

ADDIS ABABA UNIVERSITY  
COLLEGE OF LAW AND GOVERNANCE  
CENTER FOR FEDERAL STUDY

IMPACTS OF STATES' REVENUE CAPACITY ON SELF  
ADMINISTRATION UNDER ETHIOPIAN DECENTRALIZED  
FISCAL SYSTEM: THE CASE OF OROMIA NATIONAL REGIONAL  
STATE

A THESIS SUBMITTED IN ACCORDANCE WITH THE  
REQUIREMENTS FOR THE FULFILLMENT OF DEGREE OF  
MASTER OF ART (MA) IN FEDERAL STUDY

PREPARED BY: BEKA DIRIBI JOTE

MAY 2014

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**I would like to declare that, the topic is my original work that no one previously has done Research on it. All Sources that I have used have been indicated and acknowledged by means of complete references.**

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## **Acknowledgements**

The following persons are those who deserve my deep acknowledgment for their roles and contributions in the process and successful accomplishment of this study.

First and for most, I would like to forward my sincere gratitude to Dr Girma Gizaw (my Research Advisor). His role is beyond an advice. Besides his heartily advise, he provided me various experiences he obtained in education in the Country and Abroad which has substantial importance for the success of my study. He owed me not a mere advice but also, a challenging advice and his criticism which enabled me to complete this research in this manner.

Secondly, I would like to owe a great appreciation and thank for Danno Wereda and Ilu Galan Wereda Administrations offices. They have a great role in my study through their financial support which encouraged me to complete the study in this manner.

Thirdly, my thank goes to Kebede Zegeye who works in Bureau of ORG Revenue Authority. While interview, he provided me an enabling comment and reliable information as well as his educational and other experiences around my topic.

Fourthly, Abdissa Dashura and Rebuma Tefera deserve my deep acknowledgment. They have taken the same program with me and have undertaken their research successfully on other title in which the interchange of our ideas and comments greatly contributed to the success of my study.

Fifthly, Hailu Kejela, Boru Insermu, Negero Debissa and Garedow Morka are important individuals for the success of my study. I owe my heartily thank and acknowledgment to these respected individuals for their moral and financial support which has paramount importance for successful completion of my study.

The last but not the least, my sincere thank goes to **Arfasse Sileshi**: My wife and mother of my lovely son **Nafirom Beka**: Had it not been for her support and encouragement, I would not have completed this Master program.

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## **Acronyms**

BoFED-----	Bureau of Finance and Economic Development
EFY-----	Ethiopian Fiscal Year
EPRDF-----	Ethiopian Peoples’ Revolutionary Democratic Front
FDRE-----	Federal Democratic Republic of Ethiopia
FGTFF-----	First Generation Theory of Fiscal Federalism
HFI-----	Horizontal Fiscal Imbalance
HoF-----	House of Federation
IGFT-----	Inter governmental Fiscal Transfer
MoFED-----	Ministry of Finance and Economic Development
PDRE-----	People’s Democratic Republic of Ethiopia
SGTFF-----	Second Generation Theory of Fiscal Federalism
SNN-----	South Nations Nationalities
SNGs-----	Sub National Governments
TGE-----	Transitional Government of Ethiopia
VFI-----	Vertical Fiscal Imbalances
VAT-----	Value Added Tax

## **Abstract**

*As it has become the Global concern, Ethiopia, since, 1991 has undertaken dramatic change by decentralizing political, Administrative and Fiscal decentralization from Federal government to autonomous State Governments and to District levels by the respective Regional Constitutions. Fiscal Decentralization, which is the subject matter of this paper, is an important dimension of Decentralization which influences both Political and Administrative aspects of decentralization. This paper utilized both quantitative and qualitative method in describing and analyzing causes of high degree of vertical Fiscal Imbalance in Ethiopia and its impacts on principle of its Federalism particularly, on the self Administration of Regional Governments taking ORG as a case study on the base of primary data obtained through interviews conducted with tax officials and experts in Regional Revenue Authority, officials and experts in Regional BoFED and through questionnaires provided for selected informants and secondary data obtained in the mentioned regional Bureaus and MoFED. Here, what motivated the researcher to conduct the study on the topic is that, on the base of the 1995 FDRE Constitution, Ethiopia adopted dual federal structure composing nine regional states and two city administrations (Addis Ababa and Dire Dawa) by giving them the right to self determination expanding even up to secession (Article 39 of the constitution). Accordingly, regional governments are responsible for implementing economic and social development policies and for maintaining public order, including administering a Police force while the federal state is responsible for all powers not delegated to, or shared, with the regions. It can be observed that, the FDRE Constitution assigns various responsibilities to the lower units of governments in its expenditure side while on the Revenue side, however, it assigns more buoyant sources of revenues to the Federal government creating vertical fiscal imbalances which resulted in high dependence of States on Federal subsidy for the execution of these responsibilities. On one hand, the Constitution label Ethiopia as fully fledged federal political system which claims the independence of each level of governments in relation to Constitutionally Delimited Spheres of its Jurisdictions from the other. On the other hand, there exists much Vertical Fiscal Imbalance creating much dependence of States on Federal Government as they do not have Revenue Capacity even to cover half of their expenditure needs from their Own Revenue Sources. The finding of this paper, point out that, the cause of vertical Fiscal imbalance in the study Region, shows the domination of Major Revenue bases by the Federal government than less commitment of tax collectors, tax evasion, corruption etc. Further, the paper, viewed that, less revenue capacity of the Region and high dependence on Federal Subsidy affects its constitutionally guaranteed self Administration (developing socio- economic and political affairs), its autonomy, quantity and quality of public services, accountability of officials. Finally the paper recommends that, revenue capacity of Regional Governments should be enhanced to enable them to exercise their constitutionally promised Self Administration by expanding their own Sources of Revenues and conducting effective Transfer System in the absence of sufficient Revenue Bases in some Regional Governments.*

**Key words:** *Self Administration, Fiscal Decentralization, Revenue and functional assignment, Revenue Capacity*

# Chapter One

## 1.1 Background

Federalism is a form of state structure in which two or more constituent units exist and division of powers and functions are constitutionally guaranteed.<sup>1</sup> For instance, Daniel Elazar (1987) viewed that, Federalism is political system within which, each level of government is legally supreme over its internal affairs cooperating with each other on common interests as opposed to unitary form of government.<sup>2</sup> Thus, it is a governance system in which formal devolution of administrative, political and fiscal powers are constitutionally guaranteed. This paper focuses on its fiscal aspects which mainly deals with allocation of responsibilities, allocation of revenue power and Inter governmental fiscal transfer which will be discussed in subsequent sections.

