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Fiscal Federalism and Its Discontents: Theory and Policy

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Abstract: *A number of countries have pursued fiscal decentralization within a broad context of political and economic reforms to improve the performance of their public sector. Fiscal decentralization can potentially improve the allocation efficiency of the public sector and increase the capacity of a nation to address its pressing economic, social and political problems. The sustainability of such an approach is conditioned by the existence of effective democratic institutions and implementation capabilities. When political imperatives dictate the adoption of fiscal decentralization, however, the process would confront problems of the commons, capacity constraints and externalities that would limit the potential efficiency gains from decentralization on the performance of the public sector. This paper develops a theoretical argument on the economic rationale for and concerns of pursuing fiscal decentralization in a poor economy within a political environment of ethnic federalism. The paper discusses the current practice of fiscal decentralization in Ethiopia and outlines issue areas where fiscal policy could be used to address problem of chronic poverty, uneven regional development patterns, and improve the efficiency of public resource utilization.*

Key Concepts: *Fiscal federalism, vertical and horizontal fiscal imbalances, federal grants, ethnic federalism, economic growth, poverty.*

JEL Classification*: E62, H2, H41, H77*

1. Introduction

A growing number of countries have adopted fiscal decentralization in an attempt to improve the performance of their public sector. The process broadly entails decisions in identifying some optimal distribution of functions and powers between the federal and sub-national governments. This process of devolution of fiscal authority introduces specialization of functions, better identification of local factors, experimentation of democratic principles and changing the very relationship between the government and the citizen-voters in important ways.

Fiscal federalism is essentially the choice and distribution of fiscal decision-making power across multi-leveled governments. The experiences of reforming countries have been diverse and do not allow easy generalization. The practices of fiscal decentralization have diverse features and maturity across countries and yet exhibit a common departure from the practice of centralized fiscal system. The Centralized fiscal policy making, where interventionist, expansionist, corrupt, and inefficient government policies were pursued, failed to deliver efficient public services. This overriding experience created the temptation in a number of countries to experiment with some forms of decentralization of both political and fiscal power. Some countries implemented fiscal decentralization whereas others opted for de-concentration of centralized decision making without actual fiscal decentralization (Bird, 1993; Martinez-Vazquez and McNab, 2001). In some cases, fiscal decentralization followed the political imperative of establishing federal political structure whereas in others fiscal decentralization was put in place within a centralized political regime.

Fiscal decentralization has both economic and political effects. It can serve as one of the mechanisms to promote democratic institutions and expanding the quality, quantity and diversity of public services that suit the priorities of local populations. Nonetheless, undertaking drastic decentralization measures before local institutional capacity reaches some critical threshold level of policy implementation and evaluation capability at sub-national government levels might involve significant economic cost, inefficiency in resource utilization and contribute to breach of fiscal discipline (Tanzi, 1996, Prud'homme, 1995). After all, partial decentralization may not necessarily bring improved governance and accountability to the people at the grass root level that responds to local priorities and preferences. Moreover, a professional, honest and politically independent bureaucracy is a critical factor in the process of improving the performance of the public sector and in cultivating participatory decision making system. This is true both in centralized as well as decentralized fiscal regimes and yet the relative importance increases in decentralized fiscal setting.

The dust of theoretical and empirical arguments as to why countries adopt fiscal decentralization and how such measures affect the objectives of public sector efficiency, income distribution, macroeconomic stability and economic growth performance has not yet settled and remains to be a lively discourse. This paper explores the theoretical and policy issues and conditions that shape how fiscal decentralization in an underdeveloped economy could help improve the performance of the public sector, achieve fiscal discipline, promote macroeconomic stability and economic growth. It contributes to the emerging theory of fiscal decentralization and the policy discourse. The theme of this article is that the potential benefits of fiscal federalism are conditioned on the institutions and political economy arrangements of a country in which decentralized fiscal decision making could be translated into effective instruments to address core economic, political and social problems.

The rest of the paper is organized as follows. The next section reviews the main strands of the theory of fiscal federalism and develops a political economy argument on issues of fiscal decentralization. Section three reviews the main features of the fiscal system of Ethiopia. Section four discusses issues involved in the practice of decentralization and their economic implications in Ethiopia. The final section draws concluding remarks.

2. Fiscal Decentralization: Theory

Fiscal federalism and decentralization derive their nature and characteristics from constitutional provisions as well as the level of economic development, population size, urbanization, ethnic fractionalization, geographical sectionalism, the pattern of income and resource distribution, the institutional capacity of the system, openness to international trade, and the interaction of political economy forces that shape the principal-agent relationship (Panizza, 1988, Bahl and Nath, 1986, Martinez-Vazquez and McNab, 2001). The constitutional provisions define the framework within which decision-making would be exercised and establishes the vertical and horizontal structures that find meaning within the prevailing socio-economic environment of the system.

Fiscal decentralization is defined by the degree to which fiscal decision-making autonomy is devolved to independently-elected and locally accountable autonomous sub-national governments. Fiscal decentralization and how it is practiced also affects the other objectives of public finance, namely income distribution and macroeconomic stabilization. The ultimate economic effect of fiscal decentralization on the performance of an economy hence depends on these interactions and how these variables influence the growth and distribution of income opportunities.

