments. Provisions for fiscal transfer concerning revenue sharing and the allocation of grants have been included in the Constitution. As a major feature of the assignment of revenue sources the Ethiopian Constitution specifically mentions the tax sources administered (levied and collected) by the centre but shared with the regional governments.[1] It serves as an independent source of revenue to the regions since it is not a discretionary contribution by the centre. The Constitution also provides general provisions for the centre to provide grants[2] to the regions and to provide special assistance to those least advantaged in economic development.[3] Although the right of the regions to receive grants from the centre is clear, determining the total amount of the grant in question seems to be left to the discretion of the federal government. The only ambiguous limitation on this power is Article 95 of the Constitution which provides that the federal government and the states shall share revenue taking the federal arrangement into account. This provision is not sufficient for transferring revenue which is adequate to address the expenditure needs of the regions.

The explicit constitutional recognition of allocation of grants is consistent with the experience of many federations which have sought to make explicit provision for the transfer of revenue from the centre to the regions (or as between the states themselves or from the states to the centre). The drafters of some federal constitutions had realized the financial constraints which the states could face, the sizeable revenue that could be available at the centre, and the criticism that could be raised against conditional grants. The German, Indian and Nigerian Constitutions, for instance, have extensively provided for the allocation of conditional and unconditional grants, and for revenue-sharing arrangements. Most federations have made extensive use of revenue sharing, and the provision of conditional and unconditional grants to subnational governments. In general, the theory of intergovernmental fiscal transfer and the practice in most federations have demonstrated the importance of recognizing it in the constitution or in other pertinent legislation. In all cases where the provision of unconditional grants and revenue sharing are constitutionally guaranteed, the states are empowered to make independent claims. However, the amount to be transferred to the states (or lower levels) is mostly determined by the federal government or another independent institution. But if a fixed percentage share of

[1] Art. 98 as 'amended.' See infra, the discussion on revenue sharing.
[2] See Arts. 62 (7) and 94 of the FDRE Constitution.
[3] Art. 62 (7) and 89 (4) of the FDRE Constitution.

the taxes is to be paid to the states, it creates some form of financial independence for the states.

The need for constitutional provisions for the transfer of revenue may be imperative, but it is not a sufficient condition for the existence of an effective system. Nor can its absence impede a country from achieving a successful intergovernmental fiscal transfer. For example, there is no explicit provision to this effect in the US Constitution, but with the help of the judicial interpretation of the Constitution the federal government has succeeded in supporting developmental activities in the states.[4] The political process within a country, the existence of an independent institution responsible for the transfer system, or the influence of historical factors may play a pivotal role for the success of a transfer system. To mention examples, the Australian Grants Commission and the Indian Finance and Plan Commissions have been praised for their commendable contributions to the transfer systems of the respective countries. Intergovernmental relations in Switzerland, the role of the Bundesrat and the cooperative system in Germany for achieving equal living conditions and equalizing the states are also federal achievements.[5]

The other equally important question is the following: Can the federal government provide conditional grants to the states in the areas where it cannot enact laws? R. Watts and K. C. Wheare have dealt with this question as to whether the federal government can prescribe conditional grants for the execution of specific state responsibilities. Wheare argues, consistent with his definition of the federal principle, that 'on a strictly federal view, perhaps, it would seem that financial power should be confined in its objects to the same ambit as the legislative powers.'[6] That is, the centre should not circumscribe the execution of state power. Similar positions in Canada[7] have raised political controversies since the Canadian Constitution does not explicitly permit the federal government to spend in areas of provincial jurisdiction. Quebec has repeatedly argued against 'federal spending'[8] considering that it is an encroachment on its sovereignty. Watts, however, contends that the argument based on the dual sovereignty principle of federalism is flawed. Considering the experiences of several federations, he concluded that:

> Overlaps and interdependence between the orders of government within a federation are unavoidable, and that therefore a variety of devices, including a federal spending power in areas of exclusive state or provincial legislative jurisdiction, are required for federations to operate effectively.[9]

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[4] Cheryl Saunders, 'Constitutional Arrangements of Federal Systems' (Publius: The Journal of Federalism, Vol. 25 No. 2, 1995), p. 70.
[5] It does not mean that they are free from criticism. For example, the political wrangling between the Länder and the federal government, and the administrative interlocking in Germany are a case in point.
[6] K. C. Wheare, *Federal Government*, 4th ed., (London, Oxford Univ. Press, 1963), p. 106.
[7] For the analysis of the arguments, see Hamish Telford, 'The federal Spending Power in Canada: Nation building or Nation-destroying?' Working paper, Institute of Intergovernmental Relations, Queen's University, Kingston Ontario, 1999.
[8] The Canadians use the term 'spending power' instead of conditional or semi-conditional grants. The spending power is defined by the federal government as 'the power of parliament to make payments to people or institutions or governments for purposes on which it does not necessarily have the power to legislate.' Ronald Watts, *The Spending Power in Federal Systems: A Comparative Study* (Kingston, Queen's University, Institute of Intergovernmental Relations, 1999 b), p. 1.
[9] *Ibid*, p. 50.

As we have observed above, the Constitutions of Australia, Germany and India have explicit provisions on the spending of conditional grants on matters explicitly reserved for the states. The provisions found in Australia and India are more explicit and wider than others in giving a discretionary power over the allocation of conditional grants to the centre.[10] On the other hand, in the USA and Canada the federal governments are able to allocate conditional grants through the judicial interpretation of the constitutions. It is not only the explicit constitutional authority but also the existence of concurrent powers that helped to spend conditional grants in the states.[11]

If we consider the above issue in relation to the Ethiopian Constitution, will the allocation of conditional grants be in conflict with the powers of the states or with the sovereignty of nations, nationalities or peoples enshrined in the Constitution? Is the controversy in Canada an indication of a similar situation in multiethnic federations? The answers depend on how constitutions deal with similar problems. The importance attributed to efficiency and accountability of decisions to tax and to spend could also be reasons to implement conditional grants. The FDRE Constitution clearly bestows power on the federal government to raise revenue and to spend on responsibilities assigned to it. It also enunciates the allocation of unconditional equalization grants to the states on a certain (agreed) formula as set by the House of Federation (HOF). It is submitted that Article 94(2) could be an instance where the federal government may give conditional grants for the execution of matters within a state's jurisdiction. Accordingly, the federal government may grant to states emergency, rehabilitation and development assistance. The Constitution also mentions the importance of special grants to avert the dangers of unforeseen natural or man-made crises, and to provide special assistance to regions least advantaged in economic and social advantages (Article 89 (3, 4)). Federal subsidy can also be granted:

> to support projects that will help control negative economic externalities that may be reflected from region to region and strengthen projects that provide common benefit to neighbouring region, and to encourage foreign currency earning projects and other projects of national interest.[12]

Although it is not as explicit and powerful as the Indian and Australian Constitutions the Ethiopian Constitution, like other federations, permits the allocation of conditional grants to the states. Further, the experiences and the Constitutions of India, Nigeria, and Switzerland demonstrate the possibilities for allocating conditional grants in multiethnic societies. However, a query remains as to whether the HOF determines the allocation of conditional grants. In practice this does not seem to be the case. The HOF decides on the allocation of equalization grants to increase the financial capacity of each regional government. Conditional grants are specific to the performance of a particular task (or a block of tasks) which is normally the responsibility of the executive and may involve negotiation and bargaining between the executives of the levels of government. Thus, what the HOF can do is to evaluate the impact of conditional grants on the equitable distribution of revenue as the conditional grants may help to maximize the fiscal capacity of a state and address some expenditure needs.

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[10] However, most of them had some transitory provisions for obligatory grants by the centre. For a historical analysis see Wheare, *op. cit.*, p. 102-103.
[11] Watts (1999, b), *op. cit.*, p. 50.
[12] Art. 7 of Proc. No. 33/1992 for the sharing of revenue between the central and regional governments.

On the whole, federal subsidy should be granted for the fulfilment of the several objectives stated above through the sharing of joint revenues, and by the provision of unconditional and conditional grants.

2. THE TRANSFER SYSTEM: DESCRIPTION AND ASSESSMENT

2.1 Revenue-sharing arrangement

As indicated above (Chapter VI, Section 2.1.), developing a revenue-sharing system is dependent on the nature of the division of revenue sources. In a system where all revenues collected by the centre are deemed to be joint taxes, revenue sharing refers to a system for determining the amount retained by the centre and the total amount reserved to the states as a whole, but which is later divided between them.[13] In some federal systems, revenue sharing explicitly refers to the sharing of revenue generated from sources specifically mentioned as shared/joint taxes of the centre and the regions.

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

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

For instance, the budgeted federal expenditure and the grant allocated for the states from 1999 to 2003 fiscal years implied that about 70 percent was allotted to the federal government and 30 percent to the regional governments (e.g. for the 2003/04 fiscal year, from the total revenue pool at the federal level 69 percent was retained by the centre and 31 percent granted to the regions).[14] The decisions on establishing the share of the regions were solely made by the Council of Ministers on the recommendation of the federal Ministry of Finance.[15] Such an approach underestimates the relevance of an independent revenue-sharing (constitutionally stipulated) scheme for allocating the joint tax sources among the regions. It is less likely to be transparent and in conformity with the expenditure responsibilities assigned to the regions. It also penalizes regions that are the major contributors in shared taxes.

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[13] See Art. 162 of the 1999 Nigerian Constitution and Sec. 214 of the 1996 South African Constitution.
[14] Computed from the Budget Proclamations of the given fiscal years.
[15] Although in some federations it is a matter decided by the federal government, the states put forward their positions in intergovernmental cooperation forums.

Since there has not been a specific system of sharing revenue from joint (concurrent) taxes the contribution of each region for shared taxes cannot be defined. If a revenue-sharing system for joint taxes would be put in place, the regions where such joint taxes are collected would receive a share of the taxes raised in their jurisdiction. For instance, suppose that a region would share half of the joint revenue on a derivative basis. It implies that the greater the tax base of a region the more the resources will be flowing to the same region. Therefore, the absence of a specific revenue sharing system means a challenge to the potentially better-off regions. They might resent paying too much for equalizing other regions while they are facing budget constraints. If such regions can estimate the amount of revenue they share from joint taxes, this may help them to budget and plan in time. If they do not feel that revenue from joint taxes also belongs to them, it may affect the overall revenue collection from these sources. This is because as the available revenue from their own tax sources is limited, they have to discover other means that can maximize their revenue capacity.

For instance, business enterprises pay land use fees to the regional governments but they pay joint taxes such as sales and profit taxes to the federal government. Since the share from joint taxes has not been fixed the regional governments considered that these taxes play no direct role as far as they are concerned. So, they counted on the available sources such as land taxes. The debate between the Oromia region and the public enterprises existing within the region on the amount of land use fee may confirm this. In their discussion with the Public Enterprise Supervising Authority officials of Oromia region argued:

> The reason that land taxes on the enterprises are higher is that the region does not benefit from any profit tax from the public enterprises... If the [region] cannot impose other taxes, it should impose the maximum amount of land tax to generate [revenue] from the businesses that operate in its territory.[16]

The practice until the 2003/04 fiscal year appeared to be that the sharing of joint revenues was impliedly dealt with through the transfer of grants to the regions. According to the officials of the Ministry of Finance[17] the reasons for doing so boil down to the following arguments: One reason for this choice is the great disparities in revenue-generating capacity that exist between the regions. So the immediate response was to address this problem through an equitable transfer mechanism. Second, some of the mentioned sources of shared taxes such as jointly established enterprises do not have practical significance. The other sources are unevenly distributed between the regions so that this undermines the relevance of revenue sharing which is primarily based on a derivative principle.

These problems might have forced the government to focus on how much equalization could be attempted by employing a simplistic method of federal transfers. Some may even argue against the use of different sharing methods and formulas since the objective is to arrive at a final equitable distribution among regional governments. However, no less important is whether different instruments have to be put into use to arrive at the required result. The choice to use different instruments is part of the endeavour to achieve an equitable

[16] Authorities of the public enterprises argued that the fee for the land use in Oromia is higher than in the other regions. 'Oromia land tax disputes heats up'www.capitalethiopia.com, accessed on 21 July 2004.
[17] See for instance the report by the Minister of Finance and Economic Development to the HOPR, 2002.

distribution of resources. Otherwise, there would not have been the need to divide revenue sources between the levels of government and the need for a transfer system. There are also other objectives to be achieved parallel to revenue sharing, such as rewarding efficient governments for generating revenue, promoting transparency and accountability. Further, the emphasis on assistance has a danger of creating a tax disincentive and may belittle the trust in the central government on the part of those relatively better-off regions. So, the transfer system should distinguish between the sharing of revenue from joint taxes and the allocation of grants as prescribed by the Constitution.

The federal government has recently promulgated a new system for the sharing of revenue from concurrent tax sources, based on a principle recommended by both the centre and the regions and decided by the HOF. Before going through its allocation principle, let us first recall the constitutional provision on the sharing of joint taxes.[18] The Constitution stipulates that the revenue derived from concurrent tax sources shall be divided between the centre and the regional governments as determined by the HOF taking the federal arrangement into account.[19] The sources of shared taxes are: profit, sales, excise and personal income taxes on enterprises which the centre and the regional governments jointly establish; on sales and excise taxes, and profits of companies; on dividends due to shareholders; income derived from large-scale mining and all petroleum and gas operations and royalties on such enterprises.[20]

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

A close reading of the provision shows that the sharing of revenue seems to follow a tax-by-tax approach. For instance, the sharing of profit from jointly established enterprises depends on the capital contribution made by each government. Some taxes such as employment income tax are easier to collect while in the case of others, such as sales and excise taxes from companies engaged in business in several states, it is difficult to identify the source of the tax. Similarly, although the derivative principle seems to be applicable for the sharing of most tax sources, there are also taxes that may need further criteria, as it is sometimes difficult to trace the place of taxation. Some of the issues that should be scrutinized are related to the division of company profit tax and VAT.

The other basic issue would be how to determine the basis for the apportionment of revenue, since the Constitution does not set a percentage for the share of the centre and the sharing region. Therefore, what policy guidelines and criteria are used to determine the shares between the centre and the regions? Normally, the percentage can be determined considering factors such as how much the financial capacity of the centre is dependent on shared taxes, whether the division of shared taxes plays a role in income redistribution, and the need to

[18] For a fuller discussion of the joint taxes under the Ethiopian Constitution, see Chapter IV, Section 4.2.
[19] Arts. 62 and 95 of the FDRE Constitution.
[20] Art. 98 of the FDRE Constitution.

reward efficient regions.[21] A glance at the newly proposed principle (see Table 7:1 below) for the sharing of revenue shows that a higher percentage is set for the central government on sources of revenue with a national character and considering the responsibility of the centre in carrying out the collection. The share of the regions focuses on sources which can promote efficiency in the levying and collection of taxes, and on the source related to the consumption of local goods and services. Accordingly, the centre and the region share direct taxes equally, but a higher percentage of indirect taxes (70 percent) are allotted to the centre.

Table 5.1: Types and Sources of Joint Revenue*

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

* The revenue-sharing scheme as reported by the Ministry of Revenue, December 2003.
** Since there are no enterprises jointly established, the sharing of direct or indirect taxes from this source is not currently applicable.

By applying the revenue-sharing scheme, the system replies to the 'ownership' of the source of revenue. It increases the revenue capacity of the sharing government and also promotes efficiency in the levying and collection of taxes. Furthermore, it encourages the states to consider the benefit from joint taxes and to cooperate for an efficient tax administration. However, its drawback emanates from the failure to consider the difficulty of identifying the exact amount of tax collected from companies engaged in trading in several states. Whether the division of royalties from mining, petroleum and gas operations will be feasible in the long run is also another issue. To date, earnings from royalties are less significant. But in the future the fifty percent share could be challenged since the Constitution confers ownership rights in natural resources on the state and on the peoples of Ethiopia in general and not on a specific region.[22]

With regard to the sharing of taxes related to companies, the secretariat of the tax reform programme at the Ministry of Revenue affirms that the share of each region is determined on the basis of the amount collected from the respective

[21] See Teresa Ter-Minasian, 'Intergovernmental Fiscal Relations in a Macroeconomic Perspective: An Overview,' in Teresa Ter-Minassian (ed.) *Fiscal Federalism in Theory and Practice*, (International Monetary Fund, Washington DC., 1997), p. 11-12.
[22] See the discussion on the distribution of taxation power concerning natural resources, Chapter IV, Sec. 4.2.

regions, i.e., based on a derivation principle.[23] But the place of tax collection is not always effective in determining the share of each region. The tax collection system looks at the address where the company is registered. Collection and distribution concerning a private limited company running a business in a place or region where it is registered may not create any difficulty in dividing the revenue subject to a given percentage. Thus taxes levied from hotel and retail businesses are less mobile from one region to the other.

However, there are companies which are registered in one place but engaged in business throughout the country. Different types of taxes paid by such kinds of companies cannot be administered at the place of transactions. The tax administration simply looks at the amount collected at the principal address of the company. Accordingly, taxes levied on a cement company incorporated in the Tigray region but selling its products throughout the country are shared between the Tigray region and the federal government. Similarly a company incorporated in Addis Ababa collects taxes from several branches but pays taxes through the head office of the company where the sharing applies between the centre and the Addis Ababa Administration. Most of the bidding and purchasing of equipment for regional governments take place in Addis Ababa. In sum, it is important to use an effective estimation mechanism or the population size for sharing revenue derived from such mobile taxes.

On the basis of the above mentioned criteria for the sharing of concurrent taxes, the Ministry of Revenue reported that out of the 185.13 million birr collected from joint taxes (mainly business taxes) in the 2003/04 fiscal year, 52.38 percent devolved to Addis Ababa; 15.97, 11.65 and 6.03 percent devolved to Oromia, Tigray and Amhara. These data demonstrate that Addis Ababa, Oromia, Tigray, and Amhara are the homes of major companies or they are the major contributors of business-related taxes.

At present, the revenue sharing arrangement may have a double message: the developmental activities in a region are an indication of its active role in economic development, and, on the other hand, it justifies that companies having their headquarters in a region are involved in business in the country at large. For instance, this positive development in Tigray is welcomed by many, but some with suspicion. This is because the reason for the business flourishing or for the companies to prefer the region for their base was not convincing when seen in relation to the relatively richer business centres such as Oromia and SNNPR. The main reason could be that most of the companies based in the region are linked to TPLF or local NGOs in the region.[24] Although issues related to party-affiliated companies are currently disputed, the increase in the revenue capacity of the region contributes to its socio-economic development which must fairly be considered in the criteria included in the allocation of federal grants (see in the next subsection).

On the whole, as a result of the introduction of sharing joint taxes, the revenue portion of each state has several sources: revenue generated from the sources assigned to the states, revenue from shared taxes and revenue distributed from the federal pool as general purpose grants. Normally, revenue from these

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[23] Interview with Ato Zeru G/Selassie, tax reform program, Ministry of revenue, January 2004, Addis Ababa.

[24] See the discussion above, Chapter III (2.4.2). See also Merera Gudina, *Ethiopia: Competing Ethnic Nationalisms and the Quest for Democracy, 1960-2000* (reprint, Addis Ababa, Chamber Printing press, 2003), p. 149-50 & 181.

sources can be spent on responsibilities and priorities determined by the respective regional governments. Next we discuss the nature of the allocation of federal grants in Ethiopia.

2.2 Allocation of federal grants

As mentioned in several sections above, fiscal decentralization has become an important aspect of the devolution process in Ethiopia. Despite the fact that the spending and revenue-raising powers have devolved, the main source of revenue for regional governments is still federal grants. Thus, the allocation of grants on a formula basis has been found to be a necessary step towards resource allocation, but it has not yet been perceived as an effective instrument in achieving equity. Rather, there is a spillover from other political wrangling to fiscal-related issues, particularly to the grant formula. Thus, designing an effective grant formula and selecting appropriate variables have become necessary steps in determining the trends of fiscal federalism. Developing a grant formula that can be applauded by all the constituent units is a difficult task, but an initiative to implement a reliable formula could be a significant step towards efficient intergovernmental fiscal relations.

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

- The first step is determining the overall resources that could be available during the fiscal year for the federal government from the national treasury, external assistance (foreign grants), and external loans. But this step encounters problems as most of the revenue sources are based on estimations from domestic as well as foreign sources and overall forecasts in GDP. As a result, the actual budget distribution is subjected to several revisions.[25]
- Second, dividing the overall amount between the federal and the regional governments on the basis of the expenditure assignment of each level of government. The total amount available for the regions is determined after deducting the budget required by the federal government which takes the major portion of the fund for road construction, defence, foreign debt payments and federal administrative costs.
- Third, allocating the total amount available to all the states from the federal government among the individual regional governments based on the applicable grant formula.
- Fourth, deciding on the amount of the grant for each region that originates from the central treasury, foreign assistance and loans.[26]

2.2.1 The grant formula and its criticisms

The grant formula used in Ethiopia has been amended on several occasions. The following summary[27] provides an insight into the nature of the grant formula adopted since 1992, the variables used and the problems inherent in the system.

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[25] The number of revisions can be observed from the 'Countrywide Budgetary Expenditure, 1992-2002', MOFED.

[26] In fact, regions do not directly receive the grant derived from foreign assistance and loans, and the amount allocated for a particular fiscal year may not benefit a region, as the fund may not be released within the given fiscal year or could be withdrawn by the donor. Regional governments, therefore, consider that the grant transferred from the central treasury is the actual transfer.

The transitional period

First, let us look at the initial two fiscal years, 1992/93 and 1993/1994. In 1992/93, no precise grant formula was implemented, because in late 1991/92 and 1992/93, the major 'breakthrough' was the process of the formation and organization of regional governments, organizing offices and the transfer of staff and projects to the regions. During this period, no precise formula was used for allocating resources to the regions. However, it can be inferred from the economic policy directives and the objectives of the Transitional Charter that the central government was primarily engaged in rehabilitating war-torn zones.

The allocation of grant subsidies in the 1993/94 and 1994/95 fiscal years followed the format of general purpose grants divided into grants for recurrent and for capital expenditures respectively. But the variables (criteria) that were used varied in these two fiscal years. In 1993/94 the grant for recurrent expenditure was allocated according to:

a) the number of zones and *weredas* in the region,
b) the number of offices organized in the regions, the staff required and their corresponding salaries and other expenses, and
c) the priorities given to education, health and road construction.[28]

The allocation of grants for capital expenditure was based on:
a) the completion of the ongoing projects transferred from the centre to the regions, and
b) the number of projects and programmes submitted by the regions to the centre and their respective capacities to implement these projects.[29]

Similar criteria were adopted for the recurrent expenditure grant in 1994/95. They were:
a) the number of zones and weredas,
b) the lengths of the roads that had to be maintained,
c) state expenditure for education and health in the previous year,
d) the number of agricultural demonstration centres, and
e) the amount of grants given to the state in the previous year.[30]

Some changes were introduced with regard to the grant formula for capital expenditure. The grant formula was originally introduced with five indicators and respective weight was attached to them:
a) each state's population size (30 percent),
b) its level of development (what economists call I-distance[31]) 25 percent.[32]

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[27] This summary has been prepared from a report by the Ministry of Finance, as referred to in a paper by Tesfaye Kassa, 'Regional Governments' Budget Preparation'(in Amharic), (Journal of the Ministry of Finance, vol. I No.2); and 'The Federal Budget Grant Formula'(Ministry of Economic Development and Cooperation, MEDAC, manuscript, 2000)
[28] Tesfaye Kassa, op. cit., p. 10.
[29] *Ibid.*
[30] *Ibid*, p. 11.
[31] 'The I-distance indicator is a synthetic variable that seeks to capture the differences in the levels of social and economic development among the states.' Brosio and Gupta, 'Ethiopia,' in Teresa Ter-Minassian (ed.), *Fiscal Federalism in Theory and Practice* (Washington DC., International Monetary Fund, 1997), p. 514.
[32] Until the 1995/96 fiscal year eight distinct variables were included to measure the development index of the regions: amount of pupils per population, hospital beds per

c) its revenue-generating capacity (20 percent),
d) its territorial size (10 percent), and
e) the percentage of capital expenditure grants in the previous year (15 percent).[33]

The allocation of grants by splitting them into recurrent and expenditure grants ceased to exist after the 1995/96 fiscal year. That means, the use of different variables for the allocation of recurrent and capital expenditure grants was suspended. Accordingly, the reallocation of grants into recurrent and capital expenditure and its further subdivision along the sector lines have become the task of each regional government.[34]

Although the grant formulas and the variables were reported to have been used during the period mentioned above, Proclamation No. 33/1992 gave broader power to the Council of Ministers (rather than Transitional Council) concerning the grounds for the allocation of grants and how much to be granted to each region. Most regional governments were not able to prepare and even to control their budget, as we saw in an earlier Chapter, III, 2.2. The problem of the allocation of budgets along sector lines was usually solved by experts from the federal government working in consultation with the regional governments. There was underspending in most of the regions. Thus, the grant allocation system suffered from several theoretical and practical shortcomings. The variables were sometimes indicated without the respective weight. Several variables were mentioned in each fiscal year but the tendency was to maintain the same percentage of grant as allocated in the previous year.[35] This could be because of the difficulty to compute the variations in situations where pertinent data were not available.

Table 7:2 The variables included in the grant formulas and their relative weight *

Year	Variables	Weight in percentage
1994/95		
	Population size	30
	I-distance	25
	Revenue-generating capacity	20
	Capital budget allocated in 1993/94	15
	Geographical Size	10
1995/96-1996/97		
	Population	33.3
	Development level	33.3
	Revenue-generated in the previous year	33.3
1997/98-		

population size, density of telephone lines and post offices, per capita industrial production, per capita crop food production, rural-urban population ratio, and the length of rural roads.

[33] Tesfaye, op. cit., p. 11.

[34] In accordance with Art. 7(3,4) of Proclamation No. 33/1992 the Ministry of Finance and the Ministry of Planning and Economic Cooperation were empowered to review the subsidy request made by the regions for recurrent and capital grants respectively. (The two ministries were separate ministries before they were merged together in 2001 and named MOFED). However, since the 1995/96 fiscal year, the federal government has been allocating lump-sum grants. Thus, the spending of unconditional grants has become a state matter. However, there is a misconception in Ethiopia that the federal government should not prescribe the spending of grants for specific projects.

[35] See the Budget Proclamation of the same fiscal year.

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[35] See the Budget Proclamation of the same fiscal year.

1999/00		
	Population	60
	Development index	25
	Revenue-generating capacity	15
2000/01-2002/03		
	Population size (est. 2001)	55
	Expenditure need-selected area (education, health, safe drinking water, roads, recurrent budget implications)	20
	Level of poverty	10
	-Revenue-Raising capacity -Execution Efficiency (change in health centres, education participation and length of roads)	11 4
2003/04 – 2004/05 (proposed)	Population size	65
	Level of development/exp. Need	25
	Revenue generating capacity (8) and Output performance (2)	10

The formulas since 1995

After the entry into force of the Constitution for the 1995/96 and 1996/97 fiscal years, the grant formula was composed of three variables, each with equal weight (33.3 percent):

a) population,
b) level of development indicators, and
c) regional revenue budget in 1994/95.