Owing to market failure to provide public goods and services in effective and efficient manner, led to various economic reforms during the 1980s in different parts of the world.<sup>3</sup> Hence, the reform, was aimed in improving the significance of public sector in achieving broader objectives such as economic stability, sustainable growth and provision of public services.<sup>4</sup> Thus, widespread attempts have been made to redefine the potential role of the public sector and improve its performance to achieve these objectives through policies to decentralize government functions with the power of financing these functions through some revenue assignment.<sup>5</sup>

As such, Fiscal decentralization which namely includes the assignment of expenditure functions, revenue assignment and intergovernmental fiscal relation, being an important element of federalism, is becoming increasingly popular around the world.<sup>6</sup> Hence, in most previous unitary state, as the cases in Ethiopia, Fiscal Decentralization is an answer to challenges of centralization of fiscal power at the center even although, its degree varies from federation to federation. This does not however mean that, fiscal decentralization is a sole element of federal political system

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<sup>1</sup> See Daniel Elazar (1987), *Exploring Federalism* (Alabama University Press Tuscaloosa, p.70-71

<sup>2</sup> *Ibid*

<sup>3</sup> See Smoke Poul (2001), *Fiscal Decentralization in Developing Countries: A Review of Current Concepts and Practices*, United Nations Research Institute for Social Development.

<sup>4</sup> EbelD.Ro bert and SerdarYilmaz (2001).*Concept of Fiscal Decentralizationand WorldWide Overview* ,<http://www.desequilibrefiscal.gour.fc.ca/en /pdf/ebel.pdf>

<sup>5</sup> *Ibid*.

<sup>6</sup> Jonathan Rodden, 2001. *The Dilemma of Fiscal Federalism: Grants and Fiscal Performance around the World*,p.5-6

as the practice of some unitary Countries such as China, shows fiscal decentralization in the absence of political decentralization. Owing to this, economists argue that, nearly all public sectors are more or less federal in the sense of having different levels of governments that provide public services, irrespective of formal constitution.<sup>7</sup> However, for political scientist, federalism is much more than mere fiscal decentralization implying that, the autonomy of the central government is effectively limited, either by constitutional rules or informal constraints.<sup>8</sup> This however does not mean that, high level of fiscal autonomy and budget discretion could not influence the relationship between the center and SNGs.<sup>9</sup>

In Ethiopian context the Transitional Government, based on the Charter of the Transitional Government, has made dramatic change in that, political, fiscal and administrative powers are devolved among levels of governments.<sup>10</sup> Hence, based on the Charter, Proclamation No.7/1992 was made forming three tiers of governments as well as dividing powers and functions between the federal and the State governments. Accordingly, the proclamation provided the Regions, with the right to prepare, approve and implement their own budgets and to "borrow from domestic lending sources and to levy and collect some taxes under their jurisdiction. The proclamation further recognized grant system in which the central government subsidizes regions that unable to finance by themselves basic social services and economic development programs due to relative underdevelopment.<sup>11</sup> However, as far as revenue assignment is concerned, it was Proclamation No. 33/1992 (TGE 1992c) which was the most important legal instrument in categorizing revenue sources for the center, for the regions, and those to be used jointly by the center and the regions. Further, it defines the objectives of revenue sharing, sets out the principles used in-framing-revenue sharing arrangements. With slight change, the 1995 FDRE Constitution formalized this devolved governance system which recognized the country as a country of fully fledged federal political system. Among the other, the Constitution importantly ensured self determination of the Nation, Nationality and People of Ethiopia. Accordingly, the

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<sup>7</sup> Fiscal decentralization is mainly to increase the effectiveness and efficiency of service provision. Hence, it should not be considered as a sole element of federal political system.

<sup>8</sup> However, the difference is that, in federal system, the fiscal relationship among different tiers of governments is provided and protected by constitution while in unitary system it is at the discretion of the central government.

<sup>9</sup> Fiscal Autonomy and budget discretion on the side of SNGs may limit the exercise of discretionary power of the center over them.

<sup>10</sup> Pre-1991 the whole budget process both in terms of revenue and expenditure were centralized at the center

<sup>11</sup> Proclamation No 7/1992, The Proclamation to define power and duty of the central and regional government

Constitution assigned various responsibilities to the lower governments to be performed under their jurisdictions. On the other hand, to enable them in executing the assigned responsibilities, the Constitution under Art 97, lists some exclusive revenue sources as well as concurrent taxation power with the federal government on taxes stated under Art 98.<sup>12</sup>

However, although the Constitution lists of sources of revenues for both levels of government, the mis- match between Regional revenue and their expenditure needs characterize the Ethiopian fiscal federalism (See table: 3.1). Various writers argued that, revenue sources assigned to the Center (Federal government) are dominant and more profitable while revenue sources left for states are less profitable and even cannot finance half of their expenditure needs. Hence, these works put that, the whole fiscal years, states are highly dependent on Federal subsidy for the execution of responsibilities assigned to them.<sup>13</sup> For instance, Deresse (2003; pp: 24) put that “central subsidy covered 71.5 and 63.9 percent of the Regional expenditures in 1993/94 and 2001/02 respectively”. This shows that, Regional governments in Ethiopia almost totally dependent on Federal government. Thus, from the above discussed general overview, below, this paper has pointed out some problems to be addressed.

## **1.2 Statement of the Problems**

In principle, under any form of state structure, Governments should have Resources (revenue) to undertake provision of effective public services. Accordingly, revenue is an important instrument to enable governments to perform their responsibilities both in unitary and federal form of political system. For instance, in federal system, revenue enables multiple tiers of governments to perform their constitutionally assigned powers and functions for the welfare of their respective subjects. Hence, proper division of revenue raising powers and responsibilities of SNGs in line with the framework of other constitutionally divided powers and functions in the federation signifies the purpose of federalism.<sup>14</sup> This would be emphasized that, if SNGs governments were financed purely by local taxes, charges and borrowing, voters and creditors would very likely view the obligations of local governments as sovereign. The opposite is that, if SNGs were

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<sup>12</sup> Art 39, 51,52, 96, 97and 98 of the FDRE Constitution.

<sup>13</sup> It is argued that, state fiscal dependency, under the Ethiopian fiscal federalism is higher than in other developing countries as there exist total dependence of regional governments for they could not finance half of their recurrent expenditure leave alone capital expenditure needs without federal grant.

<sup>14</sup> This implies that, functional devolutions without, enabling financial resources to the lower government undermine the practicality of federalism

financed by subsidy from higher level government as the case in Ethiopia, the result is that, lower level governments tend to be under the influence of higher level governments.

Under Federal political system, fiscal federalism ideally claim that sub-national government need to be autonomous with sufficient revenue sources for the execution of responsibilities assigned to them.<sup>15</sup> Irrespective of type of political system, governments are custodians of public interest which would seek to maximize the social welfare of its respective constituency promoting social interest within their limited jurisdiction. However, in most Federation as the case in Ethiopia, lower unit governments do not have sufficient revenue sources to perform their constitutionally assigned tasks but dependent on higher level government against self administration and autonomy.<sup>16</sup>

As it is also true almost for all federations of the worlds, the Ethiopian Federal government has general functions such income redistribution, economic stabilization. Accordingly, these functions of the government influence the assignment of some dominant revenue sources to be left for the central government. On the other hand, expanded responsibilities which are local in nature are assigned with Regional governments which they could not finance from their own source of revenue without federal grant. Hence, how could in reality, State governments in Ethiopia, determine and develop the socio-economic and political affairs under their jurisdiction. It is rarely practical to say that, states exercise constitutionally granted full self administration without fiscal autonomy and being dependent on central government as officials of the states lack economic incentives to provide public service in accordance with social needs<sup>17</sup>. Various domestic and foreign scholars have put their views with regard to low revenue capacity of Ethiopian State governments but, without comprehensive study on its implication on their constitutional self government.