What are the theoretical arguments for fiscal decentralization? The theory of fiscal decentralization addresses three issues related to fiscal decision-making: assignment of responsibilities and functions between the federal government and the sub-national governments, the assignment of taxation power and the design of inter-governmental transfers (subsidies) as well as other forms of financing. These factors give rise to a third issue of the relative size of the public sector in the national economy. It is therefore the dynamics of these processes and public policy choices that ultimately shapes the effects of fiscal decentralization on public sector efficiency, macroeconomic stability and overall growth performance.

2.1. Fiscal Function Assignment Issues

An important aspect of fiscal decentralization is the assignment of fiscal functions to the federal and the sub-national governments and the appropriate means of financing these responsibilities. The theory of fiscal decentralization does not provide a clear perspective on the optimal distribution of fiscal decision making authority and how such decisions are related to economic efficiency, growth and income distribution. The broad thrust of the theory is that expenditure responsibilities in areas of macroeconomic stabilization and redistribution functions should remain within the domain of the federal government whereas allocation functions should be assigned to lower levels of government (Oates, 1999; Shah, 1999; Musgrave, 1983).

The conventional theoretical discourse, following the tradition of Tiebout framework of “voting with one’s feet”, suggests that when there is sufficient heterogeneity in preferences across district administrations and high mobility of individuals, decentralized provision of public goods leads to competition and efficiency in public service delivery. Oates(1977) argued that decentralization is superior to central solution when there is sufficient heterogeneity in local preferences and no spillover effect in public service provision that is financed by uniform taxation. It also admits the possibility that when preferences are fairly homogeneous across districts and with weak spillover effects, centralized provision of public services might be more efficient.

The theoretical perspective broadly indicates that fiscal decentralization and the assignment of functions can potentially generate economic efficiency of the public sector. If preferences are heterogeneous enough across jurisdictions and local public officials can and do respond to local demands, decentralization can improve allocation efficiency by tailoring services to the preferences of the local population. It follows that local governments are closer to the local population and can identify their choices and preferences better than the central government (Basley and Coate, 1999). Accordingly, when the decision to provide a bundle of public goods is made by local officials and these officials are directly accountable to the local voters, there is an incentive for the local officials to provide the kind and amount of services that reflect the preferences of the local population. Moreover, as long as there is close relation between the benefits from public services and taxes on the local taxpayers, there is additional incentive to utilize resources efficiently and cost effectively. The decentralization theorem suggests that, under such assumptions and democratic political institutions, decentralization of fiscal decision-making authority improves allocation efficiency of the public sector. Whereas it is possible for both democratic and non-democratic regimes could exercise some forms of fiscal decentralization, the practice sooner or later confronts tensions when democratic institutions are not operational and effective.

Once the allocation of expenditure responsibilities is conducted according to such broad principles, the fiscal system needs to address the issue of assigning taxing power that broadly identifies who should tax, where and what (Musgrave, 1983). It is the devolution of taxing autonomy that gives meaning and identity to the devolution of expenditure responsibilities. In the context of fiscal federalism, the assignment process needs to identify the comparative efficiency and effectiveness of providing the fiscal instruments to the multi-tier decision-making centers so as to finance public functions and activities in the most efficient manner possible.

What kind of taxes should be assigned to the federal government and which should be assigned to the local governments? The theory and practice in the assignment of taxation power identifies the following main criteria in assignment process: taxes on mobile tax bases, redistributive taxes, taxes that could easily be exported to other jurisdictions, taxes on unevenly distributed tax bases, taxes that have large cyclical fluctuations, and taxes that involve considerable economies of scale in tax administration should be assigned to the federal government (Sobel, 1997; Musgrave, 1983; Tanzi and Zee, 2000, Oates, 1996). There are efficiency and equity considerations behind such principle of tax assignment. Local authorities should exercise taxing power on other tax bases within the settings and preferences of the local population.

The assignment of taxing power between the federal and the regional governments and the provision for concurrent power to share revenues establishes the basic link in which the behavior of one of the parties would influence the decision making power of the other and its effective tax base. There is a possibility for vertical tax externality that might require additional policy instruments to correct their effect on other levels of government (Keen, 1998).

The assignment of taxing power is a thorny issue in practice and its application is influenced by a number of considerations. First, despite the legislative assignment of taxes, the actual potency of the tax network depends on the nature and development of the national economy, the relative distribution of economic activities across jurisdictions, and the administrative efficiency of the taxation system. Second, the practice of fiscal federalism, especially when citizens across regions with diverse economic and demographic situations are treated unequally, gives rise to the violation of one of the core principles of horizontal fiscal equity. Third, despite the monopoly of taxing power resides at the disposal of the government, the reach of the taxation network depends on the economic circumstances of the potential taxpayers. It is therefore evident that the fiscal assignment issues are dependent not only on constitutional provisions but also on economic, political and institutional factors.

2.2. Intergovernmental Transfers

The distribution of the tax base and the demand for public goods does not follow symmetrical pattern and this gives rise to the emergence of fiscal imbalances. A number of reasons contribute to the mismatch between the expenditure responsibilities and the capacity of the lower levels of government to raise sufficient revenue to finance their expenditure. Vertical fiscal imbalances are the result of allocation of expenditure responsibilities with higher cost than the sources of revenue assigned to local governments. This indicates the case in which the level of revenue source decentralization is lower than the decentralization of expenditure responsibilities.