It was not clear how the regional revenue capacity was weighted. In the 1996/97 fiscal year the same formula and weighting were used but with a slight change in the number of variables included in the I-distance indicator. The variables were reduced from eight to five, namely:

1) health clinics,
2) the number of primary schools,
3) the number of telephone lines,
4) electricity consumption and
5) road density.[36]

Regions with the largest population size were disadvantaged by the grant formula used in these two fiscal years. A lower percentage was allocated for the reason that the then available population data was based on a census held in 1984 (during the former regime), which the HOF considered less reliable. The major drawback of the formula was related to the difficulty in obtaining reliable data for several variables included in the I-distance indicator. Some of the variables such as the provision of telephone and electricity are not the responsibilities of the states.

[36] See also footnote 32 above.

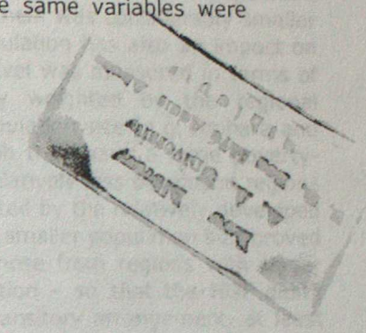
Table 7:3 Data on selected indicators distribution in the regions (1997/98)

		Tigray	Afar	Amhara	Oromia	Somali	B.G.	SNNPR	Gam.	Harari	Dire Dawa	Total
Area	In Sq. Km.	53.64	88.80	161.82	366.90	271.98	46.0	118.0	34.06	0.34	1.29	1142.83
No. of weredas		36	29	98	180	52	20	77	9	4	5	510
Poverty 1997/98	1)	2.26	0.66	9.76	8.22	1.35	0.27	7.51	0.09	0.05	0.08	30.25
	2)	57.9	51.8	56.7	34.7	34.6	47.6	56.5	41.8	29.1	24.6	45.5
	3)	7.47	2.18	32.26	27.17	4.46	0.9	24.83	0.3	0.16	0.26	100
Education	4)	53.67	7.87	32.48	37.22	11.37	67.58	53.05	78.69	69.31	52.84	39.78
	5)	51.82	22.41	46.6	42.15	20.28	46.62	57.95	38.77	23.94	41.74	46.54
	6)	59.84	41.08	52.4	57.43	68.71	54.28	68.9	56.16	45.28	63.94	59.09
Health	7)	25	5	53	76	11	4	83	3	1	2	263
	8)	117	16	231	328	43	32	282	14	59	41	1163
	9)	664	92	878	1171	141	126	627	34	26	74	3833
Water												
	10)	21.26	12.78	21.42	22.42	14.76	18.19	19.19	26.49	63.06	77.72	21.1

Source: MEDAC, 'Federal Grant Formula,' (manuscript, 2000).
Notes:

B.G. (Benishangul-Gumuz)
Gam. (Gambela)
1) No. of poor people in millions.
2) In percentage compared to the regions' population size.
3) Number of poor people in the region in percentage compared to the total number of poor people.
4) Average primary and secondary school participation rate.
5) Student-teacher ratio.
6) Student-classroom ration.
7) No. of health centres.
8) No. of doctors.
9) No. of nurses.
10) Percentage of population served with safe drinking water.

For the next three fiscal years (1997/98-1999/00), the same variables were included but with different weight attached to them:
a) population 60 percent,
b) development index 25 percent, and
c) revenue-generating capacity 15 percent.
The variables included in the development index were:
1) health services,
2) education participation rates,
3) electricity consumption,
4) water supply,
5) telephone lines, and
6) road density.



The main criticism by the members of the HOF against this formula was based on the percentage allocated to the population size. Thus, the formula used during the 2000/01-2002/03 fiscal years reduced the percentage allocated to population size and one variable on the poverty level indicator was added. Accordingly,
a) 55 percent was given to population size (estimated for 2001),
b) 10 percent to the level of poverty, 20 percent to expenditure needs, and
c) 15 percent to revenue-raising capacity and execution efficiency. The last variable was further subdivided into two components: 1) revenue-raising capacity (11 percent), and 2) budget-execution efficiency (4 percent). It would seem more reasonable if the poverty level would have been addressed through specific purpose grants to effectively address the targeted population.

The formula introduced in 2001 was different from those previously applied in that it attempted to address both the expenditure needs and revenue-raising capacity of the regional governments. For instance, the development index was designed to measure the expenditure need of the regions based on selected major expenditure responsibilities such as education, health, water, rural road construction and recurrent administrative costs related to wereda size. It was made in order to measure the differences in the cost of providing these services as the cost varies between the regions. There was also an attempt to decrease the disincentive effect on revenue rising by rewarding efficient areas.

This could be a step towards addressing some of the shortcomings of the previous formulas. In practice, however, an improvement in designing the grant formula is one thing, but working effectively and gaining credibility is another. This is because transforming the formulas into a feasible outcome encounters data-related problems. For instance, measuring the fiscal capacity of the states requires further data other than the actual revenue raised by them. Some of the states may have a higher revenue capacity but actually generate a lesser amount due to inefficient administration. Comparing the per capita income of inhabitants also requires a measurement of the contribution of the private sector or the impact of the 'black economy'. In this regard, the use of reliable and up to date data on the regional development level, the impact of extra-budgetary flows, and the importance of proportional federal spending in the regions require further refined grant formulas.

The impact of the method for territorial reorganization in the post-1991 period and the concomitant asymmetries cannot be underestimated. This can be observed in the debate on the grant formula proposed for the 2003/04 and 2004/05 fiscal years with 65 percent weight attached to population size. Regions with a larger population argue for greater weight to be attached to population since the per capita grant previously allocated to them was considerably smaller than regions with a smaller population size.[37] Population has also an impact on other variables. For instance, when the poverty level was measured in terms of the population suffering from extreme poverty weighted by the regional population size, those regions with the largest population size (e.g. Amhara and Oromia) received a less per capita grant although they have a large poverty-stricken population.[38] Further, they consider the relatively less developed regions as excessively benefiting from the revenue generated by the relatively developed and populous regions. Members of the House from smaller population size proved unyielding on one crucial factor demanded by those from regions with larger population – the 65 percent allocated to population – so that the HOF didn't come up with an agreed formula, except some transitory arrangement, at least until the beginning of 2005/06 fiscal year.[39]

There are several issues that cast doubt on the proper utilization of the grant formulas. First, as can be seen from Table 7:2 the grant formulas were revised six times within a decade. It is less feasible to implement them within this period, particularly when we observe the nature of the variables included in the formula (except population), the related data problem, and a lack of professional expertise so that there should be enough time to analyse the impact of the previous formula in order to carry out essential enquiries, to gather concrete data and to consult the stakeholders. Second, most of the regions were not able to administer their own budget, at least up to the 2000/01 fiscal year. As a result, the amounts allocated to such regions were not utilized and were therefore left to the discretion of the centre that allotted them to the others, but without the consent of the regions that failed to make use of the grant.[40]

The above factors indicate that the share of the regions was subject to discretionary transfer, or seems to have been decided on the basis of an ad-hoc approach which would give the centre the greatest flexibility. This could be the reason why the matter raised some controversy during that period. The centre was accused of allocating greater funds or demonstrating favouritism towards some states. There were allegations from regional representatives that although unutilized funds were to be kept in a separate fund so that the fund could be redistributed during the coming fiscal years, the centre granted the fund to a specific region. To allay such accusations, it is necessary that the basis of allocation is clearly laid down in the grant formula. However, many still argue that the system showed some improvements, but remained dubious because of

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[37] See Table 7:6. It should be noted that allocating a higher percentage to population size does not necessarily mean that the regions with a larger population size will have a higher per capita grant than the others. Rather, it means that the existing gap in per capita will be reduced and the gross amount of grants to be allocated to them will increase.

[38] See Tables 7:3, 7:6, and 7:4. See also World Bank, 'Public Expenditure Review Report of the Oromia Region', Report No. 23352-ET, December 2001.

[39] For some account of the debate at the HoF and the transitory arrangement see a senior essay by a former member of the House; Atakilti Gidey, 'The Role of the House of the Federation in Promoting Equality and Unity among Nations, Nationalities and Peoples' (Unpublished, ESCS, 2006)

[40] Interview with Ato Mitt Mihi, Member of Parliament from the Benishangul-Gumuz Region, December 2002, Addis Ababa.

huge federal spending in the Tigray region. Further, the grant formula indicated for the 1998/99-2000/01 fiscal years have less significance since the financial management and revenue transfer were subject to special procedures, according to the minister of MOFED, this time due to the war with Eritrea. This procedure was not even disclosed to Parliament.[41]

Although there were some convincing reasons for adopting the formula and some of the variables seem objective, it is difficult to measure the variables due to the huge disparities that exist between the regions. For instance, it was relatively easier to measure the variables in a region of manageable size such as Harari, but it was difficult to display the reality in the Oromia and Amhara regions. For example, these regions are usually considered as relatively developed but, although the total number of students in these regions is higher than others, their education participation rate showed a lower percentage compared to some of the least developed regions (see Table 7:3). Furthermore, there is a general understanding that some regions are less developed than others, but there are doubts as to whether the formulas also measure the disparities between the nations, nationalities and people (see the discussion in the next section). In this regard, Merera argues: 'These magically formulated criteria, some of which seem reasonable, do not convince the contending elite in an atmosphere of heightened ethnic nationalism. Furthermore, the politics of exclusion, lack of transparency, accountability and secrecy [...] cast doubt' on even the process of allocating more resources to the widely-known less developed regions.[42]

All the factors mentioned above convey a message that there should be a defined period in which a specific formula can operate. The variables in the formula should be manageable and focused on important issues. The process of allocating grants should be transparent and impartial. Above all, the size of the regions should be manageable and comparable. This requires a political commitment that can balance the ethnic factor with the history of the regions and the economic reality of the country.

Table 7:4: Indications of the actual share of the entitlements of the regional governments and the city administrations in percentage terms compared to the total grants allocated to the regions *

	1994/95	1995/96	1996/97	1997/98-1999/2000	2000/1-2002/3	2003/04+
Tigray	*8.94*	*8.96*	*8.33*	*7.66*	*8.2680*	7.2
Afar	*3.86*	*3.39*	*3.61*	*5.04*	*5.4367*	3.9
Amhara	*20.21*	*21.38*	*20.72*	*19.20*	*20.7164*	22.3
Oromia	*28.34*	*27.36*	*27.48*	*25.29*	*27.2924*	32.1
Somali	*4.51*	*4.21*	*4.22*	*7.57*	*8.1709*	6.4
Benishangul-Gumuz	*2.91*	*2.38*	*2.63*	*3.63*	*3.9222*	2.8
SNNPR	*16.56*	*17.17*	*16.58*	*15.90*	*17.1650*	18.44
Gambela	*2.46*	*2.12*	*2.21*	*2.80*	*3.0212*	1.93
Harari	*1.11*	*1.10*	*1.01*	*1.78*	*1.9241*	1.3
Dire Dawa	*1.0*	*0.92*	*0.93*	*1.08*	*4.0833*	1.6
Addis Ababa	*10.10*	*11.01*	*12.28*	*10.05*		1.9

[41] See the 2003/04 fiscal year performance reports by the Minster of MOFED to the Parliament.
[42] Merera, op. cit., p. 175.

* Source: MEDAC, 'The federal Budget Grant formula,' March 2000.
+ The percentage share is computed from the "1996 [Eth. Cal.] Fiscal Year Budget Proclamation No. 358/2003"

Grants from foreign aid and loans

The sources of federal grant subsidies are the central treasury, foreign aid and loans. The share of grants from foreign sources and from the national treasury was another reason for controversy. During a parliamentary debate on the budgetary allocation, members usually complain about the way in which grants from foreign sources (foreign grants and loans) are allocated. In principle, the Ministry of Finance as a guideline tries to allocate 70 percent of the federal grants from the central treasury and 30 percent from foreign aid & loans.[43] But when the grant is distributed to each regional government it is difficult to apportion exactly on the basis of 70 and 30 percent of the sources for the simple reason that the costs of each project covered by the grant cannot be the same in all regions.

Regional governments complain that the money does not flow at their own convenience and they are not fully autonomous with regard to the spending of money from such sources. According to the Ministry of Finance, grants from foreign sources are allocated on the basis of large-scale regional capital projects submitted to the federal government. The costs of these projects are mostly covered by foreign sources, i.e. 30 percent from aid and 70 percent from loans. During the 2000/01 fiscal year the percentage of grants subsidized from the central treasury and from foreign sources is indicated in Table 7:5 below (see also Table 7:6 for the actual transfer from the central treasury). If the grant from foreign sources does not flow to a region within the same fiscal year, the amount of grants which the region received for that fiscal year remains the percentage allocated from the central treasury. Furthermore, because of the 'budget offset system[44] which the country follows, the grant from foreign assistance (loans and aid) is not paid by the federal government. The regions also cannot carry forward the amount of revenue from foreign source they expected in the previous year to the next fiscal year. The problem of (the failure of) the flow of grants from foreign sources could be related to the regional or federal planning bodies as well as to the stringent requirements set by the donors.

Although different reasons could be adduced, the budget offset system remained one of the obstacles to the equitable distribution of resources between the regions. In this regard, the World Bank persuasively stated the following concerning the rational and equitable utilization of foreign loans and aid:

> The aim should be to achieve equity in the actual flow of resources to regions (and within regions to zones) not just in the expected resource flows. Ceilings for Treasury funds and for aid should be clearly separated and it should be made clear that if regions are unable to utilize available aid in a given budget year, it will normally remain available in subsequent years. If implementing agencies can clearly see that aid is additional, and can be drawn down over a

[43] 'The federal Budget Grant Formula'(Ministry of Economic Development and Cooperation, MEDAC, March2000).
[44] The deduction of foreign assistance and loans from the budget subsidy is commonly referred to as 'the budget offset'. World Bank, 'Ethiopia: Review of Public Finances,' Vol. II, 1998, p. 3-4.

practical time frame, they should be more ready to invest the additional effort needed to utilize aid funds.[45]

We can also see this from a different perspective. Regional governments are not free as to how to utilize funds from foreign sources. The choice, bidding, payments and supervision of regional projects funded by foreign finances may involve not only the regions but also the federal government and the funding institutions. The use of such grant subsidies from foreign sources exhibits the character of conditional grants. If the regions cannot claim the unutilized funds in the subsequent years, there will be a stronger reason to focus on unconditional grants funded by the Central Treasury for equitable transfer purposes, while at the same time devising another mechanism for the use of conditional grants mainly funded by foreign finances. It may also create a better opportunity to develop intergovernmental cooperation for better planning by the support of the federal planning bodies mainly focused on capital projects.

Table 7.5: The percentage of federal grants distributed from the central treasury and foreign sources
during the 2000/01 fiscal year*

	From Central treasury	From foreign source
Tigray	66	34
Afar	76	24
Amhara	73	27
Oromia	75	25
Somali	75	25
Benishangul-Gumuz	75	25
SNNPR	63	37
Gambela	78	22
Harari	75	25
Addis Ababa	57	43
Dire Dawa	60	40

* Source: MEDAC, 2000

2.2.2 *The implications and consequences of the grant system*

First, since the allocation of grants to the regions is unconditional, in principle the regions have the power to identify their preferences, to make decisions about the allocation of their own budgets between sectors, as well as between capital and recurrent expenditures. However, as we have observed above (Chapter III, 2.3.) the decisions at the subnational level are influenced or guided by the centralized party system that has been effectively controlling power at the federal and regional levels.

Second, as we have observed in Chapter V, there exist considerable imbalances between the centre and the regions, and also between and among the regions themselves. As a result, there is heavy reliance on the federal government by the regions. But the grant formulas show that the focus has been to create equitable distribution between the regions. This is to address the disparity in economic and infrastructural development, poverty and human capacity. That explains the

[45] *Ibid.*

higher share of per capita grants for the Gambela, Benishangul-Gumuz and Afar regions (Tables 7:6 & 7:7). However, the problem is that this argument does not apply evenly to the least developed regions. Thus, we can observe that the Somali and Afar regions did not have an equal per capita grant when compared to the Gambela and Benishangul-Gumuz regions. Another interesting disparity can be observed between the Harari region and the Dire Dawa administrative council. Although they are on a comparable level of development, the per capita grant for Harari by far exceeded that for Dire Dawa (see Tables 7:6 & 7:7). A similar anomaly is also noted between the relatively developed regions of Oromia, Amhara, SNNPR and Tigray. As we see in the data, the per capita grant for Tigray excelled the rest.

One may wonder why such anomalies exist or why some regions benefit more from the allocation of grants than others. One of the reasons could be to address the fiscal disparity between the regions and the development issue of the hitherto marginalized places. Also due to a relative difference in the level of development between the regions although they belong to the same category of developed or least developed regions. But this reason is not completely convincing when seen in relation to Table 7:3. Rather, the *de facto* asymmetry in territorial size and population is a stronger reason. That is, regions with larger territory and population size have benefited less compared to the others. For example, the population size of the Somali region is considerably greater than the other least developed regions.[46] In spite of the effort to transfer revenue equitably, the anomalies may create a disincentive for revenue raising since those regions with the least per capita revenue are the major contributors to domestic revenue sources.

Third, the grant formula has been working in a situation where there has barely been any disagreement between the centre and the regions. The variables included in the grant formula are also less controversial since no region can claim to be a source of the bulk of federal grants, unlike, for example, Nigeria where most of the federal revenue is generated from petroleum found in a specific region. However, the grant formula cannot be exonerated from creating some resentment. To begin with, regions such as Oromia and SNNPR, which received less per capita grants, are the resource areas for the country's export trade earnings. As a result, some have resented the fact that the grant system disfavoured these regions. On the other hand, the grant formula has resulted in a better share for states with a relatively small and manageable population and territorial size.

When a constitution acknowledges proportional development and national economic union as the principle for the transfer of grants, being allocated a lesser share of grants may not necessarily lead to resentment. In practice, however, the politics of ethnicity can become counterproductive in this respect.

[46] To compare the population size, see Table 1:1. See also the difference in population and per capita grants between Tigray, and Oromia, Amhara and SNNPR under Tables 7:5 & 7:6.

Table 7:6[1] Grants paid from the Federal (central) ...

Table 7:6[1] Grants paid from the Federal (central) treasury only, in millions of birr *

		1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00 [2]	00/01	01/02	02/03
Tigray	Total	187.17	261.61	261 6	278.2	265.97	229.43	188.83	237.44	225.8	291.5
	Percapita	59.68	81.68	79,3	81.92	76.12	63.85	49 35	64.3	59.5	76.8
Afar	Total	93.34	71.73	82.69	136.6	172.2	209.74	170.86	119.92	127.8	159.2
	Percapita	84.39	66.48	74.76	120.56	147.58	176.55	144.74	98.6	102.8	128.1
Amhara	Total	384.95	564.4	614.52	706.7	722.46	677 52	532.4	665.7	642.6	788.9
	Percapita	27.83	39.95	42.23	53.18	46.88	42.75	32.93	40.85	38.4	47.1
Oromia	Total	585.37	646.2	709.68	880.7	836.55	879.18	613.42	1219.2	946.2	1030.6
	Percapita	31.25	33.73	35.88	43.15	39.71	40.53	27.40	54.54	41.1	44.8
Somali	Total	59.92	63.91	105.14	124	203.8	213.1	218.06	116.9	149.5	197.7
	Percapita	17.43	19.67	31.56	36.26	58.07	59.18	63.34	31.6	39.4	52.07
B. Gumuz	Total	70.21	71.18	65.14	107	162.06	142.99	111.99	98.93	108.6	127.7
	Percapita	152.63	151.45	134.87	216.16	318.39	273.40	224.21	184.3	197.1	231.7
SNNPR	Total	336.87	470.63	469.81	517	562.72	563,63	430.02	572.73	571.6	723.06
	Percapita	32.48	44.23	42.71	45.5	47.88	46.5	35.2	45.76	44.3	56.04
Gambela	Total	53.72	56.4	78.64	88.3	65.5	130.62	97.58	63.71	86.3	98.43
	Percapita	296.8	304.8	413.9	452.8	327.5	634.1	462.6	301.94	399.5	455.6
Harari	Total	8.06	30.6	29.4	37	76.65	40.98	58.64	41.71	48.05	54.2
	Percapita	62.5	226.7	211.5	255.2	511	266	366.2	260.7	289.5	326.5
AddisAbaba	Total	111.17	90.26	45.63	1.3	2.22	1.02	0	-	-	-
	Percapita	52.63	41.8	20.7	0.57	0.94	-	-	-	-	-
Dire Dawa	Total	1.1	3	8.7	14	31.94	33.19	16.73	38.08	42.42	48.9
	Percapita	4.4	11.6	32.1	49.65	108.7	108.5	52.2	119.75	128.5	
Total		**1891.88**	**2329.92**	**2470.95**	**2890.8**	**3102.07**	**3121.4**	**2438.53**	**3174.3**	**2948.8**	**3520**
	Growth in %		**23.2**	**6.1**	**17.0**	**7.3**	**0.6**	- 2.18			

* Source: -For fiscal years 1993/94-1999/2000, MEDAC, accessed in January 2001.
-For fiscal years 2000/01- 2002/03, grants paid from the central treasury for recurrent expenditures, MOFED, as accessed in January 2004.

[1] The data have not been corrected for inflation since no official data on inflation are available.

[2] The exact share of each region depends on the amount contributed to the federal government for defence expenditure which increased due to the war with Eritrea, as per the 2003 report of the Minister of MOFED to Parliament. He did not, however, give the exact figure of the contributions made by each regional government. The mandate to determine the amount of share deducted from the allocated grant was given to the Council of Ministers.

Table 7:7: [1] Federal government subsidy granted to regions as published in the budget proclamations; in millions of birr and per capita grant*

Fiscal year	Tigray	Afar	Amhara	Oromia	Somali	B.Gumuz	SNNPR	Gambela	Harari	Dire Dawa	Addis Ababa	Total grant & Average
1993/94	279.9	113.7	697.1	882.1	137.3	85.62	471.7	65.07	25.37	29.6	357.2	3144.5
percapita Grant*	89.14	102.43	50.4	47.1	44.0	186.13	45.5	357.53	196.7	117.5	169.12	58.9
1994/95	327.8	141.8	741.4	1039.6	165.3	106.7	608.04	90.2	40.7	36.6	370.5	3668.4
percapita	102.34	131.41	52.5	54.26	50.88	227.02	57.21	487.6	301.5	141.31	171.8	67.13
1995/96	342.9	148.4	853.3	1131.4	173.6	108.4	682.0	90.7	41.4	38.2	504.6	4115.0
percapita	103.94	134.18	58.64	57.2	52.1	224.43	62	477.4	297.8	141	229.4	73
1996/97	302.5	157.1	794.5	957.5	150.0	123.2	632.8	95.7	38.1	21.6	116.4	3379.4
percapita	89.07	138.66	53.04	49.91	43.9	248.9	55.63	490.8	252.76	76.6	50.92	58.15
1997/98	293.18	237.5	767.82	909.23	326.75	172.12	642.85	132.11	80.4	35.5	54.82	3652.24
Percapita	83.91	204.74	49.82	44.6	93.09	338.15	54.7	660.55	536	120.75	23.29	61
1998/99	311.02	255.27	849.86	991.78	361.2	185	703.32	143.2	86.65	39.14	236.6	4163.01
percapita	86.6	214.9	53.62	45.72	100.3	353.73	57.98	695.14	562.7	127.9	97.61	67.5
1999/00	241.9	196.6	689.5	767.06	285.2	135.0	572.42	109.08	65.33	21.09	55.8	3142
percapita	65.5	161.7	42.31	34.31	77.12	251.4	45.74	517	408.31	66.32	22.36	49.5
2000/01[2]	360.2	237.5	929.9	1215.1	352.9	179	780.8	137.3	67	40.34	117.8	4418
percapita	97.5	195.3	57.1	54.4	95.4	333.3	62.4	635.6	418.7	126.8	47.2	69.5
2001/02	409.35	264.7	1060.8	1361.63	400.9	201.01	891.62	154.12	76.0	95.4	194.07	5103.62
percapita	104.93	208.1	61.66	57.44	102.85	355.77	67.07	694.23	441.9	279	73.34	75.92
2002/03[2]	377.6	249	974.9	1273.7	369.11	187.71	818.6	144.11	70.31	89.4	-	4555.8
percapita	96.8	195.75	56.7	53.73	94.7	332.2	61.6	649	408.7	261.4	-	67.8
2003/04	458.15	225	1335.05	1846.61	372.04	177.51	1138.92	130.58	77.52	85.91	122.52	5969.80
percapita	114.3	173	75.6	75.68	93.01	306	83.1	546.4	435.5	242.7	44.7	85.3

* The per capita grant is computed on the basis of the population size given by the Central Statistical Authority for each fiscal year.
[1] The data have not been corrected for inflation since no official data on inflation are available.
[2] The data for 2000/01 and 2002/03 fiscal years have been accessed from the MOFED.

2.3 Challenges to the grant system[1]

In this section, the focus is on the major factors that continue to haunt the grant system in Ethiopia despite the fact that the grant formula has been revised on several occasions in an attempt to address interregional economic disparities and to equalize the revenue capacity of the regions.

2.3.1 On the aim of the grant system

As Bernard Dafflon and Francois Vaillancourt remark, it is important to determine whether the allocation of grants should aim at complete equalization or simply at a significant closing of revenue gaps.[2] This indicates the importance of defining the aim of revenue transfer either for equalizing the revenue capacity only or for both revenue and expenditure equalization. The need for expenditure equalization is mostly necessitated by factors imposing additional costs for the delivery of public services such as social, demographic and geographical factors.

In Ethiopia, by revising the grant formula on several occasions (see Table 7:2) an attempt has been made to recognize the need to measure the disparity in revenue capacity, the expenditure needs across the regions and disparities related to the level of development. As a result, the formula aims to equalize the revenue and expenditure needs, and the grant that can be used for both recurrent and capital expenditures in any area of regional responsibility. Since the grant is transferred unconditionally, the subnational governments can spend it according to their own priorities and decisions even though grants should be spent on particular targets as stated above. The variables included in the grant formula and the allocation of a higher per capita grant to poor regions imply a higher spending than before on infrastructure and other basic expenditure needs. But one of the questions that could be raised would be how much of the disparity is addressed through grants. In practice a higher grant does not always mean it can achieve the intended goals, for at least three reasons.

First, there is an inherent contradiction in the allocation of resources to the least developed regions of Afar, Gambela, Benishangul-Gumuz and Somali. There is a lack of administrative capacity and skilled labour but large grants are transferred to them to spend on every aspect of their local needs. That is, the grants should be spent on major expenditure area (which requires relatively skilled labour) such as contracting and controlling building infrastructures, health and education services and local administration. What we have observed in the past ten years is the perpetuation of disparities between the regions partly because the regional governments prefer to spend more on current expenditure than capital

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[1] For a general discussion, see also Solomon Negussie, 'The System of Revenue Transfer in the Implementation of Fiscal Federalism in Ethiopia,' A paper presented to the XVth International Conference on Ethiopian Studies, Hamburg University, African studies Centre, 19-26 July 2003.