For instance, Solomon,(2005:167 ), “ put that, vertical imbalance in Ethiopia provides that the center dominates the fiscal power of the federation. The imbalance is also higher than in many

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<sup>15</sup> *Ibid*

<sup>16</sup> *Andereas Eshete (2003:95) asserted that, states with fiscal dependency on central government could not have effective self-administration. He further viewed that, official supported by transfer lack economic incentives to reach decision tailored to the needs and preferences of their constituents*

<sup>17</sup> *Ibid.*

other federations. For instance, the revenue share of SNGs in Ethiopia is a maximum of 17% compared to India 28, Brazil 24.3%, Germany 24.5%, Australia 28.2% and Nigeria 32.3%”. On the other hand, Paulos, (2009), finds that, fiscal reforms undertaken in Ethiopia have not made Regional governments autonomous as still there exists high dependence on federal subsidy.

Similarly, World Bank (2003) identifies the weak capacity of Regional governments as the main challenge to enhance their fiscal autonomy. Similarly, Abu (2003) argues that, the fiscal position of state governments is highly influenced by the federal government. Therefore, although, international and domestic writers have contributed on the issues of less revenue capacity of states, the whole work didn't properly address the problem of less revenue capacity of states in Ethiopia, on their constitutional right of self-administration. So, recognizing the scholars' views on less revenue capacity of states, this paper tries to point out the practical cause and implication of the dominance of fiscal power by the federal government.

### **1.3. Objectives of the Study**

#### **1.3.1 General Objective**

General objective of the research is to explore causes and impacts of less revenue capacities of ORG with special reference to its constitutionally guaranteed self administration.

#### **1.3.2 Specific Objectives**

Therefore, to achieve the above general objectives effectively the paper has the following specific objectives:

- Describe and analyze revenue capacity of Oromia National Regional State.
- Examine tax autonomy of the region by describing tax sources on which it has the power to set its rate and tax bases.
- Examine practical cause of low revenue capacity of Oromia National Regional State
- Assess factor influencing States' potential ability of revenue raising?
- Describe and analyze how much intergovernmental transfer and revenue sharing be incentive for the state in executing its responsibilities?

- Describe and analyze the implication of revenue capacity of Oromia National Regional State on its right to full self government and its autonomy?

#### **1.4. Research Questions**

The following research questions have been framed to address the above general and specific objectives.

- Does revenue assignment in Ethiopia enable states to administer their internal affairs properly in line with the principle of its federalism particularly with constitutional right of full measure of self government?
- What are necessary causes of vertical fiscal imbalance between the Federal government and Oromia National Regional State?
- What factors influences the revenue raising potential of ORG?
- Does limitation on the state's power of setting its own tax rates and tax bases influences its revenue capacity?
- Is revenue sharing between the federal government and ORG practically implemented to enhance the revenue capacity of the region and to provide public service effectively and to administer its internal affairs?
- What impact can be identified in Oromia Regional State because of the existence of vertical fiscal imbalance and dependence on federal government?

#### **1.5. Scope of the Study**

Although fiscal dependence is the problem of the whole regional governments, for the accessibility of data and proximity of the study region for the author, the study has been conducted in Oromia National Regional Government.

#### **1.6. Research Methodology**

As it can be clearly observed from the overall work of this paper, both quantitative and qualitative methods are utilized to indicate and analysis the impacts of less revenue capacity of Ethiopian state government in particular case of Oromia Regional government on the base of both primary and secondary data.

Primary data has been obtained importantly through interviews with key informant from Regional BoFED, Regional Revenue Bureau, and Legal expert in ORG S. Court and Master Student at AAU (See Annex four). On the other hand, primary data has been collected through questionnaires provided for informants in Oromia Revenue Authority, Regional BoFED, some lectures and Students in AAU as well as key informant from MoFED (See Table one and Annex four). Hence, these data enhanced the reliability of the paper and enabled to reflect practical cause of less revenue capacity of the Region, the actual degree of autonomy Region have over its revenues, its spending autonomy, extent and importance of transfers as well as its effect on autonomy of the region. As far as secondary data is concerned, data from Regional BoFED and Regional Revenue Bureau (Authority) in the form of statics are important sources to assess trends of Revenue, expenditure and Transfer in the Region. In other way, all relevant published materials as well as all related Legal materials were utilized as secondary data sources. Hence, based on the comprehensive nature of fiscal decentralization, data obtained from primary and secondary sources are presented, analyzed, and interpreted in the last Chapter so that findings could be drawn there from. Thus, the constitutional and statutory frameworks, revenue sources of the region, revenue autonomy, cause and impacts of vertical fiscal imbalance, importance of transfer and borrowing power of the region are described and interpreted.

Generally, both quantitative and qualitative research methodologies were utilized for the research is more of descriptive of cause, impacts and made assessment of revenue capacity of Oromia Regional State. Hence literature and scholar's ideas around the topic including perceptions of selected Federal and State official toward the problem of revenue assignment , federal transfer in relation to revenue capacity were qualified and interpreted using qualitative methodology. Using quantitative method, some mathematical calculations and use of statics were undertaken. Hence, quantitatively, some secondary data as well as primary data were quantified and put in percentage to identify and describe causes and impacts of less revenue capacity of the Study Region.

## **1.7. Significance of the Study**

The author believes that this research has the following significances:

- ✓ The paper has pointed out some implication of fiscal dependence of regional governments in Ethiopian federal context. Thus, the paper can be an input for the legislative organ for making further reform to fiscal policy.
- ✓ Readers achieve some understanding on the consistency or non consistency of Ethiopian revenue assignment with the theory of fiscal decentralization and can serve as literature for students and other researcher to undertake further research on the area.

## **1.8 Organization of the paper**

The paper was organized to be accomplished in five chapters. Hence, the first chapter started with general back ground of the study. The second chapter provides general over view by assessing different literatures about Fiscal decentralization; hence functional assignment, Revenue assignment and Inter governmental Fiscal relations would be discussed. Under this chapter, also comparative assessment of Intergovernmental fiscal relation in Canada, Switzerland, India and Nigeria has been undertaken as would enable to compare that of Ethiopian practice. Chapter three focuses on Fiscal decentralization in Ethiopia. Accordingly, functional assignment, revenue assignment, Intergovernmental fiscal relation and other important related issues are discussed. Chapter four is about data presentation and analysis by emphasizing on interoperating and analyzing the fiscal relationship of Oromia Regional State and federal government relating it with conceptual and theoretical issues discussed in the preceding chapters as well as data collected in relation to the topic. Hence it touch issues such as Revenue source, trends of own revenue in financing expenditures of the state, vertical imbalance as well as its implication, extent of Federal transfer to the state, borrowing power, were discussed. Finally, Chapter five is about conclusion and recommendations.