Horizontal fiscal inequity emerges usually as a result of concentration of tax bases due to uneven distribution of economic resources and activity across regions whereas expenditure requirements are spread more evenly.

The problems of fiscal imbalances require measures that include the provision of subsidies as well as policies that promote balanced growth of regional economies and their taxation bases. The process of changing the taxation base of regional economies is slow and requires consistent policies that address the underlying sources of inequalities across regional economies. The most common practice is providing federal fiscal transfers or subsidies to bridge the fiscal gaps in the regional governments. Inter-governmental transfers systems, however, might generate their own problems of the commons. When vertical fiscal imbalance is significant and local governments depend excessively on the federal fiscal grants, their fiscal autonomy would be compromised. Moreover, local government officials and the population would have the incentive to maximize their federal grant receipts as long as they do not proportionately share the burden of taxation. Where local governments do not bear the cost of their spending decisions, there are incentives for them to expand their budget beyond their means. Such fiscal behavior commonly leads to excessive growth of the public sector in the economy as well as a tendency to over fishing the fiscal pond.

Inter-governmental fiscal transfers involve two main decisions even if most federal systems pursue different approaches. The federal government needs to decide on the aggregate pool of federal grants and then the pool has to be distributed among the respective lower sub-national governments. The federal government can decide on the size of the federal grant pool based on certain parameters, on negotiations or on some ad hoc mechanisms. Once the pool of federal grants is decided, the distribution of such grants across regions or local governments follows a number of possibilities. The federal government may exercise discretionary decisions to distribute such resources. However, such discretionary allocation might be influenced by political considerations instead of real need for assistance at the local levels. The most conventional way is the use of some grant distribution formula that takes into account indicators of needs, fiscal effort and other factors at the sub-national government levels.

2.3. Decentralization and the size of the government

The appropriate role and relative size of government in national economies are controversial and evolving political economy issues. The actual size of government in national economies is influenced by a number of economic, social, and political factors (Lowery and Berry, 1987; Rodrik, 1996; Meltzer and Richard, 1981).

Does fiscal decentralization have influence on the size of the government? The theoretical link between fiscal decentralization and the relative size of the public sector in national economies remains murky. The public finance theory traditionally identifies forces that shape the extent of government intervention in a national economy. These forces include market failure, imperfect information, incomplete market, externalities, public goods and significant unemployment of resources (Ehadie, 1994; Grossman, 1989; Rodden, 2003). The possible impact of fiscal decentralization on the overall size of the public sector is moderated through a number of factors such as political institutions, constitutional limits, the extent to which the cost of providing public services is internalized at local levels, ideological position of the government in power, the autonomy of local governments, and the level as well as growth of national income.

The process of fiscal decentralization can potentially improve efficiency in the provision of public goods by identifying the preferences of local population and internalize the cost within the same jurisdiction. When political institutions enforce accountability and local officials are responsible to the local constituency, there is incentive for decision makers to achieve goals that are in line with the preferences of the local population. The internalization of the cost of public service provision would also provide extra incentive to discipline fiscal decisions and operate within hard budget constraint. If the expenditure choice of local governments is linked to taxation on the local population, there would be strong reason to maintain fiscal discipline and operate towards a smaller and efficient government size. However, when an increasing share of local government expenditure is financed by inter-governmental subsidies and devolution of function is not accompanied by reduction of expenditure at the federal level, there is a tendency for faster growth in the size of the government (Rodden, 2003). This might lead to the expansion of the public sector without improving the quality of public services and the efficiency of the public sector. The effect of fiscal decentralization on the size and growth of the government therefore depends on the nature of fiscal federalism pursued in the system.

The theory of fiscal decentralization and its relation with economic policy issues is a growing field of research whose framework is evolving to guide and inform public policy discussions. How the process of fiscal decentralization is related to the size and efficiency of the public sector and how such relations influence national economic performance are topical issues of theoretical and policy interest. Fiscal decentralization has potentials to improve the efficiency of public resource utilization and such an efficient government creates the environment for fast and shared economic growth in the national economy. In the next section, we discuss the performance of the fiscal sector and the practice of fiscal decentralization in the Ethiopian economy.

3. Features of the Ethiopian Fiscal System

The fiscal system of Ethiopia has historically been characterized by high centralization and concentration of fiscal decision-making power at the center. Table 1 summarizes the main features of fiscal aggregates of Ethiopia for the past three decades. It depicts how surprisingly stable the fiscal aggregates have been over the years. The nature and structure of the economy, the resulting tax bases, the excessive dependence on international trade taxes and external grants, and persistent deficits all contribute to the prevailing features of the fiscal sector as do the fiscal policy stance of the government. The economy has failed to achieve any meaningful structural transformation and fiscal aggregates reflect this general feature.

For the period 1974/75-2003/04, the government sector on average extracted about 18.5 percent of GDP from the economy and spent about 28.5 percent of GDP. The allocation to recurrent spending was about 19 percent and the share of capital spending was about 9 percent. This behavior of excessive spending has left an average fiscal deficit of about 10 percent. Foreigners provided about 3 percent as charity and about 4 percent of GDP as loans and the remainder was financed mainly from the domestic banking system. A fiscal system that resorts to borrowing to cover about 36 percent of its spending appetite would sooner or later confront the consequence of its behavior. This behavior of fiscal spending has left its mark on the macroeconomic situation of the country in which aggregate expenditure persistently runs in excess of domestic production.