[2] Bernard Dafflon and Françoise Vaillancourt, 'Problems of Equalization in Federal Systems', in Raoul Blindenbacher and Arnold Koller (eds.), *Federalism in a Changing World – Learning from Each Other: Scientific Background, Proceedings and Plenary Speeches of the International Conference on Federalism 2002* (Montreal & Kingston, McGill-Queen's University, 2003), p.395-411.

expenditure. And this is partly related to the poor ethical behaviour of the politicians.

Second, one may wonder to what extent the grant formula reaches its targets of equalization between the regions, and how (or by what instrument) the remaining disparities could be addressed. In revising the grant formula and its variables there was hardly any meaningful impact assessment on how much difference it brought about (or how equitable it was). The variables of the grant formula were hardly a disincentive to inefficiency in revenue raising and in expenditure performance.

Third, when there are special factors to be considered, there should also be a need to utilize other instruments to address these problems. Several countries employ various methods to address their special problems by investing in specific projects for a fixed period. Similarly, the Ethiopian Constitution does not restrain the federal government from using different types of grants for achieving the objectives of transfer.[3]

The above facts lead us to raise another issue, that is, whether the allocation of grants is based only on economic considerations (revenue capacity and the level of development). Although it has been EPRDF and its allies which controlled both the federal and regional governments for the last thirteen years, the use of grant allocation for political considerations cannot be ruled out. For instance, still some argue that the disproportionate share of Harari compared to Dire Dawa and Somali, and the lax financial management system towards regions such as Afar, Gambela and Benishangul-Gumuz is to maintain their affiliation with the ruling party.[4] The variation in the grant share, the federal spending in the regions and the widely different extra-budgetary sources of Tigray, Oromia, SNNPR and Amhara have become widely discussed issues among the opposition political elites.

However, the most serious allegations came from places which did not elect members of the ruling party during the 1995 and the 2000 elections. For example, the local party which claim to have won the 2000 elections in the Sheka zone in SNNPR argued that the zonal administration received disproportionately less than the other zones and the regional government is not spending on local infrastructure. What will happen after the recently held 2005 elections when opposition fiercely competed for sharing power at the federal and regional levels and change the composition of the parliament and the regional councils? If this allegation of exclusion (of opposition voters) persists in the future at the federal level, it will make the Ethiopian situation even more precarious.[5]

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[3] For instance, in Germany after unification, the use of special purpose grants by the federal government has substantially increased to address the problems of the eastern part. Similarly, Ethiopia should utilize conditional transfers for at least two main reasons: the use of different grant instruments is not unconstitutional for the reasons already mentioned above (Sec. 1), and the country cannot afford lavish spending in the prevailing political culture where local accountability hardly exists.

[4] Merera, *op cit.*, p. 140-141; See also Table 7:6 and 7:7.

[5] We can envisage serious problems concerning the relationship between the federal government and the city governments of Addis Ababa and Dire Dawa. These administrations are accountable to the federal government although the residents have the right to administer themselves. Federal laws govern the powers and responsibilities of the city administrations and their relationship with the federal government. The federal government may enact laws that can restrict the taxation or administration powers of the city administrations and reallocate to

Furthermore, in order to reduce the great disparities between the regions and to assist them in their performance, the aim of the allocation of grants should be clearly determined. For instance, if the aim is to promote proportional development, it is important to consider the impact of federal expenditures in a region, grants from foreign sources and economic opportunities. It also requires a concerted effort towards reasonable equality, reasonable and ethical spending of the scare financial resources, and some form of federal intervention in the form of explicit conditional grants. This assumes political and administrative commitment for cooperation to address the major disparities.

2.3.2 On the variables of the grant formulas and data-related issues

The objective of equity is to set criteria for the proportional distribution of resources to the residents of different states, and to bring about equivalent living conditions for people living under different jurisdictions.[6] The use of population size (with varied weighting) in the grant formula is almost a universal approach to achieving these objectives. But population size can be seen as an effective criterion in situations where states are of relatively proportional size. If there exists a considerable variation in size among the regions, the use of other criteria and the per capita distribution should be measured with utmost care.

In Ethiopia, as we saw above, the population size with different weights has been used as a variable in the grant formula since 1994/95: 30 percent for three fiscal years (1994/95-96/97), 60 percent for two fiscal years (1997/98-1998/99), and 55 percent from 1999/00 up to the 2003/04 fiscal year. There is an immense variation in the population distribution among the regions. Just two regions comprise 60 percent of the total population and three regions (out of 9) have a population of less than half a million.[7] Although the percentage allocated to population size has changed on several occasions, each regional government has its own argument. Regions with a small population size argue that their share increases when the percentage allocated to population size is less and a higher percentage to the other variables. Some regions also argue that geographical size should be given considerable weight, while those with a major population size argue that the provision of grants is to benefit people not the whole geographical mass, and therefore a higher possible percentage should be assigned to population size.[8] It is a fact, however, that the provision of public goods in a highly dispersed population area increases costs. Although geographical size may not be given a specific percentage, it seems reasonable to measure its impact on cost variations when assessing the expenditure needs of the regions.

It is also clear that measuring the difference in the development level is to show the variation in the expenditure needs. With this view, the grant formula was

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the federal government or reduce their share of grants. Unless the powers of these city administrations are provided with a constitutional guarantee, they will be vulnerable to undue federal intervention.

[6] W. Oates, *Fiscal federalism*, (Harcourt, Brace Jovanovich inc. 1972), p. 178.

[7] If we examine these figures in terms of nations, nationalities and peoples ethnic groups, less than 10 percent of the total number (about 80 groups) have a population of more than a million. See also Table 1:1 and 1:2.

[8] Interview with Ato Samuel Alemayehu, the House of Federation, December 2002.

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composed of several indicators.[9] However, as we have seen in the grant formulas used until 2000, some of the indicators such as the number of telephone lines and electric consumptions were not the responsibility of the regional governments. So, it is not clear why the grant formulas include variables which are not the responsibility of the regions.

As we have also seen above, the percentage of each indicator is determined using further specific data. However, the data are collected according to simplistic or misleading criteria. For instance, the level of education is determined through a pupil-classroom ratio and a student-teacher ratio, but does not consider the difference in standards. For instance, schools in some places have no chairs and desks while in others they are equipped with the basic infrastructure, and have a library, laboratory and even computer networks. Neither do the data make a distinction between the standard and the type of schools, e.g. technical and vocational schools, training institutions and tertiary-level institutions. The same issues can be raised with regard to health concerning the number of staff and the quality of services. Similarly, road density may have a different significance for large but sparsely populated regions, agricultural and mountainous regions and pastoralist areas.

With regard to the other variable, the level of poverty, it is observed how difficult it is in practice to address the problem through the general purpose grants. It requires specific projects on areas vulnerable to famine, agricultural productivity and food self sufficiency. Using the level of unemployment could be an important variable.[10]

Although several variables are mentioned, their input depends on the availability of adequate and reliable data to measure the variation in the regions. In general, identifying, recording and analysing data require skilled labour and adequate finance which are scarce in most of the regions. In this regard, the World Bank review report for the Oromia region indicates how difficult it is to evaluate the impact of regional public expenditure on the lives of the people. The report concludes that:

> At the regional level, there is no poverty-monitoring unit with data collection and analysis capacity, and no use has yet been made of information available from national data and studies. At the local level, no information is collected on outcomes and impacts, such as whether farmers who receive the extension package and repay their input loans are actually improving their lives, able to send their children to school, repair or improve their houses, buy assets, and so on. It seems that it would be possible with little additional effort to obtain at least some information on indicators of living standards, and that they could be very helpful in informing decisions on programs and expenditures. [11]

In addition to the report it is possible to envisage some other aggravating circumstances in the regions. There is intentional data manipulation by some regional authorities for various reasons, especially regarding variables that can maximize their share. In this regard one can notice the causes of the second population census held in 1994 in Somali and Afar regions. The figures were highly exaggerated to increase their representation in Parliament. On the other hand, in performance reports (to the party or to the higher offices) in other

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[9] See the discussion on the grant formula supra Sec. 2.2.1 and Table 7:2.
[10] It has to be noted that because of the linguistic criterion as a prerequisite for employment in the government institutions (which is by far the largest employer), there is less movement of labour between the regions.
[11] World Bank, 'Public Expenditure Review Report of the Oromia Region,'2001, p. ii.

regions, officials of a certain department or bureau manipulate the data to obtain recognition for efficiency during their term of office, but the reports may not be supported by the facts on the ground.[12]

2.3.3 On equity implications: equalizing states or ethnic groups?

The post-1992 fiscal system has witnessed positive developments by devolving power to the regions in general and the hitherto marginalized places in particular. However, its attempt at an equitable distribution of resources has been undermined because of the substantial variation among the states in their geographical size, socio-demographic variations and the tax bases.[13] Furthermore, since every nation and nationality has the right to administer itself and even to form a state (see below Chapter VIII), the grant system has to equalize not only states, but also ethnic groups. In other words, in ethnic-based federal system revenue allocation becomes more than the relations and interests of people at the regional level, but also between ethnic blocs of the population.[14] Thus, one of the challenges to the transfer system in Ethiopia is the equity implications which are subject not only to interstate but also to interethnic relations. This approach, however, is not consistent with the principle of fiscal federalism which primarily deals with the fiscal relationship between the territorially-defined constituent units of a federation.

The allocation of grants should aim, on the one hand, to increase the capacity of a state as regards its public expenditure, and, on the other, taking care not to provide an exaggerated sum in comparison with the others.[15] Because of the glaring asymmetries between the regions, however, the existing grant formula has resulted in greater per capita grants for states smaller in terms of size or population.[16] The disparity becomes serious if we compare the fiscal capacity of one ethnic group with another. *Sidama*, for example, has a comparable population size to the *Tigray* region, although the former is at the zone level and with a lesser amount of grants.[17] In another comparison, the *Bench-Maji* zone (in the SNNP region) which, according to a report submitted to the HOF, has a comparable level of development to that of the *Gambela* region, received a considerably lower amount of grant than the latter. [In 1998/99, *Gambela* which had a population of 220,000 received a 143 million birr grant; the *Bench-Maji* zone with a population of 323,000, received a 33 million birr grant].[18] We may compare *Dire Dawa* with its neighbour *Harari*, having almost the same geographical size, population and socio-economic conditions but receiving almost

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[12] Interview with the Bureau Head, Finance and Economic Development Bureau, Amhara Region, January 2003, Bahr Dar.
[13] Oromia constitutes 35% of the total population and 32% of the size of the country, whereas *Harari* constitutes 0.3 and 0.03% respectively (See Table 1:1).
[14] The FDRE Constitution has also highlighted the tension between individual and group rights. In one instance (Art. 89(2)) it guarantees all Ethiopians (irrespective of their ethnic background) an equal opportunity to improve their economic conditions and to promote equitable distribution of wealth among them. In another (Article 43(1), each nation, nationality and people of Ethiopia in particular has the right to improved living standards and to sustainable development.
[15] W. Oates (1972), *op. cit.*, p.178
[16] See Tables 5:6 and 5:7.
[17] For instance compare the 2002/03 budget laws of the SNNPR and Tigray regions.
[18] Interview with Ato Samuel Alemayehu, December 2000 and a report paper presented for discussion in the House of Federation.

half of the grant allocated to *Harari*.[19] It seems that those at the state level benefit from a relatively greater per capita grant. This may stimulate a claim for statehood at any given time (see further, below at Chapter VIII).[20]

The transfer system targets the revenue capacity of the states. However, it does not suffice to use a system which is only applicable to interstate financial relations, because the focal point of the Constitution is the sovereignty of nations, nationalities and peoples, most of which are not necessarily represented at the state level. Financially, there is a clear difference between those at the state level and those at the Zone or *wereda* level. The grant system may even be further complicated if we compare the financial capacity of most of the states with those places in Amhara and Oromia currently identified as zones but which were designated as provincial administrations in the pre-1991 period.

The method for allocating grants in the system of ethnic-based federalism exhibits a degree of complexity because of the difficulties in accommodating the interests of all groups. In this regard, the imbalance in financial capacity between groups who have established their own states and those at the subregional level could have adverse implications for the economic and political development of the country. A higher concentration of revenue power at the state level could partly be responsible for unhealthy interethnic competition for the control of a state. This kind of tendency could be a serious threat to the stability of a state or to the country as a whole. It is therefore recommended to equalize the states (territorial reorganization) by balancing the ethnic factor with economic, historical and national interests so that the fiscal and economic issues should not be subject to ad infinitum ethnic arithmetic.

2.3.4 On efficiency, transparency and accountability

As noted above, in Ethiopia mainly the general purpose grant system applies. It is aimed at giving more power and autonomy to the regional governments to identify their own policy preferences, and to make decisions on allocation and spending for recurrent and capital expenditures. But the records show that in most regions basic public services such as drinking-water, sanitation, education, public health and public works are generally unavailable or have only limited availability. Although such problems are relatively deep-rooted in the less developed regions, there has not been any consequent improvement in the efficiency of many administrations.[21] The problem is partly related to efficiency, but transparency and accountability issues have not been sufficiently addressed.

The grant system increases the resources of beneficiary governments without the need to increase their revenue-raising efforts. The provision of federal grants to the regions increased to 5,970 million *birr* in 2003 compared to 2,470 million in 1995 covering about 85 percent of the regions' expenditure; that means the percentage of revenue generated by the regions remains almost the same, i.e.

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[19] See Tables 7:6 and 7:7.
[20] Art. 47 (2,3); Nations, nationalities and peoples have the right to establish, at any time, their own states. If any group is displeased with the grant system, it may even threaten the union through Art. 39 of the Constitution.
[21] Edmond J. Keller and Smith, 'Obstacles in implementing territorial decentralization: The first decade of Ethiopian Federalism', in Philip G. Roeder and Donald Rotchild (ed.) *Sustainable Peace: Democracy and Power Dividing Institutions after Civil Wars*,(2002), p. 223.

about 15 percent.[22] The absence of conditional grants, and the states' highest priority for recurrent needs hindered capital investments in most regions. On the other hand, the regional and local administrations are completely dependent upon federal grants for their income, but they are less accountable to the federal government concerning spending the grants. Although the Constitution stipulates that the federal government should audit and inspect the proper utilization of grants allocated to the states (Article 94), the financial administration laws are less clear as to how to promote accountability at the state level. Accountability requires clear mechanisms for making the executive answerable to legislative control. In other words, whatever the executive spends should be transparent and accountable to the taxpayer.

Evaluation (widely known locally as *gimgema)* and the Anti-Corruption Commission which was established in 2001 are a step forward in the government's commitment to fight corruption.[23] However, there are also other factors which contribute to making state governments less accountable. For instance, the complexities inherent in the nature of corruption and ethnic-based federal arrangement have blurred the lines of democratic accountability. It has been argued in one of the studies that it is common for local officials to assume that 'ethnic federalism means that they are no longer accountable to any higher authority, even within their own regions.'[24] This has been identified as one of the causes of the recent crises in the SNNPR.[25] Members of the regional ruling political organization (Southern Ethiopian Peoples' Democratic Coalition) were organized on the basis of their respective ethnic group, held offices in the zonal or wereda administration, share the region's revenue and control the local police force. It was difficult to enforce the rules of accountability against the local authorities that held political power, controlled finance and the police, and even had local militia. Thus, for partly addressing the above issues, using grant instruments which enhance interdependence between the centre and the regions could be commendable. But political input towards cooperation and the empowerment of the electorate at the local level should come first.

2.4 Other federal (implicit) transfers

The constitutional recognition of conditional grants (Articles 89 (3 & 4) and 94 (2) of the Constitution) is one thing, but its implementation is another pressing issue. To what extent it can be used, what conditions should be set, and for what kind of developmental purposes it should be used, are some of the important questions to be answered. For example, without setting stringent and detailed requirements, it is possible to use block grants by allocating funds for education or the health sector.

At present, some forms of allocation of specific grants exist although they are not included as forms of intergovernmental fiscal relations. For instance, the grants allocated to projects in areas affected by the war with Eritrea impose some conditions, e.g. the power to administer or give directions to the region as to how to utilize the finance secured through foreign loans is assigned to MOFED.

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[22] See Table 5:4; The figures have not been corrected for inflation. Nevertheless, the figures do show the trends in allocating grants to the regions.
[23] See Proc. No. 239/2001 for the establishment of anti-corruption commission.
[24] Keller and Smith, *op. cit.*, p. 224.
[25] Interview with Ato Markneh, Supreme Court Judge, SNNPR and Ato Assefa Kessito, Vice Commissioner, Anti-Corruption Commission for the SNNPR, December 10, 2002, Addis Ababa.

And the allocation of finances by the Ethiopian Social Rehabilitation and Development Fund (ESRDF) addresses local expenditure needs and imposes some conditions (on choosing projects) and matching requirements (10 percent local contribution). ESRDF was established in 1996 (by Proclamation no.19/1996) as a successor to the Ethiopian Social Rehabilitation Fund, which was launched in 1992 as an emergency recovery programmes in war-torn zones to re-establish infrastructures and social services. From 1996 to 2003 ESRDF has initiated and implemented more than 3000 community based projects aiming at social and economic problems of the poor with an outlay of more than 1.3 billion birr (see Table 7.8).[26] The Fund has reported that its projects have benefited more than 21 million people as part of the poverty reduction scheme of the government. However, it is important to integrate ESRDF's projects in the form of special purpose grants with regional development strategies so that they become part of the regions' effort to prioritize their expenditure needs.

Another form of transfer may exist for reimbursing the costs of carrying out functions delegated to the states. Article 50(9) the Constitution provides for the delegation of judicial power to the states with the necessary financial reimbursement from the federal government. Statutory delegation may also take place when the federal government delegates to the states powers and functions assigned to it by the Constitution. Under the delegation schemes the federal government should pay the costs of activities executed by the states. Such kinds of transfers are tied to a particular function carried out by a state (or states). In practice, however, it may not be easy to determine the amount of costs to be reimbursed and the share of each state when power is delegated to all the states. Reimbursement takes into account the costs incurred in executing the delegated function. Therefore it can be paid to a state based on the actual costs incurred in performing the function.

However, this kind of approach may bring about unintended consequences. First, it may not always be possible, and even not reasonable, to calculate the exact cost incurred by a state. Second, it may discourage states which have a lesser share to carry out responsibilities in the future. It can also be costly to administer such kinds of costs. Thus, considering the difficulty in isolating the actual costs incurred by the courts, the Ethiopian Constitution provides for the allocation of compensatory budget to the states whose courts exercise the delegated federal jurisdiction. However, despite an explicit constitutional requirement there is in reality no compensatory budget paid to reimburse the costs incurred by the states.

Govinda Rao argues that in some federations besides several forms of explicit transfers, there could also be 'implicit transfers'. According to him, one of the sources of implicit transfers is 'subsidized loans' to the state governments by the central government, and payments made to individuals and institutions.[27] In Ethiopia, there are, apparently, no subsidized loans to the regions. But implicit transfer may refer to expenditure undertaken directly by the federal government

[26] When a bill for the ratification of loan agreements to support ESRDF projects was submitted to Parliament a question was raised as to the accountability of the institution and whether it distributes the fund equitably.

[27] M. Govinda Rao, *op. cit.*, p. 23; See also Bernard Dafflon and Françoise Vaillancourt, 'Problems of Equalization in Federal Systems,' in Raoul Blindenbacher and Arnold Koller (eds.), *Federalism in a Changing World – Learning from Each Other: Scientific Background, Proceedings and Plenary Speeches of the International Conference on Federalism 2002* (Montreal & Kingston, McGill-Queen's University, 2003): 395-411.

benefiting a region, or the transfer of revenue to a region from special funds established by law such as a road fund, rehabilitation fund, water fund, and sinking fund. The federal government may spend on large investment projects in the areas of transport and communication, energy and higher education which are mainly considered to be of national importance. These are not direct federal transfers but may benefit a region. Although such implicit transfers are meant to benefit the regions as a whole or to generate national benefit rather than benefiting a particular region, not all federal expenditures may have equal benefit for all regions. For instance, federal road construction in the Benishangul-Gumuz or Tigray region may not have significant benefit beyond the regions' border compared to federal roads in Oromia, because most of the regions are connected through federal roads within the Oromia region. Similarly the number of local people benefiting from higher education is higher in a particular place where the institution is located.

An implicit transfer may also occur outside the ordinary governmental channels, but are due to preferred lending (priorities) to companies or grants given to NGOs that are affiliated to regional governments. In this regard, accusations abound about the nature and involvement of business organizations linked to the ruling party. For instance, such accusations are reiterated by the private sector and the opposition parties against the 'endowment companies'[28] that are linked to TPLF. It is reported that the companies have secured huge loans from the federal banks so as to boost their capacity and compete in the market.[29] Development associations also benefit from tax exemption privileges which may also assist their effort in bringing changes to the lives of the local people. Nonetheless, the federal government does not seem to pay to institutions and individuals other than the states in its grant programmes.

When there are transfers that can have implications for the allocation of grants, the impact of such transfers should be considered. Otherwise it may actually create disparity between peoples' standards of living and alarmingly erode trust in the federal government.

Table 7:8 Ethiopian Social Rehabilitation and Development Fund Utilization of Costs by region, 8 July 1996 – 7 July 2003

In millions of birr

	1989 1996/97	1990 1997/98	1991 1998/99	1992 1999/00	1993 2000/01	1994 2001/02	1995 2002/03	Total
Addis Ababa	*8.36*	*6.22*	*10.21*	*9.04*	*11.03*	*11.03*	*10.23*	*66.11*
Afar	*8.65*	*7.69*	*10.32*	*14.88*	*14.73*	*12.02*	*13.04*	*81.32*
Amhara	*11.96*	*16.19*	*28.14*	*31.86*	*46.65*	*24.47*	*27.10*	*186.35*
B-	*6.83*	*6.35*	*9.56*	*12.26*	*9.19*	*15.50*	*13.64*	*73.33*

[28] Companies 'owned' by or affiliated to the ruling party are described as 'endowment companies', meaning that they were owned by the people during the civil war and were established to address major local developmental problems. However, they are the biggest domestic investment companies with a capital of more than three billion birr, and they are accused of benefiting from unfair competition because of political partisanship.

[29] See, for instance, 'Should a Political party in power become a common trader, a common businessman?'2003-11-05, http://www.ethiopianreporter.com/displayenglish, accessed November 06, 2003. The biggest loan, over 1billion birr, has been secured from the commercial bank by the endowment companies (of TPLF); Merera, op. cit., p. 149-50.

Gumuz								
Dire Dawa	0	4.96	6.36	10.72	14.96	10.52	9.33	56.85
Gamb-ela	6.80	10.46	14.76	13.87	6.31	5.92	7.81	65.93
Harari	5.37	2.51	3.93	5.22	6.80	9.68	6.14	39.66
Oromia	10.40	18.28	21.68	35.98	36.34	26.07	27.81	176.57
SNNPR	13.54	8.60	19.77	21.51	38.12	25.57	23.78	150.90
Somali	6.51	8.57	10.20	13.83	11.28	13.54	15.55	79.50
Tigray	9.90	10.68	11.04	11.15	21.70	17.17	15.05	96.68
Sub-total	88.34	100.52	145.96	180.31	217.12	171.48	169.49	1073.2
Central Office	21.68	29.71	31.75	46.18	36.50	32.18	36.28	234.28
Total	**110.02**	**130.23**	**177.70**	**226.50**	**253.61**	**203.66**	**205.76**	**1307.48**

Source: ESRDF, July 2003

2.5. Intrastate revenue transfer

In the preceding section, we have seen the evolution of the grant formula that is mainly concerned with the relation between the federal and regional governments despite the constitutional recognition of 'nations, nationalities and peoples'. This is in line with a federal principle which deals with the tension between unity and diversity between the centre and the states only since local governments do not have constitutional status. Any (financial) tension between subregional levels is left to the concern of the regional government. Of course, an issue may arise as to whether federal and regional entities would provide an effective response to all the complexities related to the needs of diversity in Ethiopia in general, and the disparity between the regions themselves and between local governments in particular. In a federation where local governments have constitutional status, they must be accorded with certain constitutional means of protection, including their taxing power and entitlements in the transfer mechanism.[30]

Against this background intrastate revenue transfer was not implemented in the regions, except for some attempts in Amhara and SNNPR,[31] until it was formally introduced in the 2002/03 fiscal year in all regions.[32] The states of Amhara and SNNPR have introduced the allocation of grants to subregional levels in the 1997/98 fiscal year according to a formula similar to the one used for federal transfer. The SNNPR has allocated grants to zones and weredas, but the Amhara region has done so only to the zones. Both regions have attempted to allocate

[30] C. Saunders, 'Budgetary Federalism: Balance of Interests and Contradictions', A paper presented to the Congress of International Academy of Comparative Law, 14-20 July2002,p.15

[31] It was relatively better practised in the Amhara region, but only during the 1997/98 and 2001/02 fiscal years. The grant system was suspended during the war with Eritrea due to financial constraints.

[32] The intrastate transfer system was initiated by the federal government to be implemented in all regions, but by the 2003/04 fiscal year it was only the Amhara, Oromia, SNNPR and Tigray regions that had implemented the system.

grants by dividing them into recurrent and capital expenditure. Their attempt to distribute resources equitably is indeed appreciated, but they have encountered a number of difficulties due to capacity constraints, a lack of available data, and the uncertainty of the volume of federal grants (particularly the unpredictability of foreign aid and loans). Furthermore, they have problems in properly distinguishing the role of zones and weredas.

Although the Constitution states that adequate power shall be granted to the lowest units of government and the *weredas* exist as local governments next to the state government, the zonal administrations act as agencies of the state government but are more powerful than the *weredas*. Thus, in order for the weredas to undertake economic and social services and to narrow the disparities between weredas, all states have amended their constitutions to focus on the transfer of revenue that augments the capacity of weredas. As a result of the revision the (state) constitutional recognition of zonal governments next to state governments is made clear in the SNNPR, Gambela, and Benishangul-Gumuz regions.[33] Accordingly, in these regions, a three-tier government exists, i.e. state, zonal (or special wereda) and wereda governments. The Oromia, Tigray, Afar, Somali and Harari regions have a two-tier government at the state and wereda levels, but zonal administrations remain as agents of the state government. The Amhara region recognizes the autonomy of three special zones.