## **1.9 Limitations for the study**

There are various elements such as corruption, tax evasion; less commitment by tax officials etc that can influence revenue collection performance of states without however, much influence on the potential ability of revenue raising (revenue capacity). Thus, this paper did not make comprehensive assessment with regard to such elements because of time and financial constraints. In other way, elements such as corruption and tax evasion by their nature are complex criminal acts which require long time investigation to obtain relevant data. Besides, there is also biased information and abstention from providing information on the side of some feeling that they are going to be liable if they tell the truth.

## Chapter two: General over view of Related Literatures

### 2.1. The Concept of Fiscal Federalism

Fiscal decentralization is an important aspect of decentralization mainly dealing with functional assignment, tax assignment and Intergovernmental fiscal relation among different tiers of governments in a federation. Accordingly, it gives authority to local governments to collect revenue through taxes and responsibility over spending decisions.<sup>18</sup> Although, fiscal decentralization is claimed to be devolution of fiscal decision making power both in terms of revenue and expenditure aspects, its implementation process has often been overwhelming task particularly in developing Countries (Mbedz, &E., Gondo, 2010). Financial responsibility is the core component of decentralization. It is argued that, if sub national governments are to carry out decentralized functions effectively, they must have adequate revenues raised locally or transferred from the central government, as well as the authority to make expenditure decisions (Martinez, 1998).<sup>19</sup> Recently, various countries of the World, are experimenting with fiscal decentralization as a means of improving their governance and economic growth.

### 2.2. Expenditure Assignment

In every countries of the World, the first fundamental concern of Fiscal decentralization is about functional assignment. For instance, (McClure and Vaillancourt, 2006), have asserted that, in any Intergovernmental Fiscal Relations, there should be a clear assignment of functions among different tiers of governments.<sup>20</sup> In relation to this, (Vazquez, 1998) argued that, instability and controversy may result when laws do not provide a clear jurisdictions and functional obligations of different levels of government.<sup>21</sup> Accordingly, it has been argued that, the assignment of revenue sources should be preceded by expenditure assignment as the later would enable to

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<sup>18</sup> *Fiscal decentralization is an important aspect of decentralization (political decentralization and administrative decentralization) which even could influence the performance of these two aspects.*

<sup>19</sup> *This implies effective fiscal decentralization would be achieved when become autonomous both in terms of revenue needs expenditure allocations.*

<sup>20</sup> *Vazquez (1998) further states that designing the other important pieces of a system of decentralized finance (notably, revenue assignment, transfer, and borrowing) in the absence of clear expenditure assignment is “to put the car before the horse”.*

<sup>21</sup> *Ibid.*

determine the way and the amount of the former to be assigned (Smoke, 2000).<sup>22</sup> Generally, in decentralized fiscal system, the design of Revenue assignment, fiscal transfer and borrowing should follow the assignment of expenditure responsibilities.<sup>23</sup>

However, an important question is which types of functions are to be carried out by which level of governments, which will be discussed here under. For instance, the traditional theory of fiscal federalism, tries to point out three major functions for the public sectors (Oates, 1972). Accordingly, functions of economic stabilization and redistribution are functions of the central government while functions of resources allocations are assigned to SNGs (Fjeldstad, 2001).<sup>24</sup>

Fiscal and monetary policies are the two important instruments to effect stabilization purpose. Although, there exists an argument that SNGs would contribute to economic stabilization through decentralized fiscal system, monetary policy is a sole function of the central government across the World. Even, with regard to fiscal policy, Prud'homme (1995: 210-26) argued that, a decentralized fiscal system may make macroeconomic policies more difficult to implement. Hence, as per this assertion, even through fiscal policy, SNGs could not perform stabilization function.<sup>25</sup> Accordingly, Macroeconomic Stabilization is assigned to the central government because, (1) sub national authorities have very few or no incentive to undertake economic stabilization policies; and (2) lower level of governments often lack the necessary macroeconomic instruments to carry out such policies (World Bank, 2000).

With regard to redistribution function, it is also argued that, it should be the function of the central government because, (i) as redistribution function requires transfer of wealth from rich regions to poorer regions, only the National government can undertake such tasks; (ii) Decentralized redistribution function result in problem in case where factors are mobile; (iii) SNGs in most cases, are not assigned with corporate or progressive income tax, rather assigned with revenue sources that are not easily levied in a way that is progressive with respect to income.<sup>26</sup>

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<sup>22</sup> Smoke, P, (2000). *Fiscal Decentralization in East and Southern Africa: A selective Review of Experience and Thought on moving Forward*. Conference on Fiscal Decentralization, Washington, DC, PPI-46.

<sup>23</sup> *Ibid.* 20

<sup>24</sup> See, Fjeldstad Odd-Helge (2001). **Intergovernmental Fiscal Relations in Developing Countries**. <http://www.cmi.no/publications/2001/wp2001-pdf>

<sup>25</sup> See Prud'homme, R, (1995). *The Danger of Decentralization*. World Bank Research Observer, Vol. 10, pp. 210-26

<sup>26</sup> *Ibid.*

As far as allocation function is concerned, various literatures and empirical studies show that, it should be assigned to SNGs for they are proximate to the citizens. In case where preferences are heterogeneous across jurisdictions, decentralized decision-making power as to the provision of local public goods and services brings efficiency by matching services to the needs and preferences of the citizens (Fjeldstad, 2001).<sup>27</sup>

In favor of the above assertions for instance, Oates (1968:38) argued ,“*Where the Stabilization and Distribution branches of the public fiscal department must work primarily at the central-government level, there are compelling reasons for believing that, in the Allocation Branch, the provision of certain goods and services is best placed in the hands of local governing bodies. In the first place, one might expect that local government would be more responsive to the particular preferences of the community as regards expenditure and revenue policies. A greater reliance on the central government would probably result in a substantially higher degree of uniformity in public services among communities.*”

Hence, from the above assertion, it is apparently observed that, local governments are closer to local population and can identify their choice and preferences better than the central government.<sup>28</sup> On the other hand, an argument goes that, effective and efficient decentralization would be achieved when there exists a close correspondence between responsibility and decision making authority.<sup>29</sup> Besides, decentralized allocation function creates a close relationship between the benefits from the public services and taxes on the local taxpayers which in turn enhance the utilization of resources efficiently and cost effectively. Hence, for the above discussed main reasons, allocation functions are assigned to SNGs in most cases.