Table 1- Ethiopia: The Structure of Government Revenue and Expenditure 1974/75 – 2003/04 (As a percentage of GDP)

Period/ Regime	Tax	Non-Tax	External Grants	Recurrent	Capital	Deficit excl. Grants
1974/5-1983/4	13.45	3.75	1.94	18.26	6.28	-7.35
1984/5-1990/1	13.50	6.24	3.43	20.92	9.32	-10.49
1991/2-1994/5	9.59	3.89	2.80	14.86	7.52	-8.90
1995/6-1997/8	12.37	6.33	3.04	14.91	9.20	-6.34
1998/9-1999/00	11.84	6.99	2.84	24.17	7.76	-13.10
2000/1-2003/04	15.43	5.10	5.77	21.03	11.74	-13.35
1974/5-1990/91	**13.48**	**5.14**	**2.77**	**19.74**	**7.97**	**-9.10**
1991/2-2003/04	**13.00**	**5.51**	**4.06**	**19.02**	**9.69**	**-10.84**
1974/5-2003/04	**13.12**	**5.41**	**3.73**	**19.20**	**9.25**	**-10.39**

Note: Figures for 1999/00 to 2002/3 are preliminary actual and for 2003/04 are budgets.

Source: computed from Ministry of Finance and Economic Development data sources

The change in government in 1991 created the environment and opportunities for reforms in almost all sectors of the economy. Fiscal policy reforms were undertaken that could shape and refocus the activities of the government sector. The first wave of reforms focused on demand management and improving underutilized capacity in the economy. And yet, there was no major and genuine shift in the policy stance of the government with respect to the level of intervention in the economy. The current regime inherited a stagnant economy and a policy regime that drove the private sector away from a meaningful participation and a leading role in the economy. The policy reforms during the 1990s partially addressed these problems and at least nominally admitted the critical role for the private sector. However, the regime has maintained its interventionist policy that has deprived the nation the emergence of a dynamic private sector and market oriented economic system.

The reforms have had mixed implications on government revenue collection and expenditure allocation patterns of the public sector. The amendment in the tax codes, devaluation and gradual depreciation of the exchange rate, introduction of new taxes and expansion of the tax bases, and the privatization process all have had important implications on the amount and structure of government revenue. The overall share of tax revenue to GDP is not unduly high relative to developing countries (Tanzi and Zee, 2000). The share of government revenue indicates resource extraction from the economy and the command the government exerts on the rest of the economy. The state of economic development, the tax base, degree of monetization and marketable surplus, and the design and efficiency of tax administration in the country has limited the growth of the government sector relative to the other sectors as well as the economy. The government sector, nonetheless, has exhibited expenditure expansion faster than revenue generating capacity of the economy. This in a way positioned the government to resort to alternative, though more distortion creating forms of revenue generation schemes. Despite its relative small size, the fiscal system of Ethiopia is typically intrusive and restrictive in nature creating hurdles for private investment, weakening the domestic saving effort, stifling competition and dampening cooperation, and in the process affecting the sustainability and pace of economic growth in the country.

The current government in power shares important characteristics and behavior in fiscal policy with its predecessor. Despite marginal changes in some aspects of the fiscal components, there has not been enduring and significant shift in policy. The current regime spends about 29 percent of GDP and extracts from the economy about 19 percent of GDP in the form of taxes and non-tax revenues. Foreigners provide about 4 percent as grants and lend about 3.7 percent of GDP. The remainder of about 2.4 percent of GDP has been financed from domestic borrowing. This is as stable as a fiscal aggregate can get. The current fiscal system of Ethiopia exhibits departure from as well as striking continuities with the previous fiscal policy regime. The data indicates that either the current regime is not willing to fundamentally change its fiscal policy stance or the fiscal system is governed by the structural features of the economy that are not easily amenable to fiscal policy reforms. A closer examination of the main features of the fiscal system suggests that both factors play a role in the process.

The result of such features of government revenue and expenditure has been the emergence of persistent fiscal deficits and the accumulation of public debt. Domestic government revenue apparently has recently been barely enough to cover recurrent government expenditure let alone to generate resources for financing capital expenditure. The level of deficit has increased and recently even surpassed the total tax revenue collection. Such a stance of fiscal policy is unsustainable and external grants, even if important to partially narrow the gap, would not and could not resolve the problem. The government has increased its appetite for borrowing from foreign sources to bridge the gap and, when external borrowing does not satisfy, it resorts quite liberally to borrow from the domestic banking sector.

The fiscal performance of the country is a reflection of a typical underdeveloped and agrarian based economy in which the majority of the population lives in chronic poverty and a government that devotes its effort to extraction of resources from the economy. This is accompanied by failure to allocate these resources to priority areas and sectors of the economy. However, both political imperatives and changes in the overall economic policy of the country opened the door for fiscal policy innovation. The fiscal situation and the overall economic performance of the country call for even more innovative and effective approaches that maximize the efficiency of using economic resources for addressing pressing national problems. We will focus our discussion on fiscal federalism and its implication on the exercise of fiscal policy.