During the 2003/04 fiscal year, the grant formula which was applied at the federal level, was used to determine the amount of grants allocated to weredas and zones in SNNPR, Amhara and Oromia. Thus, the variables used in the grant formula were population (55 percent), level of poverty (10 percent), expenditure needs (20 percent), and revenue-raising capacity and execution efficiency (15 percent). According to the preliminary data the State Council[34] of Oromia transferred to the weredas 47 percent, Amhara 51 percent and SNNPR 81 percent of the total regional financial resources.[35]

However, the report from the regions shows that the grant formula has resulted in a number of obstacles which should be resolved in the subsequent fiscal years. As the grant formula was mainly based on population and development level it did not necessarily correspond to the existing situations. The allocation did not consider the existing expenditure needs and the available resources of urban and rural weredas. Accordingly, some weredas had a financial surplus but were

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[33] The process of constitutional revision has been criticized for its failure to emanate from within the states. The regional authorities were not aware of the reasons for this massive revision. It did not follow the amendment procedure set out in the states' Constitutions, and, moreover, it was an abrupt process under the command of the Prime Minister's office. Nonetheless, as a result of the revision of states' Constitutions bicameral Councils, with an institution (House of Nationalities) analogous to the HOF, have been established in the SNNPR, Gambela and Benishangul-Gumuz regions. The Amhara region reaffirmed the powers of the three autonomous zones for minority groups, but it did not establish a 'House of Nationalities'. In all regions the revision has resulted in a separation of power and has abolished the role of the presidents as speakers of the State Councils. The president remained as the head of the executive while the State Council (state legislature) elects its own speakers and approves cabinet nominations (and other authorities). The implication of the reform is partly to determine those levels of government eligible for the revenue transfer system.

[34] According to Art. 50 (3 &5) of the FDRE Constitution, the State Council is the highest organ of the state authority with the power of legislation over state matters. For further discussion, see Chapter III, Sec. 2.1.

[35] Source, Macroeconomic Department, MOFED. In Oromia and Tigray grants are transferred to weredas. In SNNPR grants are transferred to zones, special weredas and weredas, and in Amhara to weredas and the three special zones.

administratively incapable of planning and executing projects. This was because rural and less developed areas did not attract skilled labour. There were also certain institutions in which the provisions of their services were not limited to only one wereda. For example, some schools and hospitals provided services to several weredas, but their costs were covered by the wereda where the institution was situated. Such kinds of costs which provided external benefits to other governments should have been covered by special grants or by the regional government. Another problem was encountered in allocating grants from foreign aid and assistance. It is recommended that such financial resources should be administered solely by the regional government as special grants (see the arguments above on grants from foreign aid and loans, Section 2.2.1).

3 A PROPOSAL TOWARDS IMPROVING THE SYSTEM FOR THE ALLOCATION OF GRANTS

The purpose of this section is not to design a fully-fledged grant formula. It is to suggest improving the system to overcome the shortcomings observed in the previous formulas. As we observed in Section 2.3, several criticisms are made against the grant formulas in relation to the variables incorporated and the shares allocated to the regions.

The allocation of grants should aim at a balanced development in all the regions and, thereby, to assist in correcting disparities in development among the constituent units of the federation. As a result, people living in different parts of the country will be provided with a comparable level of public services. In general, the design of the grant formula should aim to alleviate the problems associated with vertical and horizontal fiscal imbalances associated with expenditure needs and revenue capacities among regional governments. However, an overview of the grant formulas used until 2003 fiscal year has demonstrated several shortcomings as discussed above. After 2003 the HOF worked with provisional grant formulas. Here, we focus on those core issues that should be considered in a more permanent improved grant formula.

- First, although the grant formulas incorporated several variables to estimate the expenditure need, the weight attached to each variable did not provide adequate answers to the costs variation between the major expenditure responsibilities of the regions.
- Second, they placed emphasis on the infrastructure gap among the regions, but did not take the recurrent budget requirement for the existing infrastructure into account (regions with better infrastructural levels did not proportionally receive grants to budget the existing services). That was because they did not take into account sectoral per capita expenditure requirements.
- Third, until very recently the formulas did not consider the potential differences in revenue raising.
- Fourth, although different percentages were allocated to population size, the general feature was to allocate a higher per capita grant to (the population-wise) small regions and smaller per capita to the big regions.

The above mentioned shortcomings highlight the difficulty in assessing the differences between regions in their underlying financial needs and capacities. As we have observed above from the experiences of other federations, such disparities could be addressed through a fiscal equalization mechanism that can

assess both the expenditure needs and the fiscal capacities of the states. The objective is to enable each state to provide a comparable level of services with an average revenue capacity and expenditure levels. This is a feature of the Australian grant system as we have already discussed it in the preceding chapter. The system determines what amount of revenue each state would raise and how much expenditure it would incur if it taxed and spent at the standard level which is an average of all states (per capita basis). It also measures other factors such as remoteness or transport costs that may force a state to spend more than the standard. Normally, the states differ in their per capita revenue and per capita expenditure. Thus, the system allocates different per capita grants depending on the variation between the states. The allocation of grants favours those states which have relatively lbw taxes or high expenditure needs measured in average per capita terms. This will reduce the huge per capita gap (sometimes unexplainable) that has been observed in the previous grant formulas.

Actually, assessing the revenue capacity and the expenditure needs of each state is more feasible in a country where the states have a broadly comparable level of development, where an institution equipped with the necessary human and material resources is assigned with this specific task, and where the problem of the availability of reliable data is less serious. Because of these factors it is not possible to analyse all the expenditure items of the states and to arrive at an equitable allocation of grants in Ethiopia.

In this regard, we recommend adopting two methods. The first method is to analyse only the major expenditure responsibilities of the states and the states' revenue sources. This suggestion centres on four variables: population, the relative variation between regions in their expenditure needs and in their revenue-raising capacities; and reducing disincentive effects to regions which behave in financially responsible ways.

Thus, in order to correct the exaggerated per capita variation between the regions, it is recommended to introduce population size in measuring the expenditure needs and the revenue capacities of the regions. That is, the grant allocation will be based on the difference between the region's need or capacity and the average per capita distribution of expenditure needs or revenue capacities. With respect to measuring the revenue capacity of the states the assessment will follow the constitutionally assigned revenue sources to the states. With respect to assessing the expenditure needs of the states, it should focus on the sectors which the regions have identified as appropriate in the previous years. These major functional areas are education, health, administrative and general services, agriculture, and rural water supply. The actual expenditure need in these areas could be measured by using major factors that can take into account cost variations between the regions. For instance, the distance factor could increase prices in the regions far from the centre.

The second method is to allocate conditional grants for specific projects or needs that may not be included in the general grant system. It should be utilized if the general purpose grant allocation has not fully taken into account the differences between the regions in the level of public services, particularly in the historically marginalized and less developed regions. This approach should however be used for a definite period of time and for funding specific projects. That is how it can serve as an incentive for regional performance. It should be noted that the second method is not to compensate a region that might have received a higher share of grants as per the previous grant formulas.

3.1 Some suggestions to improve intrastate grant transfers

Defining expenditure responsibilities

It is contended that the intrastate transfer system empowers local governments and makes them active participants in poverty eradication and development objectives. It has been claimed that the revenue transfer follows the decentralization of expenditure and revenue powers to subregional governments. To that effect, state constitutions have declared that local governments (weredas) have 'the autonomy to administer their own affairs'. But no appropriate statutes or other laws have been proclaimed to that effect. However, this *catchall phrase* blurs the allocation of powers and functions between the three layers of government stated above. Thus, there is a need to define the powers and responsibilities of local governments.

If the ideal is to make local governments developmental agents, their powers must be delimited. In this regard, as we submitted in Chapter II, it is important to identify which powers are decentralized from the regional government through devolution, delegation or deconcentration to the weredas or shared with the zones. Delimiting the powers and functions of local governments may show wide variations between the regions, but it is important to list some common functions that can be performed by all local governments such as primary education, health care, agriculture and the provision of safe drinking-water. There is a variation in the powers of urban and rural areas. Thus, the responsibilities of urban municipalities such as cleaning, services, training of unemployed youths, urban roads, and other factors that can increase the recurrent budgets should be defined. Similarly, for rural areas the difference between agrarian and pastoralist areas should be defined. On the whole, despite the possible variations in the regions, local governments should know, to the extent possible, what their powers exactly are.

Assigning revenue-raising power to weredas and municipalities

As a corollary to decentralizing expenditure responsibilities, the power to raise local revenue should also be determined. It is, therefore, important to identify which taxes and charges can be efficiently and effectively administered at the local level. It is also important to identify functions and revenue sources that can be concurrently exercised with the state governments. Although the devolution of responsibilities involves specific conditions for each state, it is important to assign some tax and non-tax revenue sources to the local governments. For instance, land-related taxes such as fees for land use, agricultural income and taxes related to agricultural products are easier to allocate to weredas. The personal income tax of wereda employees, individual employees and rental income tax from individual properties are easier for the local administration to implement.

Charges and fees related to local services and licences could also be effectively collected at the wereda level. Weredas should also share from other revenue sources assigned to the states, the sources of which are widely recognized as being unevenly distributed between the weredas. These are sales and excise

taxes and taxes on profits of individuals residing in the wereda, capital gains tax, and income tax from small-scale mining activities.

Sufficiently declaring the financial autonomy of local governments lies at the heart of the principle of facilitating local government. However, this cannot solve the occurrence of vertical as well as horizontal imbalances at the local level. Further, the availability of skill, capacity and infrastructure is at the lowest level in most localities. In order to address these problems, an effective system of revenue transfer should be put in place so that the weredas can spend on local needs and build their capacity.

Equalization at the local level

As a result of the new intrastate transfer system, each *wereda* government (and zone in SNNPR)[36] is allocated with state government grants that can be spent in areas which it deems necessary for development. For this intrastate transfer of grants the State Council is the responsible institution. The responsibilities of the Council should include:

- determining the division of shared taxes, as recommended above, between the state, zone (as the case may be) and weredas,
- determining, on the one hand, the total amount disbursed to all local governments, and, on the other, the allocation to individual local governments,
- determining the share of each local government from local and foreign sources.

The proposal for the allocation of grants to subregional levels should be based on the method of assigning expenditure and revenue sources suggested above. Thus, the allocation of grants should aim to reduce the horizontal imbalances caused by differences in expenditure needs and fiscal capacity between the weredas or zones as the case may be. The expenditure needs should follow the assigned functions to the weredas and be based on urban-rural categorisations. But this measurement depends on the availability of data. A problem could be encountered in measuring the revenue capacity since it requires an effective revenue estimation mechanism.

To minimize the impact of the above constraints, the allocation of grants for recurrent expenditure could be feasible. The allocation for capital expenditures seems less reliable in many regions as local governments are hardly in a position to execute developmental schemes. It is therefore advisable to use specific project grants that can be carried out in cooperation with regional sector bureaus. Focusing on allocating recurrent grants could be used as a transitory mechanism so that the weredas should first build up their skills and administrative capacity.

In general, powers must be clearly demarcated, to the extent possible, between the levels of administration in the regions. In addition to unconditional grants, the use of specific purpose grants allocated by the central or regional government, and promoting effective intergovernmental cooperation is highly recommended. It is also important to take some precautionary measures against factors that can endanger the objective of wereda decentralization such as the

[36] In SNNPR the transfer of revenue mainly focuses on allocating to the zonal administration. However, the state's Constitution is unclear as to the role of the zonal councils on revenue allocation to weredas within a zone. See Art. 81 of the Constitution of the SNNPR.

dangers of corruption and the lack of accountability. It is therefore important to legally determine the form of intervention or supervision by the regional level and exceptionally by the centre without contravening the guaranteed autonomy of local governments.

3.2 General issues to be considered with regard to intrastate transfer

The recent introduction of the system of intrastate transfer is a package within the comprehensive programme of the Sustainable Development and Poverty Reduction Programme (SDPRP) in Ethiopia. This program aims to reduce the revenue deficits by revising the tax laws and maximizing revenue-generating capacity, upgrading the expenditure management and control system, building the capacity of the government from the kebele to the federal level, and particularly capacity building in lowland regions. This is the first step towards an effective implementation of the revenue-transfer system at the subnational level.

One cannot deny the importance of capacity building in a country where the level of development and service delivery was languishing at its lowest ebb. That is why the Ethiopian government has been able to win the support of the donor communities for funding these objectives. The important point, however, is how to attain the target with appropriate human, financial and institutional instruments. In relation to our problem, i.e., the allocation of grants to the subnational governments, the major query would be how the federal government can equitably distribute resources and assist all levels of government in its noble mission of capacity building. Because the programme has been recently introduced and there is a serious lack of data, it is difficult to speculate on the outcome of this programme. Nonetheless, it is possible to present the following important remarks.

The executive should not only come up with a formula or principle regulating the equitable distribution of resources (secured from foreign sources) for this specific programme but it should also determine conditions and standards for the use of funds for specific purposes targeted by the programme. Any rules governing the allocation of grants or any means of using the funds should be designed in a transparent way. Above all, the capacity-building programme should primarily focus on how the country can better exploit skilled labour, enhance efficiency and responsibility, but not on capitalizing political loyalty.

Generally, the objective of the introduction of the intrastate grant formula is to redress the failures of devolving meaningful power to the local level during the last decade. It favours fiscal decentralization and is a step forward in the equitable distribution of resources. However, there should be a thorough enquiry as to whether there is a close connection between the failure of decentralizing power within a region and the lack of equity, whether the intrastate transfer follows a meaningful devolution of power to the grass-roots level, and whether appropriate legal institutions are in place to make the authorities accountable to the public. Above all, there should be close scrutiny as to whether a decade-old system of revenue transfer has helped macroeconomic stability, reduced the poverty level and narrowed regional as well as personal inequality. Some of the challenges to the grant system come from the disparity between urban and rural areas, the needs of poverty-stricken areas, a lack of basic infrastructure in rural areas and the special problems of urban areas such as unemployment.

As we have observed in Chapter III, devolving power to the local level has economic, political and social objectives. The main focus of the recent subregional decentralization process is political, i.e. to contain interethnic competition within a region. By focusing on equalization at the local level, it aims to contain the tendency of those *kebele*s aspiring to having *wereda* status and those *weredas* aspiring to have zonal status, as was witnessed in the SNNPR in 2001/02. There the tendency was to secure a better share as their status increases from the lower level to a higher one. For example, the share of the *Siltie* zone has become greater than the share it received when it was at the wereda level.[37]

However, it has shortcomings due to the fact that the competition cannot be limited to a region although that is where the competition normally begins. There is no reason why the Kafa zone cannot compete with the share of the Gumuz zone (in the Benishangul-Gumuz region) or the Sidama zone of SNNPR with the Tigray Region.

These issues remind us to consider at least two problems: The first one is that intrastate revenue transfer cannot adequately address interethnic competition as long as the federal transfer remains vulnerable thereto and the impact of interregional asymmetry influences the outcome of intrastate transfer. With regard to the first problem, as one study puts it, the post-1991 period 'has ossified elite rivalry by further aggravating the intra- and inter-elite struggles for state power and material resources.'[38] The second refers, for instance, to the problem of addressing the horizontal imbalance between 190 weredas in Oromia which cannot come about easily like that of the 36 weredas in Tigray. Thus, the need to develop an improved grant system can be addressed by reducing the asymmetry.

4 INSTITUTIONAL MECHANISM FOR REVENUE TRANSFER: THE ROLE OF THE HOUSE OF FEDERATION

Although the FDRE Constitution provides for the sharing of concurrent taxes between the centre and the states and the transfer of grants from the centre to the states, it refrains from laying down any rigid formula or specific amount payable to the states in the form of shared taxes and grants. The drafters of the Constitution seem to have learnt from the experience of other federal countries or have realized the problems of determining permanent formulas in an effort to meet the changing socio-economic conditions of a country. Unlike the early days of the Canadian and Australian Constitutions, in which the use of fixed formulas proved to be inadequate, the experiences of many federations have shown the importance of adequate room in the constitution to set specific formulas and to make any necessary adjustments taking into consideration the contemporary economic conditions and the financial position of the centre and each region.[39] This approach stresses the importance of intergovernmental fiscal transfers

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[37] For instance, in the 2002/03 fiscal year the Silte Zone became a recipient of grant (52,458,310 birr) directly from the regional government. In the previous fiscal years its share was determined by the Gurage zone. See the 2002/03 draft budget law of the SNNPR.

[38] Merera, op. cit., p. 152.

[39] M.P. Jain, *Indian Constitutional Law*, 4th ed. reprint (Wadhwa and co. law pub. India, 1998), p. 336.

based on some mechanism or set of formula that can be adjusted from time to time. As Wheare asserts:

> There is and can be no final solution to the allocation of financial resources in a federal system. There can only be adjustments and re-allocation in the light of changing conditions. What a federal government needs, therefore, is machinery adequate to make these adjustments...[40]

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

In Ethiopia, the institutional arrangements took different approaches during the transition period and after the adoption of the federal Constitution. During the transition period, the Council of Ministers had the power to decide on the sharing of joint revenues and the provision of grant subsidies to the newly formed regional governments based on the recommendations from the 'Committee for the sharing of revenue' and the Ministry of Finance.[41] The Committee for Revenue Sharing was empowered by law to study conditions and make recommendations to the Council of Ministers on matters concerning revenue sharing, particularly the percentage according to which the joint revenues of the centre and the regions are shared. The Committee, which was supposed to be composed of representatives from the central and regional governments, was hardly transparent in its role. There were at least two objections: first, some regional authorities complained that the actual transfer was different from what they had been informed previously, and the sinking fund was utilized by some regions without their knowledge. Second, there was no specific percentage of shares for the division of joint taxes between the centre and the regions and among the regions, but the grant subsidy was budgeted for recurrent and capital expenditure on the basis of criteria which were not clear to most of the regional governments.[42]

After the adoption of the Federal Constitution, the power to determine the sharing of revenue collected from joint tax sources and of grants that the federal government provides to the states is vested in the HOF.[43] It may be worthwhile to raise questions in relation to the power bestowed on the HOF: Why is the power conferred on the HOF? Can it help to achieve the objective of the equitable distribution of revenue?

Concerning the first question the Constitution suggests two answers: First, the Constitution follows the principle that non-political or majoritarian institutions should not deal with all major political issues. Accordingly, constitutional adjudication, secession issues and the transfer of revenue are the major political issues that have to be decided by the representatives of 'nations, nationalities and people' at the HOF. Second, the HOF is designed as an institution that can play a role similar to that of intergovernmental councils. So, by having authority over revenue sharing and the transfer of grants, the HOF promotes intergovernmental relations. The idea of assigning the power over

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[40] Wheare, op. cit., p. 123.
[41] See Art. 6 of Proc. No. 33/1992.
[42] Interview with the then heads of the Finance Bureaus of the Oromia and Amhara regions, January 2003.
[43] Art. 62(7) of the FDRE Constitution.

intergovernmental fiscal relations to the HOF seems similar to federations (such as Germany and the USA) whose Upper House plays a significant role in the allocation of revenue. But there are some interesting differences. Unlike the others, the composition and competence of the HOF are unique; the HOF has no legislative power, and although it was expected to be a counter-majoritarian institution to balance the majoritarian Lower House (House of Peoples' Representatives), its composition replicates the situation in the latter institution.

Table 7:9: Composition of the House of Federation

Regions	Total Number of Representatives	Represented ethnic diversities	No. of representatives for the major ethnic groups in the region
Tigray	6	3	Tigre 4
Afar	2	2	Afar 2
Amhara	17	5	Amhara 15
Oromia	16	1	Oromo
Somali	4	1	Somali
Benishnagul-Gumuz	4	4	
SNNPR	54	46	
Gambela	4	4	
Harari	1	1	Harari
Addis Ababa	-	-	
Dire Dawa	-	-	
Total	108	67	

Source: The HOF, January 2004.
- It should be noted that the composition of the House may change after the 2007 population census

The functions of the HOF, as prescribed by Article 62(7) of the Constitution, are 'determining the division of revenues derived from joint federal and state tax sources and the subsidies that the federal government may provide to the states.' Concerning the sharing of revenue from joint sources the HOF can determine the division of the revenue between the centre and the states, on the one hand, and the distribution among the states, on the other. Concerning the allocation of subsidies [grants], the English version[44] (Article 62(7)) is not clear whether the HOF can determine the total amount to be distributed and the manner of its distribution as between the states. However, this is clarified when it is compared with the *Amharic* version of the same provision. The Amharic version specifically refers to 'determining the grant formula' for distributing the grant to each member state. The HOF will deliberate on the disbursement of the revenue pool made available by the federal government from sources assigned to it. There seems to be a division of labour between the federal executive and the HOF, where the former determines the grant pool to be distributed among the states while the latter decides the grant formula. However, the HOF should come up with a proposal to set a certain percentage share of states instead of leaving the matter to the discretion of the federal government.

[44] Note that federal legislations are issued in both Amharic and English versions, but in cases of inconsistency the former prevails over the latter.

Another issue may arise as to whether the Constitution, Article 62(7), also gives authority over conditional grants to the HOF. Or can the House propose guidelines to allocate conditional grants? The power bestowed on the HOF is to determine the formula concerning how the grant can be distributed between the states. The formula is necessary for the equitable distribution of revenue (to equalize the fiscal capacity of the states) which normally results in the allocation of unconditional grants. Thus, the HOF cannot choose projects or functions and allocate specific purpose grants to perform these functions. According to Article 94, the federal government can allocate different forms of grants to states for the purpose of a state of emergency, rehabilitation assistance or loans, but Article 62 (7) does not give power to the HOF to allocate domestic loans to states. However, in the process of designing grant formulas, the HOF can take into consideration the amount of conditional grants and its impact on the process of determining the grant formula. In the long run, the HOF, if it acquires the necessary skill and capacity, may make recommendations for allocating conditional grants.

The Ethiopian HOF, unlike the Upper Houses in many federations, has no legislative power, but assumes major responsibilities in promoting intergovernmental relations ranging from financial, economic and administrative relations to dispute resolutions and political relations between the levels of government and the people.[45] In executing the function in relation to intergovernmental fiscal relations, the House is expected to perform a full-time job, although in practice it meets only twice a year for a few days. If the power of the HOF is similar to that of other institutions bestowed with the same power, its task requires the gathering of relevant data from appropriate governmental bodies, analysing and deciding on the adoption of grant types or a revenue-sharing formula. Furthermore, carrying out essential inquiries, consulting appropriate institutions and conducting meetings with representatives of state governments will be necessary. Above all, undertaking a series of studies on the impact of revenue transferred to the member states and whether it has achieved a balanced development would be its concern. However, the HOF during the course of its work in the last decade has been entirely dependent on the recommendations of the MOFA and MEDAC. It has had no experts of its own, and most of the members hardly understand the complexities of the grant system.[46] Therefore using the Ministries to coordinate transfers has the disadvantage, *inter alia*, that the decisions could be less objective because they could be acting at the discretion of the central government, and employees of the ministry could not have the authority to discuss sensitive issues.

Thus, in general, of all the powers and responsibilities which the HOF assumes, the role it plays in intergovernmental fiscal relations is technically and politically sensitive. This role can be better performed if an extra professional advisory body assists the House. It would be more effective if the power is reassigned to a

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[45] See Art. 62 of the FDRE Constitution. See also Proc. No. 250/2001of the Council of Constitutional Inquiry; and Proc. No. 251/2001 for consolidating the powers and responsibilities of the House of Federation.

[46] When a new formula or a revision was proposed, the House held discussions with representatives of state governments and authorties from the relevant ministries. Within eight years, the House reviewed the formula on five occasions. The members, who normally meet twice in one fiscal year, were heard arguing in favour or against the percentages allocated according to population size and the revenue-generating capacity where there is a great rift between the regions concerning these two factors.

permanent independent institution which has the necessary expertise and autonomy to conduct ongoing complex data gathering and analysis.

The representation of each nation, nationality and people at the centre gives the impression of promoting a strong relationship between them and the centre, thereby undermining centrifugal tendencies. But when it comes to dealing with real problems such as revenue sharing and setting grant formulas, the decision may not necessarily reflect this assumption. As can be seen from the Constitution, the HOF takes decisions according to a simple majority. Presently, if representatives from the groups of the SNNPR and Harari states take the same position on an issue, say the grant formula, it will be a majority decision. How would this position be acceptable to some of the others - Amhara and Oromia - which have more than three quarters of the population? Would the system be acceptable for anyone coming to and leaving political office in a democratic manner? If we expect them to come up with a consensus, as occurred during the last decade, there must be a stronger force that works behind the scene. As the House was and is composed of the ruling party – the EPRDF (and its allies) - decisions are passed through party discipline. In effect, the same body takes decisions at the federal, including the HOF, and at state levels. However, one can easily query whether the effect would be the same if different independent parties control regional governments.[47]

Can the system avoid unnecessary strains on the function of Ethiopian federalism? One way for the federal system to function without such strains is to establish a non-partisan professional institution that can make persuasive recommendations to the HOF. This could be consistent with the procedure for constitutional adjudication where the HOF receives recommendations from the Council of Constitutional Inquiry.[48] In this case, the political objective is preserved by retaining power for the HOF itself, but the expertise input is secured through the role of the Council of Constitutional Inquiry. Similarly, concerning revenue transfer, the ultimate decision-making power can remain in the HOF, but the technicalities could be efficiently handled if an independent council (or commission) assisted the House. This would have a twofold purpose: one, guaranteeing the separation of power to determine the method of allocating grants and revenue sharing from the central government; and two, the possibility to secure a relatively objective role from a non-partisan, non-political council as can be learnt from the experience of other countries. Also, the House cannot play a non-majoritarian role as its composition is mainly determined by population size.

In general, if an independent agency is established in Ethiopia:

> There is a greater chance of being perceived as being free from central government policy influence; ...that it is more likely to be seen to give full and equal consideration to all parties' arguments; that it removes the onus of responsibility from a central minister and thus reduces one point of negotiation, making the process of acceptance easier; and the independent and identifiable chairperson of the organization gives the results a higher status...[49]

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[47] See the composition in Table 5:9. If the oppositions win in SNNPR and Gambela regions, they can easily control the majority of the House.

[48] For the powers, functions and structure of the Council of Constitutional Inquiry see Art. 62 (1, 2), 82, 83 and 84 of the FDRE Constitution.

[49] C. Richard Rye and Bob Searle, 'Expenditure Needs: Institutions and Data', in Ehtisham Ahmad (ed.), *Financing Decentralized expenditures: An International Comparison of Grants*, (UK, Edward Elgar, 1997), p. 60.

That is why India and Australia are praised for having successful independent commissions. The major function of these institutions is to determine the mode of grant formulas for distributing equalization grants between the states. Although developing a grant formula seems to be a technical matter, it normally involves political considerations. That is why the grant commissions in these countries are considered to be 'a relatively objective adjudicator of interests.'[50] It should be noted that the need is not only for the establishment of such a commission, but also for ensuring that it functions in a non-partisan manner.

5 TOWARDS COOPERATIVE, COMEPETITIVE OR CONTROLLED FEDERALISM?

The transfer system is one of the important characteristics of the coexistence of the two levels of government in one system in general and the workings of federalism in particular. Thus, one of the main questions would be whether the transfer system promotes competition or cooperation between the levels of government, and why it opts for either.

The system of the transfer of grants can be characterized by less institutional cooperation between the levels of government, but with competition and rivalry between the constituent units. However, it may also be regarded as cooperative in the sense that the federal government allocates a substantial amount of revenue to fill the regional fiscal gap and the representatives of each nation, nationality or people cooperate and negotiate to determine how federal grants should be divided between the regions.