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<sup>27</sup> *Ibid.* 24

<sup>28</sup> See, Oates, W. E. (1968), *The Theory of Public Finance in a Federal System. Canadian Journal of Economics*, 1,p.38

<sup>29</sup> *Ibid.*

### 2.3. Revenue Assignment

The performance of expenditure responsibility of different levels of governments should be followed by an assignment of proper revenue sources because, once the allocation of expenditure responsibilities of different tiers of governments is conducted, an important issue is designing assignment of taxing power which enable to identify who should tax, where and what.<sup>30</sup> Further, proper revenue assignment or devolution of taxing power make subnational governments autonomous and it would influence the performance of their expenditure responsibilities. Thus, in the context of fiscal decentralization, the assignment practice needs to identify the comparative efficiency and effectiveness of providing the fiscal instruments to tiers of governments so as to finance public functions in the most efficient manner possible.<sup>31</sup>

Accordingly, in decentralized fiscal system, tiers of government to finance their assigned responsibility, rely on different sources for their revenue needs, including direct and indirect, tax and non tax revenue sources, business and individual taxes etc. However, as far as devolution of revenue sources is concerned, there is no clear cut rule of assignment among different levels of governments. Therefore, in response to this, tax-assignment rules' has been developed which relate the assignment of tax sources to the respective responsibilities of central and lower tiers of government in macroeconomic stabilization, income redistribution and resource allocations.<sup>32</sup>

Hence, as it has been mentioned above, purpose of macroeconomic stabilization can influence the assignment of certain tax sources that may substantially influence central budget deficits or inflation which calls for central control over these revenue sources. Thus, in most countries, taxes which are the most power full stabilizing effects such as corporate income tax and Progressive Individual income taxes are assigned to central government<sup>33</sup>. Further, the central governments centralize taxes such as taxes on international transactions (customs duties) and a considerable share of income and general sales taxes (such as VAT) on the base of macroeconomic stabilization and redistribution functions. This can be emphasized that, if the above mentioned tax bases are decentralized to the lower units of governments, horizontal fiscal

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<sup>30</sup> See, Musgrave, Richard. 1983. "Who Should Tax, Where, What?" in Charles McClure, Jr. (ed.) *Tax Assignment in Federal Countries*, Canberra: Center for Research on Federal Financial Relations, ANU.

<sup>31</sup> See also McClure, Jr., Charles E., "The Assignment of Revenue Sources and the Design of Intergovernmental Transfers," in Jorge Martinez-Vazquez, Eileen Browne, Malcolm G. Lane, Charles McClure, Dale McComber, Andrew D. Pike, and Sally Wallace, "Intergovernmental Finances, Budgeting, and Tax Administration in Ukraine," *Final Report to the NIS Task Force, USAID, January 1994*, pp. 63-150.(a)

<sup>32</sup> See Oates, Wallace. 1996. "Taxation in a Federal System: The Tax Assignment Problem." *Public Economics Review*, vol. 1, Pp: 35-60.

<sup>33</sup> *Ibid.*

imbalance reaches its peak as there exist variation in level of urbanization, business transactions, composition of Enterprises and Companies etc.<sup>34</sup>

Moreover, in relation to allocation function, the central governments centralize corporate income taxes and wealth taxes because; local taxing powers may exacerbate differences in case where there are wide disparities in income and wealth across provinces.<sup>35</sup> In other case, the central governments have the capacity to live with unstable revenue sources since; the central government can borrow money to adjust the problem. However, Local governments, require relatively stable sources of revenue because of their limited borrowing power or less revenue capacity.<sup>36</sup> On the other hand, because of geographic and other factors, resources particularly natural resources would be unevenly distributed which cause economic disparities among subnational governments.<sup>37</sup> Thus, on the base of maintaining equity among subnational governments; in most case, the central governments centralize taxes from unevenly distributed natural resources.

From the above discussions, therefore, six general principles were identified in federations according Daffilon and Madies (2009).

- Taxes suitable for economic stabilization should be levied by the central government; lower- level taxes should be cyclically stable;
- Progressive re-distributional taxes should be assigned to central government;
- Personal taxes with progressive rates should be levied by the jurisdictions most capable of implementing a tax on a global base;
- Lower-level governments should tax revenue bases with low mobility between jurisdictions;
- Tax bases distributed highly unequally between jurisdictions should be centralized; and
- Benefit taxes and user charges may be appropriately used at all levels.

Some scholars however, argue that even if these general principles were laid down, the practice does not conform to these rules (Tanzi, 2000). Accordingly, while the general principles and

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<sup>34</sup> For instance, in Ethiopian case, if these revenue base are decentralized, only limited regional governments such as Oromia and Amhara would benefit but, at the cost of horizontal imbalance with the rests of regional governments.

<sup>35</sup> Ibid.

<sup>36</sup> In most federation as it is also true for Ethiopia, SNGs are limited to borrow from International Institutions and have limited revenue capacity to escape the instability which necessitates them to depend more of on stable revenue sources.

<sup>37</sup> See also Sobel, Russell. 1997. "Optimal Taxation in a Federal System of Governments" *Southern Economic Journal*, vol. 46, Pp: 468-485.

theoretical discussions of tax assignments are useful, in practice, country-specific factors play a large role.<sup>38</sup> This would imply that, the socio-economic and political background of a country may influence the assignment of revenue among tiers of governments. However, from both theoretical and practical perspectives, it can be identified that, 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 mostly assigned to the federal government.<sup>39</sup>

## **2.4. Fiscal Autonomy of SNGs**

Various scholars viewed that; effective decentralization is which gives fiscal autonomy (Revenue autonomy and spending autonomy) to SNGs.<sup>40</sup> Further, it has been stated that, important elements of decentralization are the degree of autonomy that Sub-national governments have over revenue raising and spending decisions. Thus, one can observe from the above assertion that, fiscal autonomy is the extent of SNGs control over own revenue sources through their taxing power and the extent of their capacity to match it with their expenditure without the influence of other level of government. The concept (fiscal autonomy) also deals with full benefit that SNG acquire from decentralized fiscal system and their fiscal importance i.e. the extent of their revenue generation or contribution of revenue generated by autonomous SNG for total revenue of the Nation.<sup>41</sup>

Chapman (1999) in analyzing fiscal autonomy differentiates Local government's autonomy (Political and Demonstrative autonomy) from Local government's fiscal autonomy in which the later can determine the former. Thus, according to the scholar, local fiscal autonomy is one of the necessary conditions for local autonomy to exist. Basically however, Fiscal autonomy is related

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<sup>38</sup> See Tanzi, Vito and Howell Zee. 2000. "Tax Policy for Emerging Markets: Developing Countries," IMF Working Paper, WP/00/35.

<sup>39</sup> This however, does not mean the assignment is without negative impact on some regional governments. This is because; such revenue sources originate from limited regional governments. Hence in the absence of equitable transfer system or revenue sharing, these regional government equally face the problem of vertical fiscal imbalance.