4. Fiscal federalism in Practice

The policy of fiscal federalism in Ethiopia has followed the political imperatives of establishing an ethnic federalist structure. The overthrow of the military regime of Ethiopia in 1991 by a coalition of rebel forces set the stage for a drastic shift in the political landscape of the country. The process culminated in the formalization of the ethnic-territorial federal structure of government with the adoption of the Constitution of the Federal Democratic Republic of Ethiopia in 1994. The Constitution formalized the experiment of ethno-linguistic based structure of government into a federal structure. Nonetheless, the Constitution shares essential features from former constitutional or legal provision in practice in the country. The very spirit of these Constitutional provisions and their genuine nature has been limiting individual citizens and hence the society in the exercise of their political and economic rights and freedoms. Instead of limiting the actions and powers of the government sector, which is a defining feature of a democratic constitutional setting, the governments were allowed to exercise and often times abuse political power under the veils of constitution. This interaction of political and economic issues is no where more apparent than in fiscal policy and practice.

The Ethiopian federal structure consists of nine regional states and two chartered city administrations. The administrative structure divides the nine regional states into 70 Zones and 550 Woreda (districts) with elected councils creating a four-tier level of government. The Woreda serves as the basic unit of administration. Moreover, there are municipalities in urban areas undertaking both taxation and public service provision decisions. The devolution process is still in progress and has not yet fully reached the Woreda levels of government. The system is moving towards a three-tier structure of decentralization: federal, regional and Woreda levels. This structure creates a principal-multi-agent setting in the political and fiscal relationship in the country.

The Constitution divides responsibilities under the jurisdictions of the federal government and the regional governments. It provides extensive decision-making legislative and executive powers and responsibilities to the regional states. The most notable ones are: enactment of state constitution and laws; formulation and execution of economic, social and development policies, strategies and plans; administration of land and other natural resources in the territory; levy and collection of taxes assigned to the regional states; designing standards for state level civil services and payment; and maintenance of state level security forces. The Constitution reserves all powers not provided to the federal government to the regional governments.

What are the implications of such changes in the political and policy environment in terms of the design and implementation of fiscal policy in the country? Fiscal federalism in Ethiopia has been put in place within the dictates of political imperatives. One of the effects of the redrawing of the political map of the country is forming extremely heterogeneous economic regions. Unlike a system in which resources can easily flow across regions, the ethnic based political boundary establishes administrative, institutional and political restrictions for a full realization of the economic potentials of the country.

The federal structure of Ethiopia carved regional states that exhibit significant variations and heterogeneity. These diverse circumstances of regional states have given rise to horizontal fiscal imbalances. The regional distribution of revenue sources is such that most regions could not generate enough revenue to cover their expenditure responsibilities. For the period 1993/4 – 2003/04, the regional states as a group managed to finance on average only about a third of their expenditure from their own revenue sources. Depending on financing mechanisms and options to externalize regional fiscal deficits, such regional fiscal imbalances pose risk for macroeconomic stability and the efficiency of public resource allocation and utilization.

One of the yardsticks to evaluate the efficiency gains from fiscal decentralization is the extent to which it has enabled regional states to tailor their fiscal resources to the needs and priorities of the local population. Have they managed to identify the local preferences for public goods and reflect them in their budgetary allocations? The Constitution and related laws provide the framework for the assignment of revenues and expenditure responsibilities between the federal government and the regional governments. The Constitution defines the powers and responsibilities of the federal government that broadly include areas that have national public goods character. Regional governments have responsibilities that are critical in the provision of public services that influence standard of living in the regional economies, such as the provision of health and education services, the provision of core regional infrastructure, the promotion of investment and growth in the regional economies. There has been a remarkable increase in the share of expenditure on social and economic services and this is conducted mainly through regional fiscal budgets. The shift partially indicates the change in the fiscal resource allocation preferences of the government whereas the decentralized decision making further enabled regions to put increasing emphasis on such expenditure in their fiscal resource allocation.

The Ethiopian Constitution defines the assignment of tax and non-tax revenue sources to the regional and the federal governments (Proclamation No. 1/1995: Art. 96, 97, 98). This assignment provides exclusive right for the federal government to tax international trade and the dominant share of domestic indirect taxes. These two sources have on average a combined share of about 64 percent of the tax base. Hence, the most potent source of tax revenue is assigned to the federal government. The regional governments are assigned with the collection of direct taxes within their jurisdictions, land use fees, and taxes on a subsistence based farm households. Moreover, the federal government collects payroll, sales taxes and non-tax revenues from public enterprises owned by the federal government irrespective of their location across the country. The tax base allocated to regional governments generates relatively meager revenues and is relatively stagnant with a property of low buoyancy. The situation is more or less similar with respect to non-tax revenue sources in which the federal government collects about 80 percent of non-tax revenue of the fiscal system. The combined regional share of revenue collection has remained within a range of 12 to 20 percent of total revenue and further declining in recent years.

The state and distribution of economic activities across the country has exerted its influence on the regional distribution of revenue in the new framework of fiscal federalism. The vertical fiscal imbalance is accompanied by concentration of revenue mobilization capacity across regions. Relatively prosperous city administrations coexist with extremely poor and fiscally and economically dependent regions. Table 2 depicts the summary indicators of horizontal fiscal imbalances in the country. It exhibits considerable variation across regions.