In this regard, it is important to note some arguments that consider the system to be more than cooperation and moving towards unitarization. Firstly, the regions are completely dependent on federal grants, and, secondly, they are subject to a centralized decision and uniform implementation of laws, policies and institutions through party discipline.[51] It is not possible to refute the latter part of the argument, but the former does not necessarily hold true. Of course, a higher degree of fiscal imbalances should not be welcomed in any federation, but a greater amount of transfer does not necessarily imply a centralized system. Whether the system of fiscal federalism is centralized or not depends on both the revenue and expenditure sides. Although the allocation of revenue sources is tilted towards the centre, the regional governments have wider expenditure powers as federal grant subsidies are allocated to them unconditionally.

When viewed from the types of grants, the transfer system is less cooperative in the sense that the types of grants that imply cooperation between the centre and the regions are not implemented. It lacks conditional grants that operate within a complex network of centre-state or interstate cooperation. Furthermore, the Constitution lacks concurrent tasks that could engage coordination and co-financing of projects. Once the amount of grants transferred to each regional or lower level of government is determined, it can be unilaterally spent on areas of preference. The existing grant system does not allow the federal government's

[50] Roy Bahl, 'Revenues and Revenue Assignment: Intergovernmental Fiscal Relations in the Russian Federation', in Christine Wallich (ed.), *Russia and the Challenge of Fiscal Federalism* (Washington DC, The World Bank, 1994), p. 139.
[51] See, for instance, Edmond J. Keller, 'Ethnic federalism, Fiscal Reform, Development and Democracy in Ethiopia'(African Journal of Political Science, vol. 7 No.1, 2002), p. 21-50.

intervention in regional or local spending, as the system employs an unconditional allocation of grants only. In countries that exhibited cooperative federalism besides legislative and administrative relationships, fiscal instruments (mainly conditional grants) resulted in a wider interaction between the centre and the states. Even in the USA, which is typical of competitive federalism, it is through the allocation of grants (several conditional instruments) that the federal government engaged in collaboration with the states. The use of general purpose grants has a passive role in promoting cooperative federalism. Thus, the existing grant instrument in Ethiopia plays a limited role in promoting cooperative federalism, as the grant instrument does not require cost sharing, influencing the planning process, or administering functions and responsibilities at the state level.

Competition is also manifest on the expenditure side since the allocation of unconditional federal grants does not allow federal intervention in the states. Thus, the tendency was to restrict both levels of government addressing their problems competitively. This normally leads each regional government to compete for a better performance of responsibilities within the limited available finance. The states may also compete among themselves to secure a close relationship with the federal government for financial and technical support. These instances, however, may spark serious political conflicts between the regions and between the ethnic groups in their attempt to reassert their domination at the federal level. Such political competitions may not be limited to the relationship with the federation. They can also be manifested between the fragmented groups within a region.

However, the competition for a better grant share has also been demonstrated by the challenges which the regions have raised against the grant formulas, but politically remained less problematic, thanks to the effective control of power at both levels of government by the ruling party. For instance, the regions with a relatively large population and territorial size argue that the grant formula emphasizes historical and political factors, but does not take into account their revenue contribution and the actual problems related to unemployment, poverty and population size. Others, especially the lowland regions, emphasize the political factors that they are historically marginalized, have a lower level of development and infrastructure services, lack skilled labour, etc. For the 2003/04 and 2004/05 fiscal years, a higher percentage of population size was proposed, but the regions with less population size and that had a higher share in the previous grant formulas, vehemently opposed this.

In none of the grant formulas which we discussed above are the actual or special expenditure needs of the individual regional government properly taken into account. We have also seen that the impact of actual or potential revenue capacity is minimal even though the so-called relatively developed regions raise higher amounts and per capita revenue is not significantly higher than the less developed regions. The argument from Oromia could be different considering the potential tax and economic activities within the region; if tax levies and dues that are assigned to the centre only, or jointly shared with the centre, were reserved for the region, then the revenue accruing to the latter would have increased. The argument also implies that assigning such tax sources to the centre penalized a specific region. Different arguments were also heard from different stakeholders about the imbalance of federal expenditure in the regions, the extra-budgetary flows to some regions and the dominant roles of some of the member organizations of the ruling party.

As a result, the regions consider only population size as an objective criterion that can influence the actual revenue transferred to each of them. The competition between them is expressed in terms of the percentage allocated to the population size in the grant formula. In this regard, the aim of each regional government was to secure a larger share of the federal grant by refuting the arguments raised by the others; accordingly, regions with a higher population size argue for a higher percentage share in the grant formula, while the others look for variables that maximize their share. Some form of competition between the zones, the weredas or between zone and wereda could exist at the state level, particularly in regions with multiethnic societies such as SNNPR, Amhara, Benishangul-Gumuz, and Gambella. Although the regional and the subregional governments were trying to compete for a higher portion of the revenue, there is on the contrary little similar competition as regards spending on developmental aspects in practice.

The above arguments between the levels of government could be an illustration of competition for a higher share of federal grants and thereby for a better performance of expenditure responsibility. But the adoption of the formula requires the consent of the HOF which is composed of representatives of every nation, nationality and people and has a direct correlation with population size. Since the House itself decides on any constitutional matters, its decision cannot further be challenged by another institution (court), as is the case in Germany, Canada or India. In practice, due to party discipline it is not difficult to compromise on variables that may favour a region's share. Although the Constitution provides for the creation of one economic community, promoting solidarity between nations, nationalities and peoples and promoting proportional development between the regions, the above arguments are effectively controlled owing to the fact that there is no opposition which shares power either at the centre or region levels. All this may change when opposition parties acquire a position within a federal state which in its centre is dominated by another political party.

6 REGIONAL BORROWING

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

The major issues concerning borrowing are the adoption of appropriate criteria for acquiring the loans, setting the upper limit to be borrowed, interest obligations, the repayment period and debt servicing capacity.[52] Unlike the centre, subnational governments are mostly restricted to domestic borrowing and they may even be subject to direct control by the central government. The main reason for participation and control by the centre is that monetary and fiscal policies are centralized.[53] But there are various forms of control and the extent of central control might significantly differ from one country to another. In a more general approach, control mechanisms have to be designed to suit the circumstances of a particular country. Moreover, it requires the creation of

[52] Teresa Ter-Minassian and Jon Craig, 'Control of Subnational Government Borrowing,' in Teresa Ter-Minassian (ed.), *Fiscal Federalism in Theory and Practice* (Washington DC., International Monetary Fund, 1997), p. 156-172.
[53] For instance, Arts. 51(7), 55(10) of the FDRE Constitution.

possibilities for a timely adjustment, depending on the capacity and fiscal balances or imbalances of regions.[54]

Teresa Ter-Minassian and Jon Craig in their studies of the practice in several countries conclude that the central control mechanisms generally encompass either of or a combination of the following four broad categories.[55]

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

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

The third approach is to set rules for the cooperation of all levels of government in the preparation and adjustment of financial administration to reduce the indebtedness of the governments.[56] The objective of their equal participation is to enhance responsibility in the use of budgets supported by loans.[57] In Australia, for example, public borrowing by the federal and state governments has been a matter which is regulated by an intergovernmental council called the Loan Council and which is established by the Constitution. The main reasons for establishing the Loan Council were to avoid loan competition and to control state spending 'which had been lavish for some years and which in the end imposed a burden on the commonwealth to make up deficits by grants.'[58]

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

Compared to the above categories, the laws concerning state borrowing in Ethiopia emphasize the importance of federal control through statutory regulations and intergovernmental cooperation, but presently subnational borrowing has a very limited application.

In Ethiopia, the federal Constitution recognizes the states' right to borrow from domestic sources. It stipulates that the federal government shall determine by law the conditions and terms under which states can borrow money from

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[54] Teresa Ter-Minasian, 'Intergovernmental Fiscal Relations in a Macroeconomic perspective: An Overview,' in Teresa Ter-Minassian (ed.), *Fiscal Federalism in Theory and Practice* (Washington DC., International Monetary Fund, 1997), p. 19.
[55] For a detailed analysis of the four categories, see Teresa and Jon Craig, op. cit., p. 156-172.
[56] Teresa, *op. cit.*, p. 20.
[57] *Ibid.*
[58] Wheare *op. cit.*, p. 104.

domestic financial institutions.[59] This provision, on the one hand, affirms the possibility that states can borrow from domestic sources and, on the other, grants the regulatory power to the central government. Accordingly, the federal financial administration law[60] requires the regional governments to provide all the necessary information to determine the amounts to be borrowed by individual regions. Thus, the states have to fulfil the obligation to submit to the Ministry of Finance and Economic Development the loan amount required to cover their deficit together with statements showing the relations of the requested amount with their revenue collection forecast and with economic indicators, and shall attach a copy of their consolidated loan as required with the loan application form.[61] However, under the present economic conditions it is hardly possible to imagine that regions can repay their debts from revenue collected within their jurisdiction.

According to the Finance Administration Law, regional governments may borrow from the National Bank of Ethiopia[62] and/or from other commercial banks. First, if they borrow from the National Bank, the amount has to be determined by the ministry and its disbursement has to be managed by the National Bank. According to this law each region must convince the Minister that the money is required for financing a specific project and they have a capacity to repay the loan within the appropriate time as laid down by law. The Minister to whom the application is submitted must evaluate the capacity of the regions and the impact of the loan on the national budget if the loan is granted.[63] The Minister has the power to study the accuracy of the information and later to communicate a decision indicating the amount of loan to be given to the state. Whatever the decision may be, limiting the purpose of the loan to a specific project is usually considered to be a good case of borrowing. The assumption is that if it has an investment purpose it may have an adequate economic and social return.[64]

Second, if borrowing is to be made from commercial banks (or other financial institutions), the respective regional government and the federal Ministry of Finance shall jointly agree on the administrative arrangements relating to such borrowing. This has the drawback that borrowing is only considered as a bilateral issue, but in reality, however, it may become a national burden. Thus, in the long run there should be a forum to accommodate the participation of all regions. But if we limit ourselves to the existing legislation, what could be the objectives of the agreement? And what could be the role of the national bank in dealing with the cooperation between MOFED and a region? Does the ministry or the national bank guarantee the loans? Can the agreement authorize commercial banks to lend money to the regions? If that is the case, then, on what criteria do they lend the money? If the same rules and procedures which are applicable in the market

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[59] The same provision was stipulated under Proc. No. 7/1992 during the transition period. It has to be noted that when a central government incurs a debt it can avail itself of several methods such as issuing securities like debentures, bonds, and treasury bills; or by printing currency; or by borrowing money from external sources. They are typical cases performed by and reserved for the central government. The only means which the regions have is to legally obtain credit from the banks.

[60] See the Federal Government of Ethiopia Financial Administration Proc. No. 57/1996 and Regulation No. 17/1997.

[61] See Art.59 of proclamation No.57/1996 and Art10, Proc. No. 33/1992.

[62] The National Bank of Ethiopia being the central bank of the country plays a key role in the Ethiopian economy by formulating and implementing the country's monetary policy. (See the Monetary and Banking Proc. No. 83/1994).

[63] *Ibid.*

[64] Ter-Minassian, *op. cit.*, p. 20.

are equally implemented, then the regional governments have to fulfil the requirements set by the banks. In normal circumstances, the banks have to secure the repayment capacity of the regions and study the feasibility of the projects. However, considering the very limited revenue-raising capacity of the states and the fact that they are absolutely dependent on grants given by the central government, borrowing from banks currently does not seem to be a workable alternative to finance regional governments. Finally, what would be the situation if a regional government borrows without presenting the case to the MOFED? The existing financial laws do not give adequate answers to the issues raised above.

Nonetheless, few cases of borrowing have been witnessed in the regions. For example, the Amhara regional government authorized its finance bureau to borrow money (150 million birr in each year) and to issue security on behalf of the regional government for the provision of agricultural inputs and animal packages to farmers with a view to developing regional agricultural production.[65] However, the whole process of lending the money to and collection from the farmers has led to controversies. affiliated to (or owned by) the ruling party irrespective of the consent of the farmers, the impact of the repayment and its administration of the debts of the farmer – land use fee, income tax and loans. As Professor Mesfin observes:

> In addition to the regular taxes and contributions [the regime] has introduced involuntary seed and fertilizer purchases from its own business enterprises, which are made to prosper at the expense of the peasants. The demand for cash from peasants has another exploitative side. Cash collectors of legal and illegal obligations arrive at harvest time when the peasants will squander harvested crops; all peasants are forced to take their produce to the market at about the same time. Prices for their crops drop abysmally. Consequently, they are forced to sell more of their crops in order to meet their cash obligations. This is the socio-economic origin of famine.[66]

One important point is that in spite of central control of borrowing, regional (or local) governments may become indebted for large sums of money. This may compel them to seek supplementary funding from the centre or further borrowing and therefore this should be treated cautiously. One can easily envisage several grounds which may lead to indebtedness which in turn requires some form of intervention from the centre or to force the region to cancel its planned expenditure. On the one hand, regional governments with a relatively better administrative capacity and commitment to executing their responsibilities may genuinely need more funds. For example, a report by the assessment team of the World Bank and other donor institutions shows that although the Tigray region has the capacity to execute more projects, it is forced to revise its plans according to the federal grants available.[67] However, the report does not comment on whether the region has a debt-servicing capacity from its own revenue sources if it borrows to execute projects.

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[65] The Amhara Regional government, Zikre Hig, Proc. No.26/1998, to authorize borrowing for the provision of agricultural inputs to the farmers; and Proc. No. 36/1999 to authorize borrowing for the execution of animal package during the 1999/2000 fiscal year. The legislation, however, did not mention whether agreement has been reached with the MOFED as per the Financial Administration Law.

[66] Mesfin Wolde-Mariam, 'Ethiopian Peasants and Development.' A paper presented at the second international conference on Ethiopian Economy, Ethiopian Economists Association, June 3-5 2004, Addis Ababa.

[67] See the World Bank, 'Public Expenditure Review Report of the Tigray Region', 2001.

On the other hand, in the infamous lowland regions such as Somali,[68] sometimes it is difficult even to pay salaries or cover the ordinary costs of running the administration. This is due to a lack of skilled personnel, lavish spending, embezzlement and a lack of political commitment. Moreover, sometimes people abscond with a great deal of public funds so that the budget lapses before the end of the fiscal year. Some of the major problems in the lowland regions are large debts through payment arrears due to the failure to effect payments to projects and a lack of effective monitoring and controlling mechanisms. The subnational governments may therefore face serious financial problems for various reasons ranging from personal incompetence and criminal behaviour to national economic problems. The consequence is a major concern not only for the creditors of the government concerned, but also for the citizens living in that area in particular and the nation in general.

The decision to bail out the debts of a state could be considered as a necessary measure taking into account the cost and its political and economic implications. But this will be a financial burden to the central government. At the same time, such problems imply that the viability of the regional government is in question. When regional governments fail, at least, to manage the costs of administration according to their own budget, the dire consequence should be a limitation of autonomy for the financial assistance they seek. The impact of such financial problems in developed federal systems could be the imposition of high taxes and a relatively lesser provision of public services in the region concerned. But the impact in a country like Ethiopia will be considerable and may mean a perpetuation of poverty. The most worrisome experience is the vexatious position taken by the centre with regard to regional financial embezzlement.[69]

The issue is if subnational governments are in a position in which they cannot pay their debts, can the regular financial laws govern the problem, for instance, through a declaration of bankruptcy? The ordinary bankruptcy law accords some beneficial treatment for both the debtor and creditor, but may also lead to the liquidation of the debtor. But when it comes to government bankruptcy, the main concern is to rehabilitate not to enforce insolvency.[70]

The issue of governmental bankruptcy is better dealt with in the USA. As a result of the Great Depression of the 1930s some 2,019 municipalities, counties, and other subnational units defaulted on their obligations since they were not able to pay their debts by imposing high taxes. Since governments could not be liquidated, the option was to provide relief from court litigation, to get some obligations paid, and to provide subnational governments with a new start for their financial operations.[71] The bankruptcy law of the USA applies to municipalities not to states since the latter are sovereign concerning state matters. The law respects the autonomy of municipal governments to conduct their finances without supervision or control from the centre. But when they are bankrupt, the bankruptcy law (of the USA) on the one hand gives protection to bankrupt, the bankruptcy law (of the USA) on the one hand gives protection to municipalities to rehabilitate during a given time, and on the other paves the way

[68] The Somali state government appealed to the federal government for financial help for the payment of salaries during the 2003/04 fiscal year. www.mcc-reporter.com
[69] It is difficult to imagine the Prime Minister's response concerning such issues. It is said that the regional governments can do whatever they wish.
[70] John L. Mikesell, 'Subnational Government Bankruptcy, Default, and Fiscal Crisis in the United States', (International Studies Program, Andrew Young School of Policy Studies, Georgia State University, working paper 02-21, December 2002), p. 2.
[71] *Ibid*, p. 2-3.

for greater supervision on their autonomy. Actually, the bankruptcy law gives wider protection to the municipalities (debtor) compared to individual or business debtors. In practice, according to Mikesell, when municipalities are in financial jeopardy most state governments intervene through the respective financial emergency procedures by imposing extraordinary controls on payments, plans, and policies concerning priorities.[72]

In comparative terms, the Indian Constitution explicitly provides for a financial emergency clause perhaps to avoid the issue of state sovereignty if similar problems of the economic depression of the 1930s are to arise. Article 360 of the Indian Constitution gives power to the president to declare a financial emergency by a proclamation when a situation has arisen whereby the financial stability of India's credit, or any part thereof, is threatened.[73]

The Ethiopian Constitution, on the other hand, does not explicitly provide for a state of financial emergency as a ground for the intervention of the federal government in the states.[74] The Proclamation which enumerates the grounds for federal intervention does not explicitly mention financial problems as a ground for intervention.[75] The HOF is empowered by the Constitution to order federal intervention when the constitutional order is endangered. It envisages an armed uprising and activities that endanger the peace and security of the federation. However, in a situation where a state becomes administratively non-viable, fails to provide public services or is unable to pay its employees, it should be possible to consider them as factors which imperil the constitutional order. Generally, the problem during the last decade can partly be related to a failure to genuinely empower the people at the local level to choose their authorities, or to decide on major local interests and effectively control the misuse of power and embezzlement. Moreover, the facts on the ground indicate that the economic impact of a fiscal crisis should not be tolerated for any political expediency since it does not guarantee self-administration. Thus, to this date, unilateral regional borrowing does not seem to be a feasible alternative to finance regional expenditures.

7 CONCLUSION

This Chapter and the previous one have discussed the system of intergovernmental fiscal transfer and the legal and political impact on its objectives. The previous Chapter has explored the reasons behind the relevance of revenue transfer, the way grants are distributed and their operation in federal systems. The present Chapter analysed how the system works in Ethiopia. The intergovernmental transfer system in Ethiopia has demonstrated some important steps towards resolving the problems of historically marginalized regions, the introduction of formula-based transfers and the use of variables to measure the variation of developmental levels. The design and implementation of transfer schemes to reach solutions to regional imbalances are also significant steps.

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[72] *Ibid*, p. 8.
[73] By explicitly conferring this power on the president, the Constitution enables the central government to effectively control the states whenever an emergency occurs and also avoids any further issues concerning the sovereignty of states. But there has not been a case for invoking Art. 360. See Jain, *op. cit.*, p. 377.
[74] See Arts. 62 (9), 93(1), 55(16) and 51(14) of the FDRE Constitution.
[75] See Proc. No. 359/2003, System for the Intervention of the Federal Government in the Regions.

However, what is important is to identify the remaining mistakes and weaknesses that need to be remedied before it becomes too late for reform. In this regard, the discussion has also unravelled the legal and political constraints faced by the federal government and the states as well. In general, the devolution of powers and responsibilities seems to be a satisfactory approach, but the problems inherent in the asymmetries of the federation in general, and the fiscal arrangement and the equitable distribution of finance in particular require multifaceted solutions.

At present, the revenue portion of each state comes from several sources: revenue generated from the sources assigned to the states, revenue from shared taxes and revenue distributed from the federal pool as grants. In general, the regions should be supported in their efforts to enhance the mobilization of resources. In this regard, the newly introduced revenue sharing of concurrent taxes (joint taxes) is commendable. Since the revenue-sharing scheme is new, its attempt to follow the derivative principle is not surprising. However, in order to boost the revenue capacity of all regions, it should not only follow the head office of the companies (see Chapter VII, section 2.1) but also the share of the revenue contribution of each region. The revenue from these sources can be spent on responsibilities and priorities determined by the respective regional governments.

In Ethiopia, the major means of narrowing regional as well as subregional disparities is the general purpose grant. But the procedures of the grant system and the variables included therein require serious measures of reform to be taken. The most pressing issues are related to the ambiguities in the objectives of the grant system as to whether it balances the expenditure needs and revenue capacities of the regions, the data-related problems, the huge asymmetries between the regions and the problem of a lack of accountability. Some of the recommended solutions are related to the need to introduce conditional grants, for example to use grant subsidies from foreign sources as conditional grants but with some form of equitable distribution. It is also suggested that the grant formula should be designed to assess both the revenue capacity and expenditure needs at the state level. In this connection, the role of the HOF has not been found sufficient both in its composition and professional capacity. In order to prevent political exigencies and logrolling and to promote impartiality, emphasis has been given to the importance of a meaningful independent commission with the required professional expertise.

Although it is not considered to be a serious matter, national borrowing as a source of revenue is subject to the relationship between the centre and the regions. However, it is necessary to address the ambiguities in the law relating to the actual power of the centre and the regions.

In general, the process of intergovernmental fiscal relations should be free from unnecessary political wrangling. Especially when a constitution acknowledges proportional development and national economic union as the principle for the transfer of grants, allocating a lesser percentage share of grants may not necessarily lead to resentment. In practice, however, the politics of ethnicity has been counter-productive in this regard. As can be observed from the analysis, the grant formula has resulted in a better share for relatively small and manageable population and territorial size. Therefore, this has led to a greater possibility for claiming the right to statehood by many groups which are represented at the sub-state level (for a further analysis of this issue see the

next chapter). It is recommended that for the grant formula to be less controversial, the existing territorial and demographic asymmetry should be reduced, and the federal government should strive to develop a firm sense of national unity. But this requires a shift in the paradigm of politics from the sole language factor to an inclusive approach towards economic rationality, political and historical factors. This is because in a system where greater asymmetries exist, only the process of advancing grants hardly guarantees a (relatively) long-lasting solution. As Cheryl Saunders noted, reducing the asymmetries is more important than trying to address the existing problems of equalization attributed to the asymmetries.[76] Therefore, it is important to reduce the asymmetries attributed to the demographical, geographical, economic and historical factors. Asymmetries would render the federation vulnerable to centrifugal tendencies and abuse of power. Moreover, it is observed that the existing asymmetries have made the measurement on a per capita basis a difficult task and have hidden the actual differences between the states.

Furthermore, as has been repeatedly pointed out in the preceding sections, even the capacity of those relatively developed regional governments to efficiently generate finance and exhaustively utilize the available resources has been found to be unsatisfactory. Therefore, all-round genuine and transparent intergovernmental cooperation is important (see Chapter II, Sec.3.4 and Chapter III, sec 2.3). The issue of fiscal relations is also a political one and centres on intergovernmental cooperation between the levels of government which should be based on mutual understanding. Therefore, there should be transparent legal arrangement to establish formal intergovernmental cooperation between the levels of government.

[76] Saunders (1995), *op cit.*

8 The Constitution and the Fiscal Aspects of Ethiopian Federalism: An Assessment

1 INTRODUCTION

The study of fiscal relations between the federal and regional governments goes beyond studying the distribution of responsibilities and the allocation of revenue resources, and addresses other constitutional and political issues intertwined with regional and ethnic interests. The process of revenue allocation in combination with the politics of ethnicity fuels some of these issues. As we have seen in the preceding chapter, the process of allocating and transferring revenue to groups represented at the regional or subregional level leads to regional disparities and economic resentment, and makes it difficult to attain the objective of interethnic equity. The present chapter focuses on how these divisive characteristics can be aggravated by the constitutional rights of 'any nation, nationality or people to state formation', under Article 47 (2) and (3) of the Constitution, and even to secede from the federal union, under Article 39(1) and (4) of the Constitution.

Thus, in the second and the third sections of this chapter revenue transfer will be examined in relation to the right to statehood and secession. In general, the fiscal relationship between the federal government and the states can be the driving force behind a claim for the right to statehood by groups that are not represented at the state level (see Chapter VII, 2.3.3). Similarly, secessionist tendencies can be easily triggered. We also attempt to show how the constitutional guarantee of these rights can in themselves lead to the danger of destabilizing the relationship between groups in a state and even threatening the stability of the federal system in general.

In a multiethnic developing federation several groups could contend for governmental power as a means of access to the control of national resources. This is because government is the major employer in the country; it is the driving force for development, and plays a major role in the quantity of revenue transfer. Therefore, the control of government power can become a major political battlefield. However, the danger which a federation like Ethiopia faces is not only the political power struggle to control government, but also the danger which decentralization itself poses.

In the Ethiopian federal system ethnicity[1] has permeated the economy, financial relations, politics and all spheres of intergovernmental relations. This chapter

[1] 'Ethnicity is a political ideological manifestation of an ethnic group which emanates from the feeling of separate identity and belonging in turn based on shared 'cultural stuff'. Secondly, ethnic nationalism generally refers to a demand for creation of an independent state and are political and ideological expressions of an ethnic group or nation real or imagined. Explicit in this definition is... that ethnicity and/or nationalism involve the mobilization of collectivities for collective action to change their situation within or outside a given nation state.' Merera Gudina, *Ethiopia: Competing Ethnic Nationalisms and the Quest for Democracy, 1960-2000* (Reprint, Chamber Printing House, Ethiopia, 2003), p.22

also focuses on some of the dangers which fiscal decentralization can pose to an ethnic-based federal system in section four.

2 STATE CREATION AND REVENUE

The introduction of federalism in Ethiopia was initiated during the transition period and was affirmed in the federal Constitution which came into force in 1995. The territorial reorganization and the establishment of regional governments were based on the principle enshrined in the transitional charter as well as in the Constitution (Article 39(3)) which states 'every nation, nationality and people has the right to a full measure of self-government in the territory that it inhabits and to equitable representation in regional and national governments.' And according to the Constitution (Article 8(1)) 'all sovereign power resides in the nations, nationalities, and peoples of Ethiopia'. States as members of the federation are, therefore, primarily delimited on an ethnic basis, but some of them are home states for specific groups while others are homes for several ethnic groups bundled together.[2] The major anomaly this territorial organization exhibited is the huge asymmetry in population size, geography and economy between the states and its failure to uniformly follow the constitutional principle.[3]

Although the Constitution refers to nine member states, the possibility of creating many more states is open. Pursuant to Article 47(2) of the Constitution every nation, nationality or people which exists within the states has the right to establish, at any time, its own state.[4] The literal interpretation of this

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[2] Although Art. 46 (1) of the Constitution provides 'States shall be delimited on the basis of the settlement patterns, language, identity and the consent of the people,' in practice it is language that has been given the utmost importance. The position of the architects of the Constitution adopting ethnic federalism has been made clear in one of the writings which says: 'This is not a constitution of the Ethiopian citizens simply lumped together as a people. The Ethiopian citizens are first defined in their different ethno-linguistic groups and then these groupings come together as authors of, and pioneer actors, from the 1995 Constitution. By so doing, the Constitution explicitly recognizes Ethiopia as a nation of nations,' Fasil Nahum, *Constitution for a Nation of Nations: The Ethiopian Prospect* (Red Sea Press, Lawrenceville, 1997), p. 51.