<sup>40</sup> See Bell, E, Ebel, R., Kaiser, K, and Rojchaichantham, J, (2006). *Measuring Fiscal Decentralization: A New Perspective. Discussion Draft, World Bank's Public Sector Group*

<sup>41</sup> The fiscal importance of a given regional government or the extent percentage share of total revenue would imply the autonomy of SNGs. Accordingly higher share of total revenue by SNGs imply higher autonomy while, lower share imply the influence of higher level government over their budget process.

with the power of SNGs to regulate and levy taxes under their jurisdiction without higher level government.<sup>42</sup>

It has been observed that, many literatures focus quantitatively on degree of revenue control and capacity to finance by SNGs to measure fiscal autonomy. However, this criterion only does not indicate real fiscal autonomy of SNGs<sup>43</sup> Liu (2007), further enhanced this argument, by stating that, most of the empirical studies aimed at measuring the degree of fiscal decentralization, have been primarily focusing on quantitative aspects of revenue and expenditure ratios of SNGs from the total revenue and expenditure of the nation.<sup>44</sup> However, “measuring fiscal decentralization on the base of quantitative measures of revenue and expenditure ratio is traditional (Liu, 2007). Accordingly, to measure fiscal decentralization, experts in public finance have been more concerned with qualitative aspects of fiscal decentralization such as the power of SNGs to decide issues such as the appropriate tax base, tax rate, regulatory framework for borrowing, nature of IGFTs” (Ibid.). This would be emphasized that, measures of fiscal decentralization should reflect the key characteristics of a fiscally decentralized system including the existence of locally elected council and locally approved budget etc.<sup>45</sup>

Generally from the above discussion, fiscal autonomy mainly includes SNGs’ spending autonomy and Revenue autonomy. Accordingly spending autonomy is, concerned with having the capacity of determining and changing expenditure patterns by SNGs under their jurisdiction. This implies that, as far as determination and allocation of expenditure is concerned; SNGs should be free from the influence of higher level government Katarobo (2004). For instance, it has been argued that, the setting of expenditure priorities under SNGs’ jurisdiction should be undertaken independently from higher level government.<sup>46</sup> Accordingly, full spending autonomy would imply that, SNGs are fully able to set their own economic and functional expenditure patterns which in turn enable to achieve efficient and locally accountable service provision. However, various argue that, spending autonomy is highly associated with revenue autonomy of

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<sup>42</sup> *The power of lower unit governments to determine its own tax rate and tax bases, would expand the revenue capacity of SNGs and can increase the quantity and quality of public services as it would increase the accountability of lower governments toward the needs and preferences of their constituencies.*

<sup>43</sup> *Accordingly, recent studies of public finance incorporate qualitative indicators arguing that, quantitative measure alone would not indicate real fiscal autonomy.*

<sup>44</sup> *See Liu, C, (2007). What Type of Fiscal Decentralization System Has Better Performance? PhD Thesis, University of Maryland*

<sup>45</sup> *See also, Prud’ homme, R, (2001). Fiscal Decentralization and Intergovernmental Fiscal Relations Cape Town Symposium, University, Paris XII, 94010 Creteil, Cedex, France, PP 11-19.*

<sup>46</sup> *However, SNGs in most federations are financially incapable or dependent on the central government to adjust their budget with their expenditure needs.*

SNGs.<sup>47</sup> Thus; a higher degree of revenue autonomy would result in higher degree of expenditure autonomy. For instance, when SNGs are dependent on the central government for their incapacity to finance their functions, their spending autonomy would be influenced by conditional and discretionary grants of the central government. Further, the structure of SNGs responsibilities and resources makes substantial differences to its discretion – its ability to make decisions over the nature and levels of local services. For example, a LG should have more ability to determine its level of expenditure if it obtains a significant proportion of its revenue from local taxes and charges which it can vary (Davy, 2003). Oates (1972) also argues that, the greatest efficiency is achieved when budgetary choices are made by local officials elected by local people who have to meet the full cost of their decisions through local taxes.<sup>48</sup>

As far as revenue autonomy is concerned, some scholars have asserted that, degrees of revenue autonomy of SNGs have been measured only on quantitative bases. Accordingly, the share of SNGs' revenue to the total revenue of a nation or the degree of control SNGs have over their revenues and own sources of revenue imply revenue autonomy of SNGs.<sup>49</sup> Oates (1972) for instance, argued that, revenue autonomy is measured by: “revenue ratio” that compares the SNGs revenue with that of the total government.<sup>50</sup> However, recently scholars' work on revenue autonomy have not just confined to SNGs' share of total government revenues rather, concerned with the actual degree of autonomy localities have over revenues.<sup>51</sup> This can be emphasized by focusing on three types of revenues: own-sources of revenues, shared revenues, and a variety of transfers (Bell, et al, 2006). In most cases in measuring the revenue autonomy of SNGs more emphasize is given for own revenue than the share of total revenues of SNGs. Accordingly, supporters of own revenue as a measure of revenue autonomy claim that, unless SNGs do not have the power of altering the tax bases and its rates neither local autonomy nor local accountability is meaningful (Bahl and Bird; 2008).

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<sup>47</sup> *Particularly in case of conditional grant SNGs have no spending autonomy as far as the allocation of grant is concerned as it has been predetermined by the central government.*

<sup>48</sup> Oates, W. E. (1972), *Fiscal Federalism*. New York: Harcourt Brace Jovanovich.

<sup>49</sup> *Ibid.*

<sup>50</sup> *Ibid.*

<sup>51</sup> *Hence, composition of own revenue sources or the power of SNGs in determining tax rates and bases are included to indicate revenue autonomy.*

For, instance, OECD (2002) has pointed out that SNGs have total or significant control over the taxes of which SNGs set the rate or/and base. Accordingly, local revenue autonomy is influenced where the central government sets tax rates and bases. Some argue that, Non-tax revenues are included in “locally owned revenues”, while fiscal transfers are not included. However, the other line of argument, has point out that, grants from a higher-level government as “own revenues” McLure and Martinez (2006). Generally most recent empirical studies show that, emphasis is given to “own-revenues” of SNGs, as one of the key indicator of fiscal autonomy.

## **2.5. Intergovernmental Fiscal Relations**

### **2.5.1. Fiscal Imbalances**

While public expenditure and revenue rising are common in public finance to all kinds of governments and states , fiscal imbalances and intergovernmental revenue transfers are important elements of fiscal federalism in a country of federal form of government.<sup>52</sup> In federal political structure, powers and functions of government are subject to constitutional devolution among different level of the governments. This includes financial power of governments to satisfy the public services through expenditure responsibility and revenue raising. Though, this allocation scheme is designed with many considerations, it does not immune from creating imbalance between responsibilities and resources. The fiscal mismatch between the expenditure responsibility and revenue sources is generally termed as fiscal imbalances.<sup>53</sup> In accordance with the level of governments and their relations, there exists mismatch between revenues and expenditures that arise from fiscal relations between the center and sub-national governments creating vertical fiscal imbalance and from fiscal relations among sub-national governments causing horizontal fiscal imbalance.<sup>54</sup>

### **2.5.2. Vertical Fiscal Imbalances**

The issue of vertical imbalance is one of fiscal imbalance challenges of fiscal federalism that is encountered by either of the tiers or both governments. In most federal systems, there is a mismatch between the expenditure responsibility and the revenue capacity of regional

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<sup>52</sup> See Boadway, Robin and Jean-François Tremblay (2006). "A Theory of Fiscal Imbalance". *Finanzarchiv* 62, 1-27.