Table 2: Ethiopia: Elements of Regional Horizontal Imbalances

Characteristics/ Regional Governments	Population Share (%)	Area Share (%)	Own-Revenue per capita (Birr) 2000-01	Poverty Index 1999/00	Regional Fiscal Imbalance (%)2000-01
Gambela	0.35	2.40	35.6	0.51	5.40
Afar	2.03	7.07	12.7	0.56	6.36
Benisha-Gumuz	0.88	4.30	24.2	0.54	7.15
Somali	3.55	19.82	8.2	0.38	8.31
Harari	0.26	0.03	54.0	0.26	12.04
SNNPRs	19.84	10.28	11.5	0.51	16.38
Amhara	26.48	17.34	11.3	0.42	17.36
Tigray	6.02	5.53	20.8	0.61	18.39
Oromiya	35.89	33.05	15.2	0.40	20.91
Dire Dawa	0.50	0.15	71.7	0.33	37.66
Addis Ababa	4.02	0.04	409.5	0.36	79.27
Ethiopia/Regions	100.00	100.0	13.8	0.44	46.11

Note: The regions are ranked by the degree of their fiscal imbalance during 2000/01.

Sources: Ministry of Finance & Economic Development; FDRE (2002); World Bank, 2001.

Despite considerable horizontal fiscal imbalances across regions, even relatively prosperous regions have problems providing essential public services to its constituents. This issue touches three important elements in the current fiscal policy of the country. First, the federal government needs to reconsider its fiscal policy and facilitate directly the provision of basic public services to all households irrespective of their residence across regions instead of just leaving the matter to financially dependent regional governments. This is justified on the ground that even in Addis Ababa, where the own revenue is relatively high, about a third of its population live under the national absolute poverty line with limited access to basic public services. Second, if the current arrangement is to continue, it is imperative that in the allocation formula of federal grants, proper weighting is attached to the actual contribution of regions to the tax base of the revenues of the federal government. The third alternative might involve changing the relative weight of federal grants distribution in favor of poverty indictors and consideration to include public sector financing of basic necessities to poor households.

Table 3: Vertical Fiscal Imbalances in Ethiopia [1993/94 – 2003/04]

Category/	Combined regions'	Combined regions' share	Vertical

Year	share of revenue (%)	of expenditure (%)	Imbalance*
1993/94	17.8	34.5	0.4841
1994/95	15.4	38.3	0.5979
1995/96	16.6	41.2	0.5971
1996/97	18.0	42.5	0.5765
1997/98	19.7	39.6	0.5025
1998/99	18.0	30.5	0.4098
1999/00	18.3	23.3	0.2146
2000/01	18.0	33.4	0.4611
2001/02	15.3	30.8	0.5032
2002/03	13.4	30.4	0.5592
2003/04	12.6	32.0	0.6063
1993/4-2003/04	**16.65**	**34.23**	**0.5136**

Note: *-The vertical Imbalance index is computed as: VI = $\{1-[(R^R/R)/(E^R/E)]\}$ where R^R is combined revenue of regions and R is the consolidated revenue of the government, E^R measures the amount of combined expenditure of regions whereas E measures the total (federal plus regional governments) expenditure.

Source: Computed based on data from Ministry of Finance and Economic Development

The assignment of revenue sources and expenditure responsibilities between the federal and the regional governments is such that almost all of the regional governments can not generate enough own revenue to cover their expenditure responsibilities. This mismatch has given rise to the problem of vertical fiscal imbalances. As table 3 depicts, the regional governments have a combined expenditure responsibility of about 34 percent of total consolidated government expenditure whereas their share of own revenue was just about 17 percent. This is a clear indication of situation where revenue decentralization is by far narrower than expenditure decentralization the apparent consequence of which is the emergence of vertical fiscal imbalance.

The extent of vertical fiscal imbalance in Ethiopia is quite high and increasing. The dependence of regional governments on the federal grants is so significant that without federal grants most of the regions could not even cover their recurrent expenditures. Moreover, the dominant part of their expenditure is absorbed by recurrent payments such as salaries and allowances, which are difficult to reduce, and leaves little for important anti-poverty reduction efforts. It is therefore clear that the fiscal policy stance of the federal government directly affects the policy choice variables at the regional levels despite the nominal fiscal autonomy that the regional governments seem to exercise.

Fiscal imbalances emerge from the interactions of fiscal policy stance, distribution of the tax base, and the state and distribution of economic development across the country. The government has put in place mechanisms to subsidize the fiscal deficits of regional governments. The magnitude and distribution of such federal subsidies poses two political economic issues: deciding the aggregate amount of federal subsidies from the total purse of the federal government and distributing this amount across regional governments.

The Constitution, as well as the various laws related to fiscal policy, does not specify the absolute or relative magnitude of aggregate budgetary pool for the federal grant. The Constitution, (Article 90), states a general principle in which, given the resource constraints, policies shall be aimed to provide all Ethiopians access to health and education, clean water, housing, food and social security. The actual execution of such principle has been constrained by the budgetary allocation preference of the federal government. In practice, the federal government develops an envelope public expenditure budget. The allocation of funds between the federal and the regional governments has been made on an ad hoc basis combining budget requests from regions and the budgetary preferences and allocation decisions of the federal government. This makes the pool of the federal grant somewhat unpredictable from the perspective of regional governments.