[3] For example, the *Harari* city-state has only 0.1 percent of the total population and occupies 0.01 percent of the national territory, whereas Sidama with 5.5 percent of the population is at the sub-state level. Furthermore, *Harar* is the home state of the *Hararis* who comprise only 7.42 percent of the state's population. Oromia is the biggest state with 33 percent of the population and about a quarter of the total size of the country. The Harari state comprises of 7.42 percent Hararis, 52.2 percent Oromos and 32.6 percent Amharas. The Oromos can be elected and share power but the Hararis have a veto power on major issues. Merera argues that this is 'a paradox of Ethiopian 'democracy'.' Merera, *op cit*. p. 139. For a detailed analysis of the Ethiopian federal structure, see Chapter I.

[4] Article 47 of the Constitution reads:
'Member States of the Federal Democratic Republic
1. Member States of the Federal Democratic Republic of Ethiopia are the Following: 1) The State of Tigray
2) The State of Afar 3) The State of Amhara 4) The State of Oromia 5) The State of Somalia 6) The State of Benshangul/Gumuz 7/ The State of the Southern Nations, Nationalities and Peoples 8) The State of the Gambela Peoples 9) The State of the Harari People.
2. Nations, Nationalities and Peoples within the States enumerated in sub-Article 1 of this article have the right to establish, at any time, their own States.
3. The right of any Nation, Nationality or People to form its own state is exercisable under the following procedures:
a) When the demand for statehood has been approved by a two-thirds majority of the members of the Council of the Nation, Nationality or People concerned, and the demand is presented in writing to the State Council;

constitutional provision allows us to assume that there exist, or purport to exist, as many states as there are numbers of 'nations, nationalities or peoples'. Thus, every nation or nationality organized at the zone, wereda or k*ebele* level could form a new state after passing through the procedures enumerated in the Constitution.[5] This utmost importance given to ethnicity[6] and its somewhat strange approach to territorial organization has captured the attention of several scholars; some have hailed it while others have denounced it or warned against its dangers.[7] It is also sometimes described as depicting a 'confederal' character.[8]

The right to statehood for every nation, nationality and people raises constitutional issues relating to the exercise of the right and has fiscal implications. The constitutional issue relates to the difficulty to define whether the ethnic groups or the states are the holders of the territories and become the constituent units of the federation under the Constitution.[9] Under Article 47 (2), every ethnic group is the holder of the right to establish a state. This right does not have relevance to those who have already been given their home states, such as Oromia, Afar, Somali, Amhara, Tigray and Harari. Under Article 47 (3, a), the right can only be exercised by a nation, nationality or people which has a 'council' of its own at the subregional level. Accordingly, those which are not yet territorially recognized as distinct groups or do not have their own local council

b) When the Council that received the demand has organized a referendum within one year to be held in the Nation, Nationality or People that made the demand;
c) When the demand for statehood is supported by a majority vote in the referendum;
d) When the State Council will have transferred its powers to the Nation, Nationality or People that made the demand; and
e) When the new State created by the referendum without any need for application, directly becomes a member of the Federal Democratic Republic of Ethiopia.
4. Member States of the Federal Democratic Republic of Ethiopia shall have equal rights and powers.'

[5] The established procedure (Art. 47(3)) requires approval by a two-thirds majority of the members of the council of the nation, nationality or people concerned at the subregional level, when the demand is approved by a majority vote in a referendum organized by the state council, and the state council has transferred power to the nation, nationality or people that made the demand. The procedure creates an impression that the ethnic groups can create their own states in a short period of time, but there are several legal complications that can influence the outcome of the claim for statehood. To begin with, the role of the state council, let alone the federal government, does not seem to be clearly stipulated. The state council requires the consent of the majority of the voters and the qualified majority of the members of the local council. But it is not clear how the democratic nature of the whole process can be ascertained. The HOF plays a role when the nation, nationality or people that made the demand for statehood submits complaints against the state council. Until then, the process seems to be left to the state council. Moreover, the Constitution does not refer to the issues of the division of assets and liabilities. And the Constitution does not give clear and more active role to the centre while it provides for unremitting claims for statehood.

[6] See Arts. 8, 39, 46, and 47 and the preamble to the Constitution.

[7] See the several authors mentioned under chapter I. For recent articles see Maimere Mennasemay, 'Federalism, Ethnicity, and the Transition to Democracy,'(Horn of Africa Journal, vol. XXI, 2003), p. 88-114; Alemante G. Selassie, 'Ethnic Federalism: Its Promise and Pitfalls for Africa,'(28 Yale Journal of International Law 51, 2003), p. 51-107.

[8] Assefa Fiseha, 'Federation and the Threat of Local Tyranny: The Case of Ethiopia,' (Horn of Africa Journal, vol. XXI, 2003), p. 65.

[9] It is evident from the above provisions that the ethnic groups can realize the right to statehood if they exist in a defined territory. This gives the impression that each ethnic group establishes a state in the territory it inhabits. If this is the case, then the state of Tigray belongs to the Tigre although the Kunama and Irop exist in the state. Similarly the State of Amhara belongs to the Amharas, irrespective of the existence of the Agaw, Oromo and Argoba groups. If this is the case, then it makes the right to statehood precarious for the ethnic groups that exist within the states of Tigray and Amhara.

cannot exercise the right. This may refer to 15-20 ethnic groups which do not yet have representation in the HOF.[10]

As to the fiscal aspects, the constitutional right of statehood could pose a serious problem to the federal system when seen in the light of intergovernmental fiscal relations. The main reasons are the following: first, the general problem the process of intergovernmental fiscal transfer can face in an ethnic-based federal system[11], and, second, the impact of the practice of revenue transfer in Ethiopian federalism.

Concerning the first point, intergovernmental fiscal relations are, on the one hand, inherently related to the policy making at the federal level where states are parties to the process of intergovernmental relations. But, on the other hand, in an ethnic-based federal system different groups that exist at several layers of subregional government strive towards state formation. The role of intergovernmental fiscal relations is to maintain effective and cohesive relations between the constituent units of the federation at the state level. Thus, the fiscal system is primarily maintaining relations between the *states* and not between as many ethnic groups as possible. However, as a result of their constitutional right it is possible to argue that a claim of particular group may not stop short of the realization of the right to statehood. This is simply because 'a successful policy of intergovernmental relations, including its financial aspects, [is] part and parcel of the ongoing legitimating process for a given state.'[12] As a result, we may observe a tension between the fiscal system and related policy matters focused primarily at the state level (the nine member states), while there are dozens of ethnic groups striving for the realization of their right to statehood.

As to the second point, the way in which revenue transfer works in practice in the Ethiopian federal system reinforces the problem mentioned above. The problem emerges both at the level of financial relations between the centre and the states, and that of the states with local governments. The system of intergovernmental fiscal relations has had as a result that states with larger populations and territorial size obtain a smaller per capita revenue compared to states with smaller populations and geographical size (see Tables 7:3, 7:7) Thus, when we compare the per capita revenue of Gambela, Harari, Afar and Tigray with Oromia, Amhara and SNNPR the former retain a higher per capita revenue not only because their level of development is lower but also because of numerical factors and they are party to the transfer process at the federal level.[13]

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[10] Currently (2004) sixty seven ethnic groups are represented in the HOF. It is, however, claimed by many that there are about seventy to eighty groups that exist in the country. The holders of the right are at present four ethnic groups in Gambela region, four in Benishangul-Gumuz, three in Amhara, two in Tigray and about forty eight in the SNNPR (See Table 7:9). Similar provisions referring to the right to statehood are laid down in the Constitutions of SNNPR, Gambela and Benishangul-Gumuz. However, the Constitutions of Amhara and Tigray states do not specifically mention a right of statehood despite the presence of other nations, nationalities and peoples within the respective states.

[11] See also Chapter II, section 3.1.

[12] Lidija Basta Fleiner, 'Comment on 'The Dynamics of Decentralization' by R. Watts', in Richard Bird and Thomas Stauffer (eds.), *Intergovernmental Fiscal Relations in Fragmented Societies* (PIFF vol. 33, Fribourg, Helbing & Lichtenhahn, 2001), p. 36.

[13] For instance, the variables of the grant formula can be directly measured with respect to the level of development of these groups. See chapter VII, 2.2.

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Similarly, when we compare the per capita revenue (and the relative revenue share) of ethnic groups represented at the subregional level in the SNNPR and Amhara regions with those that have acquired statehood such as Gambela, Benishangul-Gumuz and Afar, the relative shares of those in the former regions are far lower than the latter (see Chapter VII, 2.3.3). Such groups can claim their right to statehood on the ground that they will become directly party to the bargaining process at the federal level; their revenue shares will very likely be proportional, and they can benefit from the decentralized decision-making power. That is what mainly triggered the 2002 crisis in the SNNPR (see Chapter V, section 3 and Chapter VII, section 2.3.3). The regional administrative hierarchies were challenged by those groups which were represented at the lower levels. Moreover, the parochial ethnic authorities (who controlled local 'political organizations') were able to manipulate the local supporters to claim independent regional government. At the same time, the arguments that can be made to state formation can *mutatis mutandis* apply to intra state level. Accordingly, in the SNNPR, those groups who were at the Wereda and kebele level took action to claim zonal status. That means it is partly a claim for a higher share of the regional revenue.[14] A typical instance was the *Siltie* case which substantially increased its share of revenue when it attained zonal status. Although the regional and federal authorities did not welcome this crisis, the number of local governments in the region increased from nine zones and three special weredas to thirteen zones and eight special weredas.[15] However, the issue is not simply related to regional fragmentation but also to the difficulty it presents for redistributing the limited financial resource. Moreover if the regional fragmentation continuous to the formation of additional states, it increases regional asymmetries.

Whether the constitutional right to (ethnic) statehood benefits the local people and whether there is any economic justification for the nation at large are matters that cannot be left to mere speculation. The effects can be seen or heard in the reports of the ruling party itself. The ethnic competition for a larger share of the federal grant failed to bring about economic benefit to the local people, as the prime minister has reported. In the 2002 report to the parliament he said, 'they ought to have used their budget as *maresha* (ploughshares) [implying to finance specific plans bringing returns], but they used it instead as *genfo* (porridge).'[16] The problem, however, is how to make them accountable to their acts which have implications to the limited resources of the nation at large. To what extent are the authorities exempted from accountability and legal responsibility? It is no surprise that the tendency in the federal arrangement is towards an increasing number of local actors, but without giving due attention to what the nation may get in return for spending its scarce resources. It should be clear that the right to share the national cake does not absolve the local actors from implementing their responsibilities with regard to expenditure and being accountable to the local community.

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[14] Interview with *Ato* Assefa Kessito and *Ato* Merkneh, December 2003.
[15] In 2002, out of the 48 ethnic groups from SNNPR represented at the HOF, 21 of them have zonal and special wereda status and the rest are at the wereda and kebele levels.
[16] Assefa Fiseha, op. cit., p. 72. In his relevant interview the prime minister has also confirmed that regional spending is not the concern of the federal government. In principle this may hold true. However, when there is a clear transgression of the constitutional obligation on the part of regional authorities and institutions do not function well, the silence of the federal government could be considered as unconstitutional political expediency.

The revenue issue is also related to the trend whereby effect is given to a kind of 'one ethnic group, one subnational territory' principle. As a result, the system of intergovernmental fiscal relations operates within the huge asymmetry that exists between the constituent units. As shown in chapter VII, the system of revenue transfer clearly demonstrates less relative per capita revenue for the Oromia and Amhara regions. As can be seen from Tables 7:2-7:7, the per capita revenue of Harari, Dire Dawa and Tigray is significantly higher than Oromia, Amhara and SNNPR, *inter alia*, due to the anomalies in state formation. This kind of imbalance, coupled with growing ethnic nationalism and competition, undermines the viability of the federal system, as it can be used as an effective weapon to mobilize opposition against the system. The danger of revenue imbalances can be effectively used as a political weapon. For instance, referring to the per capita imbalances between Oromia and Tigray, Merera said: 'Such naked discrepancy has served the Oromo movements as an important agitational weapon in mass mobilization [in support of their movements].'[17]

The constitutionally-based right to form a state (or sub regional authority) based on ethnic grounds can have a number of other fiscal and political consequences. Politically, it can lead towards guaranteeing 'ethnic self-determination' at the expense of maintaining power relationship between the levels of administration within a region. This tendency could have the character of a specific power relationship between several groups of a region in the same manner as the power relationship between the centre and the states, which may have the features of a 'federation within a federation'. This is because ethnic divisions intensified with local ethnic political parties, local police forces managed and controlled by the local party, and local parties working on differences rather than similarities will lead to rigid internal divisions and will finally establish a loose power relationship between the tiers of government. This will create discrete ethnic groups represented at different levels of regional government. As Minase says, this could be one of the arrangements that would legally replace the Constitution of the country with 'a treaty of ethnic alliances'.[18] This again can bring about a continuous political rivalry between the ethnic groups. Primarily, this would be ethnic rivalry claiming statehood and then competing for controlling the central power to the extent of securing political supremacy that can generate economic benefits for the ethnic group.[19] Such a practice has been lingering on in Nigeria since its independence and people warn for a similar trend in Ethiopia.[20]

The tendency to set state boundaries in accordance with simple ethno-linguistic territories also causes higher administrative costs and inconveniences for certain states, which again imply an indirect relation to fiscal imbalance. For instance, there is no easy access between the state capital of Somali region and one of its zones, *Liben* zone which is part of Somali State only due to linguistic reasons without regard to its infrastructural vicinity to other zones in Oromia and SNNPR. Sometimes it takes three to four days to travel from the regional capital to the zone, crossing three regions and travelling almost double the actual distance between the zone and the capital. Similar problems are witnessed in Afar (areas neighbouring Tigray), Benishangul-Gumuz and Amhara regions.

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[17] Merera Gudina, *Ethiopia: Competing ethnic nationalisms and the quest for democracy, 1960-2000* (Reprint, Chamber Printing House, Addis Ababa, 2003), p. 175.
[18] Minase Haile, 'The New Ethiopian Constitution: Its Impact upon Unity, Human Rights and development,'(Suffolk Transnational Law Review, Vol. XX, No.1, 1996), p. 20.
[19] For instance, see Merera Gudina, op. cit.
[20] See Minase Haile, op. cit.

[illegible]

example, should the Amharas, Oromos or Somalis belong to one state only? Would it be unconstitutional if those of a single language group such as Oromo or Amhara were to be organized in more than one regional government? Does it contradict the principle of self-determination if they acquire more than one state? Although the people speak the same language they have different experiences and history (see Chapter I, 1.1), different culture, and also geographically, it would be much more convenient for them to be organized in more than one state territory than being contained in one state territory. Despite the assertion that sovereignty lies with each nation, nationality and people, they do not each enjoy the opportunity of state government. Some have coalesced into a single regional government and, therefore, it is hardly possible to say that all are equal. On the other hand, there are many convincing reasons for dividing a single language group or state - Oromia, Amhara or Somali - into more than one state government, besides the primary objective of promoting unity in diversity. First, besides language, it can accommodate other factors such as history, culture, religion and settlement patterns. Second, by reducing imbalances, it can create economic and administrative efficiency, promotes federal loyalty, reduces the politics of ethnicity and promotes national integrity.[21] Furthermore, the Constitution itself tacitly assumes the difficulty of promoting all nations, nationalities and peoples to state level and state governments.

The issues of state creation or fragmentation of subregional administrative levels can bring about a continuous territorial reorganization which at the same time may lead to new conflicts between groups. The conflicts could be interstate or intrastate depending on the parties involved in the conflict. We have mentioned the intrastate problems in the state of SNNPR. Interstate conflict is a possible scenario with regard to border issues, for example, between Oromia and the neighbouring regions of Somali, SNNPR, Afar and Benishangul-Gumuz. The conflict with the Somali region has flared up because of the economic benefit from the local produce, *chat*,[22] as it is the major source of local revenue.

The problem of interethnic strife may continue, as the regional or subregional boundaries in those areas do not seem to have a stable character. Further, when state creation becomes linked with the right to secession (as will be discussed in

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[21] With regard to the above reasons, it is important to note the experiences of other multiethnic federations such as Switzerland and India, although they have different historical, political and economic realties. Switzerland has succeeded in maintaining unity in diversity without necessarily granting territories that correspond only to language or religion. The territories counterbalance language and religion, which enables the states to shift alliance from language to religion. The politics of ethnicity is hardly observed. So, it would probably be difficult to envisage the present-day federal system in Switzerland had there been three states with only German, French and Italian - speaking territories. In India, although language plays a role in territorial organization, religion (more than 82 percent of the population have Hinduism as their religion) plays a cohesive role.

[22] *Chat*, some write it *qchat*, is a leaf of a plant chewed mainly for therapeutic purpose. It is widely consumed in Ethiopia and the neighbouring countries. However, in some countries it is categorized as some sort of narcotic.

As we have observed above, the anomaly has resulted in more than sixty percent of the country's population living in only two states and the rest - forty percent - in seven states and two federally controlled city administrations. Further, despite the adoption of the ethno-linguistic factor as a foundation for organizing states' territory, it has not brought about homogenous ethnic states. On the contrary, this leads us to the issue of whether people who share the same language and culture in the broadest sense should necessarily be grouped in one region. For example, should the Amharas, Oromos or Somalis belong to one state only? Would it be unconstitutional if those of a single language group such as Oromo or Amhara were to be organized in more than one regional government? Does it contradict the principle of self-determination if they acquire more than one state? Although the people speak the same language they have different experiences and history (see Chapter I, 1.1), different culture, and also geographically, it would be much more convenient for them to be organized in more than one state territory than being contained in one state territory. Despite the assertion that sovereignty lies with each nation, nationality and people, they do not each enjoy the opportunity of state government. Some have coalesced into a single regional government and, therefore, it is hardly possible to say that all are equal. On the other hand, there are many convincing reasons for dividing a single language group or state - Oromia, Amhara or Somali - into more than one state government, besides the primary objective of promoting unity in diversity. First, besides language, it can accommodate other factors such as history, culture, religion and settlement patterns. Second, by reducing imbalances, it can create economic and administrative efficiency, promotes federal loyalty, reduces the politics of ethnicity and promotes national integrity.[21] Furthermore, the Constitution itself tacitly assumes the difficulty of promoting all nations, nationalities and peoples to state level and state governments.

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the next section) this could have a complex effect on fiscal matters unless both issues are addressed in a timely fashion. Thus, politicizing the ethnic factor should be limited and territorial organization should also be inclusive of other factors such as economic reality, history, geographical locations and administrative efficiency, while the federal government should also play a significant role.

To conclude, the constitutional guarantee in favour of continuous state formation cannot be taken at face value especially when seen in the light of intergovernmental fiscal relations. Unless the politics of ethnicity and the asymmetries are reduced, there will be an endless claim for statehood, and so the problem of regional financial inequality will very likely continue. The problem, however, is not only in the claim for statehood and regional disparities, but also in the solution to addressing the problems, i.e. the centralization of power. Power is centralized to address the problem of asymmetry and because of fear that the regions will become powerful and challenge the centre. As is currently observed, power centralizes through the channels of the centralized party system. However, as the centre strengthens its grip on power it may contradict the Constitution or may retreat from implementing fiscal discipline for reasons of political expediency. This is a deplorable strategy since neither option can be a lasting solution. This is because these strategies fade away, sometimes with devastating consequences, as one's hold of power at the centre deteriorates.

3. REVENEUE AND SECESSION

The FDRE Constitution (Article 39(1)) provides 'every nation, nationality and people in Ethiopia has the unconditional right to self-determination, including the right to secession.'

Historically, the right to secession has developed within the broader concept of the right to self-determination, but different groups have used it as a tool for different purposes.[23] Some used it to achieve independence from colonial powers while others used it to change a dictatorial regime within a state; some have redefined their subnational territories to exercise more autonomous rights within the territories but not going as far as independence, while others opted for independent states; some guaranteed subnational rights within a federation, while others remained within a decentralized unitary state.

Despite the fact that some have claimed independence, there is no consensus as to whether self-determination leads to secession. It seems that the course of this right has assumed a wider path after the end of colonization and the cold war. But any argument that self-determination should lead to the emergence of continuous fragmentation of a country and to the establishment of tiny sovereign

[23] During World War I, US President Widrow Wilson and the Soviet leader V. Lenin espoused the concept of 'self-determination' but from a different philosophical background. After World War II, the principle was widely used as an instrument for the process of decolonization as a legal and moral right. And after the cold war, self-determination has assumed a wider perspective as a result of the dissolution of the Soviet Union, Yugoslavia and Czechoslovakia, the attempted secession of Quebec, and the secession of East Timor and Eritrea. In general, depending on the way self-determination has manifested itself, it is sometimes classified as internal self-determination and external self-determination. When part of a state breaks away peacefully or by force and attains independence, it is considered as 'external self-determination'. When more autonomy is secured within the existing state instead of full independence as a sign of maintaining diversities, it is 'internal self-determination'.

ethnic, religious or clan states does not seem to be recognized by the international community.[24] However, the post-1991 Ethiopian government has made history by recognizing the secession of its own territory and proclaiming a constitution that explicitly recognizes secession. Here our objective is not to analyse whether secession is justifiable or not, rather to show how secession and revenue issues intertwine with each other and create a precarious condition for the viability of the federation.

According to the Ethiopian Constitution,[25] the 'unconditional' right of every nation, nationality and people to secede from the federation is considered, to use Professor Minase's parlance, 'so precious' that it cannot be suspended even in times of external invasion, natural disaster or other emergency factors, even when most of the individual rights can be suspended.[26] According to Article 39 (4) of the Constitution this right shall come into effect:

a) when a demand for secession has been approved by a two-thirds majority of the members of the legislative councils of the nation, nationality or people concerned;
a) when the federal government has organized a referendum that must take place within three years from the time it received the concerned council's decision for secession;
b) when the demand for secession is supported by a majority vote in the referendum;
c) when the federal government will have transferred its powers to the council of the nation, nationality or people who has voted to secede; and
d) when the division of assets is effected in a manner prescribed by law.

Several issues can be raised in relation to the procedures mentioned above. The first issue relates to the phrasing of the Constitution which affirms that the right to secede belongs to the 'nations, nationalities and peoples of Ethiopia'. Does it require each group to attain statehood before exercising the right?[27] The Constitution refers to the fact that members of the legislative council should initiate the demand for secession and to submit it to the HOF. But can the HOF review the decision of the legislative council of the nation, nationality or people concerned? The HOF shall organize a referendum within three years of receiving the demand, but what happens if the term expires before the referendum is held? Who participates in the referendum, only the members of the concerned or all the residents of the state irrespective of their ethnic background? If membership of a group is a requirement, who verifies it? Once a referendum is held in favour of secession, how long does it take to divide assets and to transfer power? There is also an ongoing debate as to why secession is

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[24] See Alan Buchanan, 'Symposium Issues in the Philosophy of Law: Federalism, Secession and the Morality of Inclusion', (37 Arizona Law Review 53, 1995), p. 53-63; Michael J. Kelly, 'Political Downsizing: The Re-emergence of Self-determination and the movement toward Smaller, ethnically Homogenous States,'(47 Drake L. Rev. 209, 1999), p. 209-276; James Crawford, 'State Practice and International Law in Relation to Unilateral Secession', Report to Government of Canada concerning unilateral secession by Quebec, University of Cambridge 19 February 1997, posted at, http://www.tamilnation.org/selfdetermination/97crawford.htm accessed on 10 November 2004.

[25] The same statements are found in all state Constitutions and in the federal legislation proclaimed to consolidate the HOF and to define its powers and responsibilities (Proc. No. 251/2001, Art. 19). The right of secession was explicitly recognized in the former Soviet Constitutions of 1936 and 1977, which, however, granted the right to each Republic but not to each ethnic group.

[26] Minase Haile, *op. cit.*, p. 32. See Art. 93(4, c) of the FDRE Constitution.

[27] Nonetheless, it appears less controversial to the states of Oromia, Somali, Afar, and Tigray, as each group has attained its own 'mother state', although most of them are potentially problematic areas. But it is far from clear whether different ethnic groups combined in one state as in the SNNPR, Gambela or Benishangul-Gumuz and Amhara can exercise the right. However, according to one of the leading authorities on the Ethiopian Constitution says 'The formal issue of secession deals with states.' Fasil Nahum, *op. cit.*, p. 158.

legitimized in the name of self-determination. It also concerns the question of whether it is a legitimate consequence of self-determination, and who should determine the fate of the federation? Why should a constituent unit of a federation, that is only the majority of the people who belong to a particular nation, nationality or people, unilaterally decide the fate of secession?[28]

Each procedural requirement poses serious issues for interpretation that are decisive as to whether the right can be realized at all or remains merely political rhetoric. Generally, it would have been far less problematic if the Constitution had not conspicuously recognized it, if not unequivocally denounced it.

As Dr. Minase remarks, 'The very fact of providing for a right to secede in the Constitution even when the actual exercise of the right is not very easy, has several consequences which reduce the prospect of a viable federalism and democracy.'[29] One of the consequences could be constant fiscal conflict between the regions, particularly the problem of the amount of federal spending in the regions (see Chapter III, 2.4.1) and mistrust towards attempts to transfer revenue equitably. This is an issue that can be easily hijacked by secessionist groups, especially those from a relatively better off region.

One of the fundamental functions of a federal government is the redistribution of wealth from the relatively rich to the relatively poor regions and citizens. This transfer of revenue is conducted independently of whether such redistribution is to the advantage of the wealthier regions. That is how the federal system works. Since intergovernmental fiscal transfer requires some form of redistribution of income from the rich to the poor regions and citizens, it would be simple to assume that the rich could be better off if they withdrew from the union (federation). However, the fact that a rich region could be better off if it divests itself of obligations to the poor and to withdraw from the union, cannot in itself be a legitimate reason for seceding in most federal systems. However, it could occur in Ethiopia. It can be used as a perverse promise to the people that if the region secedes, all sources of revenue retained by the centre and the revenue shared with the poor regions would remain solely for the region.