<sup>53</sup> *Ibid.*

<sup>54</sup> See also Bird, Richard M. (2003), "Fiscal Flows, Fiscal Balance and Fiscal Sustainability". Working Paper 03-02, Andrew Young School of Policy Studies, Georgia State University

governments. As a result, expenditure needs of Sub-national governments could not be financed without financial support of central governments.<sup>55</sup> This imbalance between the revenue raising ability of sub-national governments and their expenditure responsibilities is usually called vertical fiscal imbalance. This vertical fiscal imbalance is primarily generated by constitutionally assigned expenditure and revenue responsibilities i.e. while tiers of government have significant expenditure responsibilities, the major revenue sources remain concentrated at the centre.<sup>56</sup> Hence, in most federations, expansive and lucrative source of taxation lie within the center while the responsibility to provide for development, welfare and social activities like education, housing, health, agriculture etc. are primarily imposed on the states the cost of which cannot be internalized with own revenue source of Sub- national government.<sup>57</sup>

There are two methods which enable to examine vertical fiscal imbalance which basically based on the two aspects of public finance: the expenditure and the revenue. The first way is to measure what share of regional government expenditures are financed with its own revenue sources under its jurisdiction. Accordingly, if the substantial share of regional expenditures is financed by the revenue from tax and non tax under their taxation power, the degree of vertical fiscal imbalance is low. On the other hand, if dominant share of regional governments' expenditures are covered by the center, vertical imbalance imperatively exists.<sup>58</sup>

The second way is measuring the share of revenue generated by the regions as a percentage of the total national revenue raised by all tiers of governments. This shows the capacity of the regional government in order to incur its expenditures compared to other states. This can be emphasized that, higher share of total national revenue by regional government imply that there exist low level of vertical imbalance while low share of total national revenue by the region shows the existence of high degree of vertical imbalance.<sup>59</sup>

### **2.5.3. Horizontal Imbalance**

A horizontal fiscal imbalance is attributed by variation in demography, geography, and variation in natural resource endowment etc which undermine equal access to public goods and services

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<sup>55</sup> *Ibid.*

<sup>56</sup> See Boadway, Robin (2002). "The Vertical Fiscal Gap: Conceptions and Misconceptions". Paper presented at the conference on Canadian Fiscal Arrangements, Winnipeg, May 2002.

<sup>57</sup> *Ibid.*

<sup>58</sup> *Ibid.*

<sup>59</sup> *Ibid.*

by individuals residing in different jurisdiction.<sup>60</sup> Besides the above factors, another instance which cause horizontal fiscal imbalance is that sub-national governments may not have equal fiscal capacity to provide equal public services although they are assigned with the same revenue sources. They usually varies in their capacities because, single tax base may not generate the same amount of money in different places because factors such as low political commitment, corruptions, tax evasion etc would influence revenue collection performance.<sup>61</sup> Such phenomenon thus, leads to disparity in revenue capacity among sub national governments so that they are unable to provide their citizens with services at the same level on the basis of comparable tax levels.

#### **2.5.4. Revenue Capacity and its measure**

Fiscal capacity is a measure of a government's ability to raise revenues for the provision of services, relative to the costs of service responsibilities. Thus, in federal political system, fiscal capacity of a region can be defined as the potential ability of the government of the region to finance the provision of public goods and services by raising revenues from its own source.<sup>62</sup> Measuring fiscal capacity is essential in addressing interregional disparities and implementation of an equalization program because, it guides the central governments in their efforts to equalize the amount of resources available to each of the regions. Further, fiscal capacity measure also provides information about subnational governments' relative fiscal strengths and weaknesses.

This measure can be used to:<sup>63</sup>

- Monitor and compare trends in subnational governments' fiscal and economic situation;
- Provide information about assessing the strength of the regional economy;
- Forecast the impact of structural change in regional economy;
- Guide central government in assisting sub national governments by different grants.

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<sup>60</sup> *SNGs in a given Federation may vary in their degree of development owing to variation resources endowment, urbanization, proximity to capital city creating horizontal economic disparity. This is why in most federation, the center dominates unevenly distributed to correct the imbalance.*

<sup>61</sup> *Id.*, 36

<sup>62</sup> *See Martinez-Vazquez, Jorge and L.F. Jameson Boex (1997a), Fiscal Capacity: An Overview of Concepts and Measurement Issues and their Applicability in the Russian Federation, International Studies Program Working Paper 97-3, Andrew Young School of Policy Studies, Georgia State University.*

<sup>63</sup> *In most cases measures of revenue capacity of SNGs enable to design effective Intergovernmental fiscal Transfer.*

Provided that fiscal capacity measure has the above mentioned importance, no golden rule approach is adopted as far as its measure is concerned. For instance, (Martinez-Vazquez and Boex, 1997a & 1997b) viewed that fiscal capacity can be measured on the base of revenue-raising ability of sub national governments without considering the expenditure side of Subnational governments. Some Countries, such as Canada follow this approach by concentrating only on revenue side to measure fiscal capacity.<sup>64</sup> Accordingly, Canada designed equalization grant for the management of horizontal fiscal disparity based on revenue raising ability without considering the expenditure side of SNGs.

However, it is argued that, the mere determination of revenue raising capacity without incorporating expenditure aspect of subnational government would not be real measure of fiscal capacity. For instance, in favor of this argument, the United States Advisory Commission on Intergovernmental Fiscal Relations has developed a new methodology to incorporate expenditure side of the public finances in measuring fiscal capacity of the U.S states.<sup>65</sup> Accordingly, both Revenue raising ability and expenditure needs enables to measure the revenue capacity of SNGs which will be discussed in subsequent sections.

#### **2.5.4.1 Revenue Side**

Two basic approaches are developed in assessing the relative revenue-raising ability of subnational governments. The first one is “macroeconomic approach” which measure fiscal capacity on the base of per capita income as an important variable because, since the most obvious source of revenue for a regional government is the taxes levied on its residents’ income and per capita income reflects the relative economic strength of regions.<sup>66</sup>

The second is “microeconomic approach” which measure fiscal capacity of subnational government on the base of actual tax system with separate measures of revenue-raising capacity for each kind of tax actually levied.<sup>67</sup> Under this approach all revenue sources of subnational government are included for measuring the fiscal capacity of that subnational government in the form of Representative tax system (RTS). Representative tax system consists of national average

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<sup>64</sup> See also Martinez-Vazquez, Jorge and L.F. Jameson Boex (1997b), *An Analysis of Alternative Measures of Fiscal Capacity for the Regions of the Russian Federation*, International Studies Program Working Paper 97-4, Andrew Young School of Policy Studies, Georgia State University.