Once the pool of federal grants is determined in such a manner, with some offset adjustment for expected external aid and grants to regional governments, the federal government provides unconditional block grants according to a grant formula. The regional governments have the discretion as to detailed allocation and management of such federal grants. Following recent steps to decentralize further to the Woreda level, regions allocate un-earmarked grants to Woredas who exercise autonomy in allocation of such resources. In recent years, the federal government on average provided subsides to regions to the extent of about 36 percent of the consolidated government revenue and external grants which finances about three-quarters of sub-national government expenditure.

To address this problem of fiscal imbalance, the federal government has used grant formula to distribute federal grants that take into account a composite of several indicative variables. Table 4 depicts the summary and relative weights of these variables including population, composite index of level of development, sector performance and recently an index of poverty situation in the respective regions. The grant distribution formula has been frequently adjusted to improve fair distribution of resources and encouraging efficiency and effort of regional governments to mobilize resources from local sources. The federal grant distribution formula has been amended several times to improve its equitable distribution and redistribution of public resources across regional states.

Table 4-Ethiopia: Relative Weights of Variables in the Federal Grant Formula

Variables	1994 Formula	1998 Formula	2001 Formula	2003 Formula
1.Index of Population	33.33	60.0	55.0	65.0
2.Composite Inverted Index of development	33.33	25.0	20.0	?
3.Index of own revenue raising effort	33.33	15.0	15.0	?
4. Poverty Index	0.0	0.0	10.0	?

Source: Ministry of Finance and Economic Development

Table 5 summarizes the actual share in federal grants received by regional governments. The distribution pattern reveals that there are important variations in the share of regions. However, despite the changes in the weights attached to the underlying variables, the actual share of regional states from the pool of the federal grant remains more or less the same. It implies that the most important determinant of the actual amount of federal grants received by regional governments is the size of pool more than how it is distributed across regions. This critical power remains in the firm hands of the federal government.

When fiscal imbalances arise, regional states could bridge their finances in one of the three ways: levy additional charges, such as user fees and charges, to generate additional non tax revenue, borrow from domestic or foreign sources, and secure federal grants to finance their budget deficits. The practice in Ethiopia is that regions are not allowed to borrow and the user charges are not commonly practiced. This leaves the federal government grants as the dominant source to finance regional expenditure. The federal government also uses the fiscal subsidies to redistribute resources through the fiscal system. Whereas making resources available for regions that commensurate their expenditure responsibilities is necessary, the use of unconditional block grants for the purpose of resource redistribution has serious problems. Such an approach assumes the regional states have the capability as well as the commitment to allocate such funds to the purposes that reflect the preferences of the local population. This would be a critical issue especially when accountability is weak and centralization and corrupt practices at regional levels emerge.

Table 5: Ethiopia: Regional Share of Federal Grants (percentage share)

Year Regions	1993/4	1994/5	1995/6- 1997/8	1998/9- 2000/01	2001/2- 2003/4
Tigray	10.58	11.39	9.52	7.61	7.68
Afar	4.92	3.29	4.88	6.85	4.72
Amhara	20.09	24.56	24.00	21.80	21.58
Oromiya	32.25	28.12	29.01	27.34	30.14
Somali	3.09	2.79	5.04	9.00	7.33
Benisha-Gumuz	3.29	1.47	3.86	4.76	3.68
SNNPRs	15.85	20.51	18.58	16.07	17.95
Gambella	2.77	2.46	2.54	3.97	2.80
Harari	0.83	1.33	1.69	1.76	1.49
Addis Ababa	6.27	3.94	0.38	0.01	0.85
Dire Dawa	0.06	0.13	0.63	0.82	1.78
Average Amount (Million Birr)	1950.1	2292.7	2866.1	3194.8	4779.9

Source: Ministry of Finance and Economic Development

If the federal grants are distributed with such provisions that commit regional governments to finance public services that reflect the preferences of the local population, then the same funds could go a long way to address critical economic and social problems. There is a certain degree of heterogeneity in the preferences of the local population. Nonetheless, in a country where poverty is widespread and basic public services are not widely available, basic preferences and choices are broadly similar enough to warrant shared, if not uniform, provision of public services across districts and even regions. Centralized design of the blue prints and implementation by regional states and districts does not exclude diversity in public service and it does not violate the autonomy of regions. A certain share of the federal grants could be used to bridge such critical needs which could also be matched by local private sector funding mechanisms. In this context, it would be necessary to study further the heterogeneity of preferences across regions and identify the minimum set of public services, subject to prudent variation, that every region should be able to provide irrespective of their actual capacity to generate own revenue.

The current practice uses the poverty index as a yardstick to distribute federal grants to regional governments. However, it falls short of ensuring how such funds are used to improve the poverty situation of the chronically poor across the country. It is important to establish a mechanism that would ensure such funds be directly used to create opportunities for the poor to escape poverty and in the worst cases to reduce the suffering of the poor from destitution. Despite the variations in the index of poverty across regions, it is clear that poverty is a nationally shared phenomenon that deserves to be the responsibility of the federal government. In a system where destitution is a reality and national in scope, there is strong rationale for the federal government to assume responsibility and design a basic social security scheme.