In this regard, several questions could be raised. To what extent would better off regions continue to subsidize poor regions in cases where secession is a legitimate right? How can a country regions in cases where secession is a with a low level of development make decisions to spend its meagre resources in one of the regions where its ultimate fate would be decided by the people of that constituent unit only? Can it develop trust? How can we expect ethical decisions in such conditions of uncertainty unless we believe that this right cannot be put into practice?[30] The whole purpose of (federal) investing in a particular region

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[28] For instance, Quebec's demand to decide unilaterally on the issue of secession was rejected and a referendum was held throughout Canada. Buchanan argues, 'Exploration of various forms of self-determination other than secession must proceed on the basis of an international consensus that such rights do not carry with them the right of the group to opt for full independence. Accordingly, recognizing a region as having federative rights should carry no presumption that a majority in that region may opt for secession. Thus ...federalism is likely to provide a viable alternative to secession only if the international community unambiguously rejects the principle that there is a presumption in favour of federal units having a right to secede if a majority within the unit favours secession.' Alan Buchanan, op. cit., p. 57. See also Crawford, *op. cit*.

[29] Minase Haile, *op. cit.*, p. 33

[30] Politically, at present many consider this feeling of uncertainty as the major cause of Ethiopians' to migrate to other countries.

would be defeated unless there is complete conviction that the investment benefits the whole nation.[31] A trend of blocking the flow of revenue from a richer region to the centre and the poor regions was followed in the cases which led to the history of conflicts in Biafra-Nigeria, Katanga-Congo and recently Slovenia's independence from Yugoslavia.[32] From these experiences we can learn that one of the factors that instigate secession is revenue transfer.[33]

Intergovernmental fiscal transfer is a continuous process, but may not satisfy the constituent units and the citizens all the time. Equalization through the transfer of revenue requires discriminating treatment between the rich and the poor regions so that equal per capita transfer may not necessarily occur. However, this discriminatory treatment to equalize the constituent units of the federation or to bring about an equitable distribution of income on an individual basis requires reliable and up-to-date data and the government should have the necessary political and moral grounds to do so. Building legitimacy through the political process also gives a moral ground to such decisions. This can be achieved when the system is inclusive of all groups and the pattern of redistribution is accepted by the constituent units. This requires an enduring effort to rectify the major drawbacks, to involve the participation of the people, to exhibit ethical behaviour, and, above all, to ensure political commitment to bring about the intended economic development.[34] Further, there is a need to develop an optimal (re)distribution and to share equitably the fruits of cooperation. This is to make the majorities and minorities existing in the federation believe that they are equal partners of the greater political association. It is when the relatively rich regions are committed to living together with the poor, that one can avoid the issues of secession, not by generously proclaiming it as a constitutional right.

However, the trends observed in Ethiopian federalism demonstrate some early-warning signals. For instance, there is a growing tendency of complaints, at times secessionist rhetoric, against the existing system, on the grounds that it fosters development in other regions at the expense of the Oromia region. According to these complaints, Oromia has various natural resources, is conducive to major investment sectors and is the major contributor of revenue, but receives less per capita federal subsidy compared to others.[35] Although the export trade is very limited and the country is dependent on foreign grants and

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[31] For instance, there was an outcry in the private media (those blamed for being affiliated with OLF) when the federal government concluded an agreement (a company widely known as being affiliated to the ruling party is a sub-party to the contract) for the construction of a hydroelectric dam in Tigray region for at a cost of 1.2 billion birr. They considered it to be proof of the preferential policy of the government towards Tigray where the investment is considered to have less benefit for the major producing areas of the Oromia or SNNPR region.

[32] Alemante, *op. cit.*, p. 92; and see Augustine E. Ikien and Comfort Briggs Anigboh, *Oil and Fiscal Federalism in Nigeria: The Political Economy of Resource Allocation in a Developing Country* (Aldershot, Ashgate, 1998).

[33] Buchanan argues that the demands for secession target the means for maximizing self-interest. However, he said, 'These proffered justifications usually take the form of grievances, more specifically, allegations of injustice. Secessionists may claim that they are seceding to escape violations of their human rights or to redress the historical injustice of having had their own sovereign state unjustly annexed.' Buchanan, *op. cit.*, p. 63.

[34] See, for instance, Bernard Dafflon and Françoise Vaillancourt, 'Problems of Equalization in Federal Systems' Raoul Blindenbacher and Arnold Koller (eds.), *Federalism in a Changing World – Learning from Each Other: Scientific Background, Proceedings and Plenary Speeches of the International Conference on Federalism 2002* (Montreal & Kingston, McGill-Queen's University, 2003), p.395-411.

[35] See Merera, *op. cit.*, p. 150.

agriculture, the above complaints cannot be rejected, as noted in Tables 7:2-7:7. Taken at face value, this illustrates how difficult the fiscal relation in this country will be, particularly if the revenue which the country generates from existing sources (coffee) increases, natural resources (oil) are explored and employment booms in the regions which are conducive for investment. Obviously the flow of wealth from one region to the other may easily trigger secessionist tendencies.

Moreover, there are also serious complaints about political domination at the federal as well as regional level by a single party, business domination by companies affiliated with the ruling party, and the lamenting state of intergovernmental relations and extra-budgetary financial flows in favour of a specific group. All fiscal politics intertwined with Article 39 of the Constitution, which was praised by its architects as a solution to the survival of the nation in 1992, may incubate other problems that could lead to the demise of the federation. A legal instrument that can shake the very foundation of the federation ought not to have been included in the Constitution.

In general, secession issues can be related to the fiscal powers which the states exercise and/or the benefit they can expect after breaking away from the federation. In this regard two specific issues arise: whether the division of revenue-raising powers between the tiers of government can have an impact on secessionist demands or tendencies? And vice versa: Can secessionist movements influence the revenue-transfer mechanisms and the overall division of revenue sources? Although the causes of secession vary in nature, the politics concerning fiscal matters can have a direct or an indirect relationship with secession. First, the assignment of revenue sources and the transfer of revenue can affect secessionist demands, and, second, secessionist movements can also influence the measures taken to decentralize fiscal powers and the transfer of revenue from the centre.

The first issue concerns the manner of assigning revenue sources between the centre and the regions and the mode of revenue transfer. If the fiscal powers are highly centralized or if a region which is a major source of revenue benefits less than the others, secessionist movements may flare up due to resentment against the fiscal system. In short, the less effective the fiscal instruments are in addressing the fiscal disparity between the regions, the greater the chances for secessionist movements. What we learn from successful or unsuccessful secessionist movements in the world is that fiscal resentment is part of the cause, whether or not it is sincere.

As we have noted above, the resentment in Oromia concerning the fiscal system has been, to some extent, the cause of secessionist rhetoric. The argument is that if more lucrative natural resources were exploited, the issue of revenue sharing would give rise to more secessionist tendencies unless resources are equitably distributed. However, even in case of proportional distribution, secessionist movements may still arise, partly due to the reason that regions could claim to be better off by seceding from the federation. If such demands persist they can lead to the second issue, i.e. the impact of secessionist movements on the pattern of fiscal federalism.

Thus, the second effect is that when secessionist movements intensify, they can influence the fiscal policy of the central government particularly concerning the system of revenue transfer. In this case the centre could be forced to design policies depending on the nature and extent of the problems: that is assigning

more tax powers to the regions, and/or designing central transfers that may satisfy the most likely secessionist regions. First and foremost, if the separatist region is the major source or contributor of revenue, the centre should take serious note of the amount of transfer, loans or aid paid to other regions in comparison to this region. This is the first important step that should be taken by the centre. However, proportionality or equalization transfers may not always contain separatist movements, especially in regions which are a major contributor to the national revenue and which believe that they can financially stand on their own. In this case, 'the most effective strategy to pre-empt secession is to design central transfers to appease the most likely separatist regions.'[36] That is to employ other transfer mechanisms that can disproportionately favour the seceding region.

Genuine demands for secession due to fiscal resentment could be addressed by either of the above different approaches and fiscal policy instruments. The problem, however, is that the above approaches may not help much in achieving the intended objectives if secessionist movements are made for different 'strategic reasons'. Depending on the motives of their approach the strategists, according to Aleman and Treisman, can be classified into three groups: 'autonomists', 'opportunists' and 'local ethnic entrepreneurs.'

> Autonomists hope, by threatening secession, to win greater authority to set local policies within the existing state. Opportunists hope...to extort a greater share of central resources. Local ethnic entrepreneurs attack the centre, politicize ethnic difference and demand independence as a way of rallying local support.[37]

The Ethiopian federal system may face serious challenges from these strategists if they invoke the constitutional right of secession. Aleman and Treisman[38] further argued that all the three motives compete in terms of maximizing their share of the central transfer, and each motive requires different fiscal instruments and is not in harmony with the existing symmetrical power distribution between the regions. The strategy of 'autonomists' requires an asymmetrical power distribution between the constituent units of the federation, i.e. reassigning revenue sources to the regional and subregional administrations (i.e. decentralizing more fiscal powers) and following an upward transfer of revenue (see Chapter IV, 3.2). In Ethiopia, this option is hardly feasible since institutions at the local level are not well established. Where there are limited revenue sources and huge disparities between the levels of government, an upward transfer of revenue would become complex and difficult to administer. Moreover, there is no evidence that once the regions retain all the revenue sources the strategists would reduce their incentive to demand secession.[39]

The 'opportunists'' approach requires a system of revenue transfer that can appease their demand. But the appeasement policy does not serve very much in a developing federal system like Ethiopia, as revenue sources are very limited and unevenly distributed between the regions. It can also lead to unremitting claims for a disproportionate share from certain constituent units of the

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[36] Eduardo Aleman and Daniel Treisman, 'Fiscal Politics in 'Ethnically-Mined,' Developing, Federal States: Central Strategies and Secessionist Violence,'in Philip G. Roeder and D. Rotehchild, *Sustainable Peace: Democracy and Power Dividing Institutions After Civil Wars*, (2002), p. 120.

[37] *Ibid*, p. 118-119.

[38] *Ibid*.

[39] The danger of 'upward revenue transfer' is that the states or local governments can threaten the union at any time by halting the flow of revenue to the federal government.

federation. The problem is also that there is no guarantee that the desired result, i.e. reducing secessionist tendencies, will be brought about. The strategy of the 'ethnic entrepreneurs' remains a constant challenge in a multiethnic federal system, but renouncing the politics of ethnicity or not using it in every sphere of activity can reduce its impact. Otherwise, as Paul Henz warns in the Ethiopian case, 'excessive attention to ethnic demands can distort key priorities in economic development.'[40]

The development of a federal system could be vulnerable to the sudden shock of secession even in the absence of a constitutionally recognized right of nations, nationalities and peoples to secede. In Ethiopia, the impact of the manner in which the Eritrea referendum was held and the precedent it created is a challenge in itself. Moreover, over time the attribution of all issues to the rights of each ethnic group may develop from rhetoric into a reality which can create a real division between them. Furthermore, political parties are organized along ethnic lines and hold government power in the respective constituent units. Thus, they may tend to focus on local and, at times, personal concerns regardless of the possible adverse consequences on the nation at large. This may also undermine any serious political effort to build common values shared by all groups to counter the adverse effects. In this regard, we consider Professor Nwabueze's account of Nigeria's experience in the1960s as a warning to Ethiopia. He says:

> The 1960 Constitution of Nigeria enabled the parties in control of the regional governments to use institutionalized power to champion, at both the regional and federal levels, the interests of the tribes which they represented. The effect of this at the federal level was particularly unfortunate. It caused the federal government to be regarded as a single huge cake, already baked, of which it was the duty of each tribal party to secure for its tribe as large a share as possible... The resulting situation was one of continued inter-tribal enmity and hostility.[41]

As has been repeatedly reiterated, the principal objective of inserting this rather strange constitutional provision on the right to secession is to deter any ethnic subjugation by another in the name of the unity of the nation. However, several countries have been successful in achieving this objective even without resorting to a federal system. It is equally, if not much more important to use other constitutional devices to guarantee a meaningful protection of civil and political rights, and, more than that, to build genuine federalism by being committed to the institutions of the Constitution. Above all, federalism works as an alternative to secession only if the minimum conditions for its existence are fulfilled, one of which is to guarantee that it is adopted as a preferred solution to secession.[42]

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[40] Paul B. Henz, 'Ethiopia and Eritrea in Transition: The impact of ethnicity on politics and Development Opportunities and Pitfalls,' in Harold Marcus (ed.) *New Trends in Ethiopian studies: Proceedings of the 12th International conference of Ethiopian studies*, vol. II (Lawrenceville, N.J, Red Sea Press, 1994), p. 123.

[41] B. O. Nwabueze, 'Constitutionalism in the Emergent States,'126 (1973) as quoted in Minase Haile op. cit., p. 8.

[42] See Preston King, *Federalism and Federation* (London, Croom Helm, 1982); and Ivo Duchacek, *Comparative federalism: The Territorial Dimensions of Politics* (Lanham, University Press of America, 1970). Both argued that secession does not go along with implementing federalism.

4 THE DANGERS OF FISCAL DECENTRALIZATION IN AN ETHNIC-BASED FEDERATION

The need for decentralization can exist for several reasons, but these can be reduced to two major reasons: to increase the efficiency of government and to accommodate different forms of diversity. But decentralization may not be without adverse consequences and pitfalls. For instance, the division of powers and functions between the central and subnational governments is in order to efficiently perform and to better suit local demands, but there can also be a tendency to undermine efficiency.[43] This could be related to the problem of a lack of skilled labour, weak governmental institutions and dependency on centrally-transferred revenue at the local level. Decentralization can also be accompanied by widespread corruption at the local level. It can increase interpersonal and interjurisdictional income and development disparities. Furthermore, the stabilizing role of the government and the execution of economic policies can become difficult because of spending by several layers of government. In this regard, economists and political scientists have repeatedly posited that the dangers of decentralization can be prevented if the necessary precautionary measures are taken before implementing the decentralization programme. One of them could be limiting the degree of decentralization to the level of responsibility that local authorities are capable of carrying out.

The adoption of federalism in Ethiopia is envisaged to promote equality, self-administration and fostering economic development. In terms of fiscal decentralization and economic development, the objectives purport to be related to the 'facts of federalism' where it is aimed to promote local participation, to better express local preferences and to achieve efficiency. Although federalism has been hailed as an instrument to solve the predicaments such as domination, economic imbalances, poverty and the lack of good governance, a lot has to be done to address these problems. It is obvious that there are plenty of reasons and complexities explaining Ethiopia's predicament, but the problems that are linked with giving utmost importance to ethnicity should not be underestimated. Thus, in this section we focus on the dangers of fiscal decentralization in an ethnic-based federation such as Ethiopia.

There is an apparent contradiction in the nature of a fiscal federalism that follows the devolution of power to local levels to distribute revenue equitably. While the ultimate objective of fiscal federalism is intended to promote national development by involving the participation of subnational governments, the process of revenue transfer requires the shifting of resources from the developed and efficient regions to others (because of its aim to equalize the revenue capacity of the constituent units). This approach normally involves conflicts, but it becomes serious in multiethnic federations. This is because, besides promoting equality between states, the objective should also be to promote interethnic equality and to ensure economic development. Such a system requires legal and political factors that can contain interethnic conflicts by narrowing down the economic disparities. However, in the case of ethnic-based federalism the

[43] For the details of the discussion on these problems see Remy Prud'Homme, 'On the dangers of decentralization', (World Bank Research Observer Vol.10 No. 2, 1995), p. 201-220; Vito Tanzi, 'On Fiscal Federalism: Issues to Worry About' http://www.imf.org/external/pubs/ft/seminar/2000/fiscal/tanzi.pdf , accessed on 15/08/2002. Also see, Roy Bahl, 'Implementation Rules for Fiscal Decentralization,' at World Bank, 1997 www.Worldbank.org/html/fpd/urban/mun-fin/toolkit/implementation.html, as accessed on 15/08/2002.

problems are to be addressed by using ethnic solutions, but the solution itself contains an apparent paradox to the federal system. This is because this kind of approach has a tendency to complicate overall interstate (at times interethnic) relations, to undermine the effects of intergovernmental fiscal relations, and to exacerbate a negative perception of ethnic groups towards each other. Let us look at these points in more detail.

First, fiscal decentralization encompasses the devolution of economic and political powers to the state and sub-state levels, but cannot guarantee the capacity of each government to move at a comparable pace. Although many factors contribute to this, organizing regions or subregional levels only on language criteria is not helpful economically. This is because it is very likely that each regional or. subregional government will demonstrate a different pace of economic development. This degree of difference in the rate of development can lead to a politically sensitive fragmentation of the national economic system, resentment and the perception of inequity.[44] Further, the system accentuates ethnicity and enables 'ethnic entrepreneurs'[45] to seize power and perceive all power relations with the centre and with states in terms of interethnic relations. As a result, ethnic elites can easily aggravate the facts of the different pace of development and interpret these as injustice, inequality and favouritism. This kind of perception generates a discernible danger to the system as a whole.

Second, as we have mentioned it elsewhere and in particular under Chapter V, the existing interregional disparity is the major concern for Ethiopian federalism, in general, and the system of intergovernmental fiscal relations, in particular. As has been repeatedly mentioned, regions are polarized into relatively developed and least developed regions, which demonstrate disparity in terms of population, economic capacity, size and geographical convenience. Having these disparities, the system strives to transfer revenue from one level of government to the other to enable them fulfil expenditure needs and achieve an interregional and an interethnically equitable transfer.

Normally, the system of revenue transfer faces a dilemma between reducing disparity by assisting poor jurisdictions and raising the level of development of the nation by spending in relatively better-off (developed) regions and in places which are conducive to investment. Spending in the developed regions can accelerate economic growth, while spending in the least developed regions implies a lower rate of return since its main objective is to narrow the disparity between the regions. Such equitable distribution means a lower share for the better-off regions by transferring a higher portion of revenue to the poor regions. But this has a greater danger of creating inefficiency (as it is disincentive to efficient regions).

In relation to the above dilemma, the major concern is how the constituent units perceive the continuous challenge of securing interethnic equality on the one hand, and the need to spend in a relatively developed region, on the other. How do better-off regions or regions with potentially better economic prospects perceive the higher share of transfer to less developed regions, and will they accept this? There is a threat, according to Aleman and Treisman, that ethnic entrepreneurs may easily trigger interethnic suspicions and economic

[44] Joshua Lincoln, 'The Effect of Federalism on Inter-group Relations in Multiethnic States: Evidence from Nigeria and Ethiopia,' (UMI, Dissertation Services, 2000), p. 234.
[45] In this thesis the term 'ethnic entrepreneurs' has been used to refer to politicians who 'play the ethnic card' in a bid for political power and campaign on an ethnic-nationalist platform.

marginalization.[46] A system of intergovernmental fiscal transfer in a highly diversified and imbalanced environment encounters serious problems which can easily be taken advantage of by ethnically-minded politicians and interpreted as ethnic inequality.

Fiscal decentralization can intensify interethnic rivalry in order to act parochially at the state or sub-state level, or to dominate the centre. It can even be serious and exacerbate people's perception of unfairness regarding revenue transfer and developmental priorities in a federal system marked by ethnic politics. In Ethiopia, for instance, at the state level, the crisis in the SNNPR and the conflict between Agnuak and Nuer in the Gambela region are mainly concerned with dominating the resources transferred from the centre to the states.[47] In the long run, one can imagine the impact of such rivalry for fiscal dominance even at the centre, particularly in cases where some regions stand out as the major source of national revenue. It would be an easy matter to arouse resentment if the usual rhetoric on petroleum exploration becomes a reality in the Somali, Gambela, or Oromia regions, as was the case in the Niger delta in Nigeria where the regions considered themselves to be victims of the Nigerian transfer system.

Another problem which the fiscal system faces is administrative inefficiency at the centre, state and local levels.[48] Several reasons can be mentioned but ethnic politics or political expediency can play a major role. In Ethiopia, for instance, the paucity of skilled labour in the newly emerging regional governments is the major complaint repeatedly heard at the federal and regional levels. In practice, however, many argue that there is a preference for using unskilled labour rather than promoting the free flow of labour to those complaining regions.[49] Actually, this problem can partly be attributed to the consequence of the 'sons of the soil'[50] theory which follows the politics of ethnicity and territorial organization along ethnic lines.

In relation to the inefficiency problem, there is also a danger of corruption and fiscal profligacy. Although there are divergent views as to whether there is a direct relationship between fiscal decentralization and corruption,[51] in Ethiopia, corruption has not shown a reduction in its magnitude and its nature has become more subtle. One of the causes is the fact that powers devolved to local based political organizations even before local governmental institutions were put in place. Recently, there have been efforts to curb corruption and financial embezzlement, but many complain about slow progress because the same people and organizations are vested with the new task. Generally, local governments are still vulnerable to corruption, a lack of skilled labour,

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[46] Aleman and Treisman, *op. cit.*, p. 121.
[47] See, for instance, Chapter III, 2.4.5 above.
[48] For a general discussion, see Prud'Homme, *op cit.*; and Tanzi, *op cit.*
[49] See, for instance, Maimere Menassemay, *op cit.*
[50] Weiner explains the theory that when local ethnic politicians find themselves unable to cope concerning jobs or education, they turn to those who claim the 'sons of the soil' right to be given preference as they complain that they were born on the land of the locality while considering others to be intruders. This theory hinders the interregional mobility of labour. According to him, many of the states in India have experienced this problem. However, it cannot be compared with the 1960s violent acts in Northern Nigeria when the southern educated civil servants were dismissed and some of them were killed by the northerners. See Myron Weiner, *Sons of the soil: Migration and Ethnic Conflict in India* (Princeton N.J., Princeton university press, 1978).
[51] Prud'Homme and Tanzi argue that as power devolves corruption becomes widespread at the local level.

hindrances in the movement of labour, and more than anything else a lack of understanding on the part of local politicians concerning their spending responsibilities for development. The overall effect could be a danger of widening the gap between regions and between local governments by engendering diversified rates of development which could be difficult to address through transfer mechanisms.

When income disparities are relatively low and when natural resources are not exploited in one region or locality only, the system of fiscal decentralization in particular, and the federal system in general may function relatively easily. However, if these facts change due to the exploitation of natural resources, or due to inefficiency, ethnicity can easily trigger centrifugal tendencies and pursuing the policies of fiscal federalism could become difficult.

It is equally important to consider the impact of the above issues on the role which the private sector can play. When assigning powers and functions to the layers of government, the private sector is assumed to be a good partner in major development activities (and the provision of goods and services). However, the private sector (domestic as well as foreign direct investment) serves as a good partner in a system where a secure and predictable political foundation exists. It can invest or engage in economic activities if the legal and administrative institutions effectively work to create transparency and accountability, and the system does not inhibit the potential mobility of labour, goods and capital. However, when ethnicity and decentralization intertwine they could easily work to reinforce visible or invisible barriers to these factors. For instance, recently the federal government was forced to deploy its army in the Gambela region to provide protection to a foreign company engaged in oil exploration since the investment was being frustrated due to the conflict between the local ethnic communities of *Agnuak* and *Nuer*.

5 SOME ADDITIONAL REMARKS BY WAY OF CONSLUSION

The underlying objective of intergovernmental fiscal relations is to address the disparities attributed to revenue capacities and expenditure needs. It also has the objective of diffusing tensions between constituent units. Pursuing all these objectives requires the transfer of higher per capita revenue to the poor regions. Even if this transfer can be considered 'equitable', there is still much amiss in the Ethiopian system of federalism. This is because:

> In the context of a federal structure that emphasises ethnicity alone its implementation is fraught with serious difficulties. As noted, ethnic based governments have a tendency to view themselves as primarily concerned with the welfare of their own citizens with little or no incentive to share income or resources with other ethnic groups. Compelling them to share their resources, constitutionally or otherwise, is possible, but this will sooner or later create resentment and become a source of political friction and instability.[52]

Moreover, there is a huge asymmetry between the regions and they have considerable financial disparity between them. At the worst, some regions lack the skill and the financial and economic strength to administer themselves. The arguments in this chapter consider that the system of intergovernmental fiscal transfer is an effective tool towards maintaining the federal system. We have also seen that the system of intergovernmental fiscal relations alone cannot solve

[52] Alemante, op. cit., p. 103.

all economic issues in general and equitable distribution of resources in particular. In fact, fiscal federalism is important in addressing most of these issues in order to promote economic development. It must be combined with other appropriate legal and political measures to avoid complex contentious issues. However, we have seen, on the contrary, the impact of excessive ethnic demands in territorial organization, and the right to state creation and secession. Thus, this chapter strongly suggests that, among other things, the existing regional asymmetry should be reduced by balancing the ethnic factor with other economic, territorial and historical factors. [53]. In this regard the suggestion focuses on three areas of reform.

First, so long as continuous state creation and even the right to opt out of the federation exist as constitutional rights, the federal system could be vulnerable to agitation in the name of these rights, at times, with devastating consequences. The *raison d'être* behind constitutionalizing these rights is less persuasive. Who benefits from this kind of arrangement? Would this be a virtue to the nation at large or will it lead to some kind of catastrophe?[54] As long as the right to secede is conferred on every nation, nationality and people, the survival of the federation will be dependent on the will of the sovereign constituent units. This will render the federal government weak. According to many scholars it is this preference for diversity over unity which would make the federation fragile at a time of crisis. Thus, although one cannot claim that dispensing with the right to secession can alone solve all the problems, the federation should exist without any uncertainty as to its survival. There should not be any ambiguity concerning maintaining unity within the federation.

Second, according to the Constitution territorial reorganization is left to the groups and the states concerned. If an efficient federal system is sought and if an effective fiscal transfer system that can help maintain meaningful relations between the centre and the states is needed, reform may be needed. If this is the case, it should focus on two factors: territorial reorganization should also consider other factors such as reducing asymmetry and future reorganizations and state creation should consider the involvement of the federal government, the state and the concerned group seeking the territorial change.

With regard to state creation, the language based approach has not only created permanent asymmetry between the subnational governments in size, population and economic resources, but it also generates conflicts between ethnic groups. One can point to the conflicts between the two major ethnic groups in Gambela and the tension between majorities and minorities in Harari, SNNPR, and B.

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[53] As Paul Henz remarks, excessive ethnic demands in legal and financial relations should also be reduced so that its threats and adverse consequences can be reduced. Paul B. Henz, 'Ethiopia and Eritrea in Transition: The Impact of Ethnicity on Politics and Development Opportunities and Pitfalls', in Harold Marcus (ed.) *New Trends in Ethiopian Studies: Proceedings of the 12th International Conference of Ethiopian Studies*, (Lawrenceville, N.J, Red Sea Press, 1994), p. 126:'

[54] Merera (op. cit.) argues that it is an attempt to impose hegemony of one group over the rest of the groups in the country. For Professor Mesfin, the Constitution is neither ethnic nor federal, but an imposition of an undemocratic system under the pretext of equality of nations, nationalities and peoples. According to him, it is simply a perpetuation of military autocratic rule (Mesfin Wolde Mariam, *The Horn of Africa: Conflict and Poverty* (Commercial Printing Press, Addis Ababa, 1999). Many other authors (see for instance, Minase, op. cit.; Alemante, op. cit.) cast doubt on the success of the federal system. On the whole, it can be said that, unlike its predecessors, the federation has many groups of actors included in the orders of government in its attempt to accommodate diversity.