The current practice attempts to address the problem indirectly through the regional administration. There are, however, limits to such an approach: First, the regional governments receive unconditional block grants and their decision-making process might not directly and necessarily reflect the preferences of poor households and the population in their jurisdiction. In a country where about 45 percent of the population lives in poverty, such indirect processes of budgetary assistance would hardly trickle down to the poor. Second, with such a level of vertical fiscal imbalances, regional governments are dependent on federal grants to carry out their expenditure responsibilities and funds for poverty reduction compete with projects that regional officials deem priority. This might not necessarily or inherently create conflict of interest, or it might. It is therefore justifiable, both on equity and poverty reduction considerations, for the federal government to directly provide social security assistance to poor households and the destitute.

The practice of providing unconditional block federal grants to regional governments has important bearings on the fiscal management of regions and how resources would be channeled to lower levels of government. The federal grants do not address the intra-regions distribution of fiscal subsidies. Regional level of centralized decision-making and fiscal behavior is a reality that needs to be addressed in time. It could absorb much of the fiscal resources at the regional centers and fail to reach agents and purposes that justify resource redistribution through the fiscal system.

What are the main effects of the practice of fiscal federalism on the policy-making behavior of the public sector? The practice of fiscal federalism can affect the aggregate behavior and performance of the public sector in three interrelated areas. The first issue is related to the impact of fiscal federalism in influencing the fiscal discipline of the public sector. As we have already observed in the previous sections, the fiscal aggregates of the general government exhibit both continuity and innovation. Despite the reform policies, the government is still running persistent and unsustainable fiscal deficit. The fact that the main driving force behind the deficits is the burgeoning public expenditure suggests that there is no clear turn in the policy stance of the government. Fiscal decentralization has played a role in the expansion of government expenditure. The increased execution of public expenditure by the regional governments and externalization of expenditure decisions has contributed to a behavior of expansive public expenditure. When devolution is not accompanied by reducing the responsibilities and fiscal resources at the disposal of the federal government, it feeds into unsustainable expansion of public sector expenditure. Reorientation and reduction in federal expenditure are necessary so that the consolidated government expenditure remains with in the revenue capacity and in consistent with economic growth path of the country.

The second impact is related to public resource allocation behavior. There were important shifts in the allocation of public resources. The most important shift was the reorientation of public expenditure from defense related expenditure to social services and economic development expenditures. Expenditure reorientation towards health and education sectors improved the efficiency of public resource allocation. The practice of fiscal federalism contributed positively in the process since the sub-national governments allocated an important share of their budgets for poverty and social development oriented activities. However, there is a clear tendency to push expenditure responsibility to the sub-national governments without a commensurate allocation of revenue sources. This would have adverse effect both on the quantity and quality of public service provision in local areas where the local capacity is quite limited.

The third element of policy interest is how the behavior of the public sector and the practice of fiscal federalism affected the overall performance of the economy and the behavior of other economic agents in the system. The reorientation of the public sector to areas in which the private sector is reluctant to operate or market failure is predominant would have a crowding-in effect on the private sector. There were important shifts in the policy stance of the government from a policy that categorically discourages the private sector to that, at least nominally, encourages and acknowledges the role of the private sector in the economy. Policy measures were taken that opened space for private sector participation in various areas of economic activities. However, there are still considerable ways to go. Reluctance remains on the part of the government to create the policy environment in which self-driven private sector initiatives and market forces could serve as engines of economic prosperity.

The introduction of fiscal decentralization has had mixed effects on the participation of the private sector in economic activities. The practice, accompanied by the underlying tone of ethnic federalism, has introduced a political risk factor in the investment decision-making. The private sector still tends to avoid long-term investment activities in which routine interaction with political decision-makers and hence interference is unavoidable. Moreover, there are factors that encourage expansion of public sector consumption expenditure at the expense of capital accumulation and hence jeopardizing the sustainability of economic growth. It is therefore clear that despite the overall improvement in the policy environment in which the private sector operates the relative expansion of public sector consumption in the economy allowed the predominance of a large and yet inefficient government sector in the economy.

5. Concluding Remarks

Ethiopia has introduced a unique form of fiscal decentralization in the context of ethnic federalism. The process is still in progress that decentralization of fiscal decision-making power has not yet fully reached the basic unit of administration in the federal structure. The regional governments have been constitutionally vested with extensive decision-making power. However, the fact that the federal government still centralizes the fiscal means of executing fiscal responsibilities indicates that there is a de facto centralization of fiscal decision-making. This is reflected by excessive dependence of regionals on federal grants to finance even recurrent expenditures within their jurisdictions. The fiscal system is characterized by both vertical and horizontal imbalances that require further decentralization of revenue sources that commensurate the expenditure responsibilities of the regional governments.

The practice of fiscal decentralization in Ethiopia, and the political and economic landscape in which it operates, has so far limited success to improve the efficiency of the public sector by diversifying output and tailoring it to the preferences of the population and priorities of the economy. Given the prevailing vertical imbalance, the system has not made regions internalize the cost of their expenditure decisions. This in turn has given incentive to expansionary fiscal policy stance and bigger government. It is such a policy stance that erodes its sustainability, allows the breach of fiscal discipline, and risks macroeconomic instability, and in the process hampers the realization of economic potentials in the national economy. It is therefore important that the practice of fiscal decentralization in Ethiopia be reoriented to improve the reach and quality of public services, to ensure fiscal discipline, to cultivate democratic and effective institutions and in the process contribute to address the fundamental economic, social and political challenges of the country.

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