Gumuz. The problems could partly be addressed if territories would consider other factors that can reduce territorial, population and economic disparities. This could result in proportional regional governments by reducing the size of Oromia, Amhara, Somali and SNNPR. It can also halt the tendencies of creating many more tiny states in those territories inhabited by several ethnic groups.

If regions were reorganized in line with the above recommendation, it would narrow the degree of asymmetry mentioned above, reduce the possibility of ethnicizing economic and non-economic factors, and address historical realities.[55] Intergovernmental fiscal relations would become more effective in addressing economic disparities, the level of poverty and actual expenditure needs, as the new regional governments would have less disparity in size and capacity. The other dimension is that fiscal relations, for example transferring revenue from the rich to the poor regions, may not be easily ethnicised. On the side of state creation, it would avoid the continuous redrawing of state boundaries for every nation, nationality or people.

By reorganizing states that can counterbalance and compensate other factors of asymmetry (such as economic resources, size, religion and human resources), the federation can still maintain unity in diversity. However, if the tendency of developing a sharp cleavage between the nations, nationalities and peoples continues, it will undermine the forces of unity and at times frustrate the very foundation of the federation.

Third, whether or not the above mentioned reforms are carried out, there is much to be done in promoting horizontal and vertical intergovernmental collaboration since the performance of governments can barely be enhanced by revenue-transfer mechanisms alone. As power is decentralized from the centre to the local levels, the need to address the economic disparity between these layers of government becomes significant. Thus, multidimensional relations between the centre and the regions, between the regions themselves and involving the private sector must be encouraged. In addition, revenue transfer should be accompanied by fiscal discipline. This includes implementing specific grants for selected developmental sectors of the regions. Moreover, the country should benefit from exploiting its human capacity by introducing and executing legal instruments that can maintain the objective of promoting one economic community and guarantee the free movement of individuals, labour, capital and entrepreneurs.

In general, it can be said that, unlike its predecessors, the federation has included many groups of actors at local, regional and federal levels in its attempt to accommodate diversity. But if the Ethiopian federal system has to succeed, if we are talking about a federation that continues to exist, or if EPRDF wants to leave a lasting legacy, then sole reliance on ethnicity that deals with all political, economic and social problems has to ber reconsidered. The federal arrangement should also accommodate other factors (such as economy, history), the territorial and economic asymmetries should be minimized and should begin from a centralized federal system rather than ascribing all rights to ethnic groups.

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[55] However, it does not necessarily consider the restoration of the pre-1991 territorial reorganizations, as often called as provinces or administrative regions. For some of the historical reasons, see Chapter I. For the detailed discussion of these issues from a historical perspective, see Bahru Zewde, 'What did we Dream? What did We Achieve? And Where are We Heading?'(Economic Focus: Bulletin of the Ethiopian Economic Association, Vol.5 No. 3, 2003), p.13-26.

9 Conclusion and Recommendations

1 CONCLUSION

1.1 Research questions

In conclusion, let us now turn to the two main questions asked earlier in the introductory chapter. The first of these questions was what form of fiscal arrangement is developed in the Ethiopian federal system. And the second question was concerned with whether the implementation of fiscal federalism operates to sustain the federal system. These major questions entailed a number of further questions which are discussed to investigate the implementation of fiscal federalism and to find the limitations that need to be addressed.

- How are the expenditure responsibilities and the revenue raising powers divided between the federal and regional governments and does the Constitution explicitly recognize shared powers?
- The related and most important issue is the degree of financial imbalances between the federal government and the states and among the states, and what it suggests to the fiscal arrangement developed in the Ethiopian federal system. In this regard, what form of intergovernmental revenue transfer system is implemented and can it sufficiently address the problems of vertical and horizontal imbalances?
- What form of intergovernmental cooperation exists and to what extent does the law regulate it?
- To what extent does the implementation of fiscal federalism underpin the federal system that operates within a high degree of asymmetry? Can it sustain the federal system with its peculiar features of the right to state formation and secession of nations, nationalities and peoples?

1.2. General conclusions

The above questions entail the analysis not only of the constitutional form but also the practice as observed so far. The major findings on these questions are discussed from chapter three up to chapter eight. The First and the Second Chapters, by providing background to the state history of Ethiopia and by analysing the theories of federalism and principles of fiscal federalism, demonstrate that the peculiar approach of the FDRE Constitution, although it aims to accommodate diversity may reinforce regional disparities, may lead to weak administrative institutions and may make it difficult to secure fiscal responsibility. And this could pose great challenges to the processes of intergovernmental fiscal relationships.

Chapters Three and Four answer the question on how the expenditure responsibilities, and the revenue raising powers and shared powers are divided.

In Chapter Three, it is argued that the division of expenditure responsibility is the reflection of the legislative and executive power relationship between the federal and regional governments as envisaged by the Constitution. However, when the

constitutional allocation of legislative, executive, and taxation powers between the regions has been applied symmetrically, it is through intergovernmental cooperation that one can address the difference in implementing capacities. But as this study illustrates, the system lacks a coherent regime of intergovernmental cooperation and viable constituent units, and the Constitution is not always clear about the division of powers as to which will be administered by federal and regional governments respectively. Moreover, the existing intergovernmental cooperation operates through extra-constitutional mechanisms, i.e. mainly through a highly centralized party system and structure. This chapter also contends that the implementation of the expenditure responsibilities considerably varies between the states due to factors (such as capacity constraint, corruption, uneven extra-budgetary sources and local conflicts) which may have serious repercussions on the provision of goods and services, proportional development and fair distribution of resources.

Chapter Four discusses the division of revenue raising responsibilities between the federal and regional governments as laid out in the Constitution. It contends that the method of dividing tax powers followed by the Ethiopian Constitution differs from many federations by constitutionally delimiting the tax sources for each government and by adopting a different approach regarding concurrent powers of taxation. By doing so, it limits the possibility of broadening the tax bases. Moreover, we found that in practice some tax sources are unduly centralized although it recognizes the reasons for centralizing most of the lucrative sources. It also explains the types, nature and reasons of the limitation of taxation power of the two tiers of government in Ethiopia. We conclude that there are certain restrictions imposed on the types of taxes assigned to a government for the purpose of preventing unfair treatment of individuals of a particular region, for the smooth functioning of the economy and to prevent a region from unduly benefiting at the expense of the federal government or the other regional governments.

One of the most crucial problems of federal-state fiscal relations concerns the ability of state governments to finance the execution of their functions, to which reference was made previously: to vertical and horizontal imbalances.

Chapter Five explores the administrative, economic and political factors that have contributed to the high degree of imbalance between and at the various levels of government and the difficulties of the mechanisms for correcting this. If regions have to function as viable constituent units, the vertical as well the horizontal financial imbalances have to be reduced. It is argued that although there are several reasons for horizontal imbalance, the territorial organization of the states and the socio-demographic asymmetries between them are the major contributing factors.

Chapters Six and Seven regard the question what form of intergovernmental revenue transfer system is implemented and whether it can sufficiently address the problems of vertical and horizontal imbalances.

Chapter Six, after laying down the general objectives and types of revenue transfer, elaborates the principles of intergovernmental revenue transfer that one observes in federations. After this background has been laid, Chapter Seven analyses the system of intergovernmental transfer which primarily aims to address the imbalances between and within the levels of government in Ethiopia. It studies issues concerning the sharing of joint revenues, the use of conditional

and unconditional federal transfers, and the institutional framework which decides on the transfer system. It analyses the impact of the *de facto* asymmetry between the regions and the extent of regional dependence on federal transfer. It also discusses the impact of federal transfer on regional autonomy. Choosing the degree of balancing the financial capacity through revenue transfer mechanisms (by allocating grants) is a political judgment. Who are to be equalized and to what extent they could be equalized is one major problem.

In Ethiopia, the practice is to equalize the financial capacity in terms of the level of development between the nine states, but constitutionally it is also required to equalize the nations, nationalities and peoples of the country. Since regions are dependent on federal grants, the grant formula could remain a battleground not only between the territorially defined tiers of government but also between the nations and nationalities. This chapter argues the importance of reducing the existing socio-demographic and territorial asymmetry between the regions while emphasizing the need to promote solidarity between the diverse groups and not to engage in regional and financial fragmentation.

Chapter Eight assesses the Constitution in light of the findings on the fiscal aspects of the Ethiopian federalism. It addresses the question whether the fiscal federalism as practiced at present in Ethiopia can sustain the federal system with its peculiar features of the right to state formation and secession of nations, nationalities and peoples We argue that the implementation of fiscal federalism in Ethiopia in the long run cannot sustain the federal system. This is because the successful implementation of fiscal federalism can be threatened by the prevailing regional asymmetry, the right to state formation and to secession. Moreover, the above factors coupled with fiscal issues can be utilized for promoting centrifugal tendencies. Thus, this chapter puts emphasis on reducing the factors which contribute to regional financial fragmentation or to centrifugal tendencies.

This study has highlighted the most important features of the federal fiscal arrangement in Ethiopia. The analysis has focused on a number of issues which are related not merely to the constitutional arrangement but also to the operation of institutions. Our review of the Ethiopian experience essentially illustrates the political and constitutional implications of fiscal federalism. As discussed in Chapter Seven, the primary problem of Ethiopian fiscal federalism is a marked disparity in size, revenue effort, performance capacity, ethnic composition and political make-up between the regions. The practice can also be characterized as a complete acquiescence in decisions taken by the political leadership through federal and regional governments. Thus, the potential variations and competitions envisaged by the Constitution are camouflaged by the fact that political decisions emanate from the same political body that controls powers at the tiers of the central as well as regional governments. However, it is possible to envisage that the *de facto* power relationship may change over time guided by the Constitution.

This book, among others, agues that the federal arrangement is an essential instrument to provide a framework for the organization and distribution of resources, benefits and burdens between the heterogeneous societies of Ethiopia. However, by following ethno-linguistic criteria as a primary factor for territorial organization and political and administrative structures, the functioning of the federal system can be threatened. This is because the implementation of fiscal federalism will be influenced by the core values of Ethiopian federalism

such as the right of nations and nationalities to state formation and secession, as well as due to the prevailing asymmetry pertaining to territorial, demographic and human and financial capacity.

Some of the recommendations which follow focus on the main analytical and empirical tasks of the study of fiscal federalism so as to better define the powers and responsibilities, the revenue sources, and the mode of intergovernmental fiscal transfers. However, the main arguments lie in two issues. First, it is argued that vertical as well as horizontal intergovernmental cooperation should be promoted. This is because the existing marked differences between the tiers of government concerning economic activities, tax sources, human and administrative capacities, and infrastructural developments cannot be addressed solely by the transfer of revenue.

Second, fiscal federalism is implemented primarily to address the financial capacity of the territorially defined tiers of government. In a country where there are not less than 80 sovereign ethnic groups with their right to state formation and secession, an equitable distribution of resources cannot be an easy task. Thus, this thesis argues that there should be a territorial reorganization that focuses on equalizing the states by balancing the ethnic factor with the geographic, economic and historical realities of the country. This should aim towards establishing balanced, viable and effective states. At this stage it is difficult to give precise criteria on how to reorganize the constituent units. First and foremost, it depends on the political willingness and readiness for negotiation between different political parties and on the consent of the people. However, the study in this book has revealed that territorial restructuring of the constituent units should address the *de facto* asymmetry in terms of geographical, population and economic capacity, the problem of administrative capacity, and the need to bring administrative convenience. It should also address the existing interethnic conflicts and aim to halt any centrifugal tendencies. Taking the above factors into account may result in restructuring the largest territories of Oromia, Amhara, SNNPR and Somali, and combining the smallest state of Harari and its contiguous administrative territory of Dire Dawa.

2 RECOMMENDATIONS

To make the operation of the federal system effective from the fiscal perspective, we submit for consideration the following recommendations which focus on the division of responsibilities, the method and institutions of intergovernmental transfer, the importance of institutionalized intergovernmental cooperation, reducing the regional asymmetries and balancing the ethnic factor with economic, geographical and historical factors.

2.1 The division of powers, responsibilities and revenue sources

A. Power sharing

- The division of powers and responsibilities are primarily determined by the Constitution and are implemented by a centralized policy where the centre dominates the power framework. This conventional approach, however imperfect it may be, is guided by the Constitution. It is important, as far as possible, to clearly demarcate the area where the centre and the regions can cooperate. With this in mind, it is recommended to explicitly provide in the

Constitution for the objective of promoting cooperation considering the administration and financial implications, or to follow an interpretation of some of the constitutional provisions which leads to the occurrence of shared responsibilities in the form of concurrent, framework or parallel powers (see Chapter III). This approach will help to identify the areas of cooperation, the manner of central influence over regional and local matters, and the allocation of finances subject to specific conditions. It also aims to increase the role of regional governments in the implementation of national policy matters.

B. Subregional decentralization

- As discussed in Chapter III, there has been a deconcentration of administrative power to the subregional levels where the weredas have remained largely dominated by the zonal and regional bureaus. But they need autonomy to better express their local preferences. The recent initiative to empower subregional governments (see Chapter VII) is likely to reflect the principles of decentralization, but this massive change should take crucial issues into consideration. First and foremost, the transfer of finance should follow powers and functions, not precede them. It should take into consideration the human, administrative, infrastructural, financial and, in general, institutional capacity. For instance, it should consider the difference between urban and rural, the agrarian and pastoral local concerns and capacities. It is recommended that the powers and responsibilities should be identified statutorily or by state constitutions so as to determine which functions are devolved, delegated or deconcentrated. This is to identify the appropriate expenditure tasks of local governments, in what areas the regional or central government could have an interest, and how to best design the intrastate transfer system. It is also important to define the area of vertical or horizontal cooperation between the weredas and the regional government, between the region, zones and weredas, and between the weredas themselves. Giving wider discretionary power over fiscal matters without appropriate institutions that can secure accountability could have adverse consequences. Thus, the need to ensure the accountability of local spending decisions should be given utmost priority.

C. Constitutional allocation of tax sources

- Concerning the system of assigning the tax powers, the FDRE Constitution follows the division of tax sources and by doing so limits the power to broaden the tax base and levy taxes. Also the Constitution has the anomaly of allocating tax sources. For example, the allocation of the levying of payroll taxes follows the employer not the employees' residence. In principle, residents should pay taxes to a government in relation to the benefits they obtain from the place where they reside. Therefore, the system should be amended to give the power of levying income taxes over public or private enterprises' employees, employees of international organisations, and NGOs to the local government where the employees reside.

The allocation of taxes concurrently (in the Ethiopian context, see Chapter IV, 4.2) to the regions and the centre is appropriate when there is an uneven distribution of sources of taxes under discussion or when they are movable in character. It is, therefore, necessary to review whether all the taxes subject to the concurrent list are mobile in nature, or are disproportionately confined

to a few regions (such as natural resources). For instance, allocating the levying of tax from a PLC engaged in an activity which does not have a movable character to the federal administration serves little purpose. It simply denies the states the possibility to levy taxes from such sources. It is therefore recommended to reserve such tax sources to the states. Further, it is essential to involve the states in the administration of shared taxes. If the states participate in the administration of concurrent taxes, it will increase the efficiency of tax administration and enable them to estimate their share.

D. Institution for re-allocation of tax powers

- As repeatedly pointed out, the tax powers are apportioned in relation to specific tax sources. Thus, it is possible to envisage the existence of undesignated types and sources of taxes which are not assigned to either level of government. The reallocation of such undesignated tax sources shall be determined by a joint meeting of the Federal Houses. Further, tax laws are subject to frequent amendments in light of the changing economic and social circumstances. These will necessitate the establishment of an institution which assumes the duty to study the overall performance of taxation and the changing conditions and submits recommendations to the Federal Houses on the need to introduce new taxes or tax sources, to amend the Constitution or to re-evaluate the taxation system (see below, the recommendation on the grant commission where both tasks can be carried out by one and the same institution).

2.2. Intergovernmental revenue transfer

A. Review of revenue sharing

- The revenue sharing scheme (see Chapter VII, 2.1) follows the constitutional allocation of taxes administered by the federal government but shared with the states (i.e. concurrent taxes). The sharing of revenue from such taxes can help to reduce the fiscal dependence on federal transfer and to make the regions responsible for their own revenue. This sharing will also enable the states to estimate their own revenue capacity and to plan ahead for the utilization of their share of revenue.

  The recently introduced revenue-sharing scheme of concurrent taxes has, strictly speaking, neither a derivative nor a redistributive objective because the place where the company is incorporated may not necessarily be the place where all the taxes are withheld by the company or paid in the form of corporate income tax. For example, a company or a business entity collects VAT or TOT from its sales throughout the branches but transfers them to the revenue authority at the place of its incorporation. That means that all forms of taxes paid by companies incorporated in Addis Ababa, but doing business throughout the country, are therefore administered by the federal government but shared only with the Addis Ababa administration. Thus, the actual taxes withheld but not accounted for by a company at the place of its incorporation require a systematic analysis that can guarantee a share for the region in which the company is not incorporated, but where the taxable item is generated or sold. The actual sharing of the tax among the regions should be assessed according to an accounting or formula basis, depending on the

appropriateness of the method, but should guarantee the share of the regions where the companies are engaged in business and have withheld taxes.

B. The grant formula

- The officially allocated federal grant to the regions/states is based on formulas with population and the level of development as the main variables (see Chapter VII, 2.2). This is an attempt to distribute resources equitably. But it has encountered many problems and requires improvement in terms of equitable distribution and securing accountability. In general, the transfer of a very large proportion of unconditional grants assumes accountability sanctioned through local citizens' active participation, institutional strength, performance evaluation, and an internal auditing system. The transfer system should be designed to secure equity but should avoid any disincentive effect. In particular, it should focus on measuring the financial disparity and the expenditure needs of the regions. The variation in the cost of expenditure needs, however, should focus on some important responsibilities that can be efficiently executed by the regional governments, for example, in primary education, improving agricultural productivity, health and water sanitation. This is because it is practically impossible to measure all the expenditure needs of a government.

C. Extra-budgetary sources

- Despite the federal government's policy to consolidate all foreign aid, NGOs' contributions, and other extra-budgetary sources so that they can be utilized for an equitable distribution of resources, there are still extra-budgetary sources in some regions which are not accounted for in the federal or regional budgets (see Chapter III, 2.3). The study has revealed that the regions have significant differences in drawing on extra-budgetary sources. As a result, the variation in the extra budgetary flows to the regions has been considered as one of the major factors in the financial disparities between the regions. Thus, account should be taken of the existing extra sources of aid, federal spending, NGOs, and similar other sources from multilateral institutions in the process of the equitable distribution of the entire national resources to the regions. This should be taken into consideration not only at the federal level, but also in the transfer and allocation of budgets within the regions. However, care should be taken not to rely on aid or extra-budgetary flows which are not certain.

D. General and specific purpose grants

- The revenue-transfer system should combine general and specific purpose grants. The objective of a general-purpose grant is to enable all the regional governments to provide the basic services within their administrative capacity at a proportional level of revenue capacity. The specific purpose transfers, on the other hand, are intended to ensure the provision of specific public services or implementation of projects by the states. As the centre and the states are responsible for such purposes, it can improve efficiency, accountability and cooperation between the centre and the regions. Designing specific-purpose grants enables the centre to cater for the needs of the people in specific localities, to protect the special interests of minorities, or to give priority to problems of national concern (see SDPRP document, e.g. food

self sufficiency). In this regard, it is important to consider problems related to equitable distribution, planning, prioritizing and executing projects financed by aid, the budget offset system, the unpredictable nature of aid, and the regional administration of projects financed by foreign aid. The problem could be reduced if projects financed by foreign aid or loans are treated separately as special purpose grants.

The above recommendations will be effective if they are supported by the following recommendations.

First, data: There is a need for good quality and genuine data. A revenue transfer system based on incomplete and less reliable data will not serve the intended purpose of a fair distribution of resources and equalizing the financial capacity of the regions. Therefore, acceptable data must be available and the data should be of good quality across the regions.

Second, an independent grant commission: To balance the bargaining position of the constituent units, to measure fairly the revenue and expenditure needs on a per capita basis, to collect and analyse data free from local manipulation, to ensure fiscal accountability, to study the fiscal imbalance in a poverty-stricken society, etc. we need not only rely on a biannual meeting of the HOF. There should be a professional, non-partisan and independent grant commission accountable to the Federal Houses.

Third, territorial reorganization: An equitable distribution of resources under the existing circumstances of a high degree of *de facto* asymmetry (see Table 1:1) is a difficult task. If no reform is undertaken, the practice of the last decade shows that it will continue to favour regions with modest territorial and population size. That means the grant formula remains the battleground between and within the regions. Thus, there should be a territorial reorganisation that focuses, as far as possible, on equalizing the states (also see No.4 below).

E. Additional policy measures

- However, only revenue transfer cannot achieve equity, because it can be overshadowed by the role of the private sector (market). The regional disparities could increase due to the role of the market and the regions' ability to attract private investment. A region with a better physical and administrative infrastructure, proximity to the market, and an efficient bureaucracy could attract a large share of private investment. This implies the necessity of corrective measures through governmental cooperation or policy directives in order to improve the competitive ability of the less efficient or less developed regions. At the same time, it requires the business regulation and competition to be free from undue political interference. At the very least, a law that prohibits political parties from engaging in business activities should be implemented to positively respond to the business communities' outcry on this.

2.3 The form of intergovernmental cooperation

The importance of intergovernmental cooperation in an asymmetrical situation is self-evident. Its objective should be to forge solidarity between groups at all levels of government by sharing material and human resources as well as

experiences in the execution of responsibilities and dispute resolution. Most importantly, the Constitution should identify functions which will be administered or financed by both federal and regional governments with decision making powers divided between them.

In Ethiopia, the need for establishing an institution for intergovernmental relations is obvious. However, as discussed in Chapter III, section 3.3, the process (of intergovernmental cooperation) has been dominated by the centralized party system and by the Ministry of Federal Affairs (MOFA). The use of the HOF as an intergovernmental institution has been less effective, while a powerful MOFA has made intergovernmental cooperation less visible. The ministry has been influencing the state governments through party channels either to enforce federal laws and policies or to assist the regions. Moreover, it did not establish formal relationships with all the constituent units, but only with the widely known less developed regions – Afar, Somali, Gambela and Benishangul Gumuz. Therefore, a formal institution for intergovernmental cooperation which can address these and other shortcomings (see section 2.3, Chapter III) of the present institutional mechanism is vital for the success of the federal system. In this regard, we recommend the following.

- An intergovernmental cooperation that circumvents undue central control but promotes equal partnership between the tiers of government should be introduced. This should be aimed at establishing an effective cooperation through an autonomous intergovernmental institution that can operate in cases where the opposition also shares power. To do so, the existing law establishing the MOFA should be revised or another law establishing an intergovernmental institution should expressly provide rules that create formal cooperation between governments as equal partners on common concerns. The institution should be composed of representatives of the executives of the regions on the one hand and the federal executives on the other. (Similar arrangements can be made by the states among themselves to promote interstate cooperation). The number of representatives from each state should be equal.
- The competence of the intergovernmental institution should focus on ameliorating the existing problems related to lack of resources, trained manpower and infrastructure by facilitating all forms of relations between the orders of government towards the efficient utilization of resources, administrative collaboration and conflict resolution. This can minimize unnecessary duplication of government institutions and wastage of financial resources. It can also assist in creating uniformity in some policy matters.
- The institutional mechanism should take into account the problem of different levels of development between the states; some are not able to take care of their own affairs while others could even be able to execute federal laws and policies. Accordingly, the institution, on the one hand, should sort out the responsibilities of the federal government and those states which can execute federal laws and policies, and on the other, the role of the federal government in assisting the least developed regions in executing their own responsibilities. This leads to establishing an asymmetric relationship between the federal government and the least developed regions in the sense that these are treated differently than other regions (for instance, see Chapter III, 1.6 and Chapter IV, 2.3.3).
- It is expected that the institution for intergovernmental cooperation works on compromise, mutual understanding and consensus because of its practical advantage for the states and the federal government as well. As has been

pointed out in Chapter II, section 1.4 and Chapter III, section 2.3, cooperation is an important element of almost all federal systems. This is due to the difficulty to divide powers and responsibilities neatly between the federal government and states, and due to the constitutional provision which requires the state executives to administer federal laws. Thus, cooperation is a good opportunity for the states to adapt federal laws to local circumstance during implementation. The federal government also retains the power of financing, supervising and monitoring the state administration of federal laws. However, it is expected that the institution, given time, would introduce a qualified majority vote of states on certain crucial matters.

- Finally, intergovernmental cooperation established either informally or by federal legislation could be formalized constitutionally. However, here the focus is that unlike the present institution which is solely controlled by the federal government, the recommended institution should recognize the regional governments as equal partners. This would satisfy the need for a normative framework for intergovernmental cooperation that recognizes the equal participation of all the stakeholders.

2.4. The need to balance ethnic identity with other factors

As noted in Chapters I and V, the major consequence of overemphasizing the 'sovereignty of nations, nationality and people' is that the regions vary in terms of their size, population, human and infrastructural capacity and ethnic composition. As a result, some of the constituent units exhibit a serious lack of financial, economic and human resources. Some of them are still struggling to establish a functioning administrative unit. Asymmetry exists not only across the regions but also within regions. In general, it is said that the discrepancy is great in the large regions and it is less problematic in a few regions with a modest population and territorial size. In reality, however, there are both small, inefficient and capacity-constrained regions, and large ones which are administratively slack, inaccessible, and prone to manipulation and embezzlement. This disparity has created anomalies in the process of measuring social, economic and demographic variations, and in the process of intergovernmental fiscal transfer. For instance, some poor communities continue to suffer in the so-called relatively developed regions. Generally, although the federal system is symmetrical in the constitutional division of powers and responsibilities between the regions, in reality it operates in an asymmetrical context. Therefore, in order to assist the less efficient regions, to narrow the existing regional disparity and to accommodate diverse interests, an asymmetrical constitutional division of powers could be an immediate alternative.

As noted, the transfer system results in the transfer of resources from relatively better off regions via the centre to the poor and inefficient regions. In the long run, this is likely to provoke resentment and secessionist tendencies from the relatively better off regions which view themselves as subsidizing the poor, and from the small and inefficient subregional levels in competition for statehood and a better share of resources. Such challenges can be contained if the regions are reorganized into manageable sizes reflecting comparable economic resources, promoting gains in efficiency, for administrative convenience, and fostering healthy interstate competition. Then, it will be feasible to equalize the revenue and expenditure needs of the regions. It is, therefore, recommended to reduce the disparity by creating two or more states from a single large regions such as Oromia, Amhara and Somali, now organized as single regions each merely

because they are mainly inhabited people of the same language group, or by merging some of the small regions or administrative levels such as the contiguous territories of Harari and Dire Dawa. Such restructuring should envisage creating balanced, viable and effective states. This recommendation brings us to the conclusion that alternatives other than maintaining the status quo or the tendencies of creating states for every nationality must be considered. It implies a territorial reorganization that takes into consideration the historical, geographical, demographic and economic factors. This requires a political commitment to balance the ethnic factor with the need to promote economic development, efficiency and accountability.

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