<sup>65</sup> See United States Advisory Commission on Intergovernmental Fiscal Relations (1990a), *State Fiscal Capacity and Effort*, Information Report M 170, Washington, DC: ACIR.

<sup>66</sup> *Ibd.* 36

<sup>67</sup> *Ibd.*

tax rates applied to all commonly used tax or revenue bases. However, one challenge to this approach that there may exist difference in tax rates and tax bases from one jurisdiction to another, in estimating RTS measures.<sup>68</sup>

As far as revenue collection effort is concerned, ( Martinez-Vazquez and Boex, 1997 ), “asserted that, revenue collection effort is considered as a poor tax capacity because, measure of Revenue capacity on this base fail to recognize that the amount of collection is affected by region’s fiscal capacity and fiscal effort. On the other hand, use of revenue collection as a proxy of fiscal capacity in equalizing grant allocation provides perverse incentive to regions to lower their fiscal effort”. Thus, regions that exert a low effort in revenue collection may benefit from grant formula. Further, Jorge, Martinez-Vazquez & Jameson, Boex (1997) asserted that, while, tax rates, enforcement effort and tax payers compliance all affect the level of revenue collection, they do not affect the potential ability of Regions to raise revenue rather it is influenced by economic structure of the regions and taxable resources or tax bases. Accordingly, for instance, Tax base of the Enterprises, Profit tax (EPT) is the amount of taxable profit earned by an enterprises head quartered in the region. This assertion therefore, enhances the above view of some of the Ethiopian Regions’ less revenue capacity because of inaccessibility of profitable tax bases.

On the other hand, the GDP of Regions would reflect their Revenue capacity. Hence the Growth Domestic Products being the total value of goods and service produced by the region’s economic resources (land, capital and labor), reflect the total amount of income potentially subject to taxation by the regional governments. Other, option in measuring revenue capacity of regional governments is determination of Total Taxable Resources by differentiating taxable resources under regional jurisdiction from federal revenue sources and Transfer in which measure of GRP does not consider because Federal tax are unavailable to regional governments as a sources of revenue.

#### **2.5.4.2 Expenditure Side**

There are factors which causes variation of casts of public services and goods from one jurisdiction to another such as the range and types of services subnational governments must provide (by law); the prices of the inputs used to produce public services, such as wages and

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<sup>68</sup> *In federation, like USA, Canada and Switzerland SNGs are fiscally autonomous in which there exist instances of variation in tax rate and base between the center and SNGs challenging RTS as a measure of Revenue capacity.*

salaries, etc; Demographic, geographic factors etc would be determining factors for variation of the quality and quantity of services provision by subnational governments. Hence, although RTS provides information about revenue raising ability of subnational governments, it is salient about the variation of costs for service delivery across subnational governments which have implication on their revenue capacity. Thus, estimating the cost of service responsibility is the second element of measuring fiscal capacity of subnational government.<sup>69</sup>

## 2.6. Intergovernmental Fiscal Transfer

Intergovernmental Fiscal transfers especially in developing countries, form a large and sometimes predominant portion of lower-level government expenditure. The design of Fiscal transfer system therefore, plays a key role in federal financial systems.<sup>70</sup> Because, the assignment of tax and expenditure between the center and sub-national levels is often not corresponding, and lower-level governments have revenues that do not match their needs.<sup>71</sup> This can be explained by the fact that, the most lucrative revenue sources are assigned with the federal government while; lower units of governments implement various policies without equal revenue assignment. This gives rise to a vertical financial imbalance in that the federal government has revenue availability owing to its general functions while the local governments find themselves in the reverse situation.<sup>72</sup> Thus, this necessitates the design of intergovernmental transfers to fill the gap by transferring some revenue share to SNGs. On the other hand, horizontal fiscal disparities can be managed through transfer in the form of equalization grant as it fills the gap being additional funds for sabnational government with low revenue capacity. However, the practice of intergovernmental fiscal transfers takes different form based on its purpose for which it is designed according to country specific.<sup>73</sup>

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<sup>69</sup> See Oates, Wallace E. (1968), "The Theory of Public Finance in a Federal System," *Canadian Journal of Economics*, pp. 37-54.

<sup>70</sup> See Breton, Albert and Angela Frascini (2007) "Competitive Governments, Globalization, and Equalization Grants". *Public Finance Review*. 35(4), 463-479.

<sup>71</sup> See Dafflon, Bernand, (2009) "Fiscal Capacity Equalization in Horizontal Fiscal Equalization Program" in Robin Boadway and Anwar Shah,(eds) *The Theory and Practice of Intergovernmental Transfers. Principles and Practices. The World Bank*

<sup>72</sup> *Ibid.*

<sup>73</sup> See Shah, Anwar "Perspectives on the Design of Intergovernmental Fiscal Relations, A Reforma Fiscal no Brasil, the proceedings of the International Symposium on Fiscal Reform, Sao Paulo, September 9, 1993.

### 2.6.1 Revenue Sharing

In federal form of political system, both in developing and developed countries, the central government adopts mechanism of Revenue sharing to correct both vertical and horizontal fiscal imbalances. Tax revenues can be shared on a tax-by-tax basis or on the entire pool of central government tax revenues.<sup>74</sup> Tax sharing is an arrangement where tax revenue is divided vertically and horizontally among sub central governments. Various scholars consider tax sharing arrangement as mechanism of correcting horizontal fiscal disparity (Equalization purpose) while maintaining central control over fiscal aggregates. One problem associated with the tax-by-tax sharing arrangement however, is that it may give the central government discretionary power to concentrate its collection and enforcement efforts on the taxes that are either not shared or shared to a lesser degree. Furthermore, the central government may have an incentive to increases in rates (for instance for stabilization purposes) on the shared taxes, something that may affect the tax system.<sup>75</sup>

Therefore, revenue sharing based on the entire pool of government revenues, may be preferable because, revenue sharing, which transfers a portion of the entire national revenue based on the existing formula, is much like a general-purpose unconditional block grant which relatively enhance the fiscal autonomy of sub-national governments.<sup>76</sup>

It has been further argued that, revenue sharing is a mechanism, whereby sub-national governments have unconditional access to a specified share of revenues collected by central governments creating fiscal autonomy of these governments (sub-national governments) to use it in their own discretion matching it with priorities they set. Two general rules determine revenue sharing between central and state governments: Principle of derivation in which revenues are transferred to the states in accordance with, where the federal revenues were raised. In other case, each state's share will reflect both its tax capacity relative to other provinces and its need for funds to finance the provision of some standard level of public services.<sup>77</sup>

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<sup>74</sup> *The practice of revenue sharing takes different forms in different federation. For instance, under the Ethiopian practice, irrespective of the constitutional assignment of concurrent tax, only the federal governments exclusively administers and collect revenue from these source while states are entitled to only its share. In other federations concurrent tax does not considered as revenue sharing as SNGs are entitled to such tax.*

<sup>75</sup> *See also OECD Economic Studies No. 43, 2006/2.*

<sup>76</sup> *Ibid.*

<sup>77</sup> *Ibid.*

## **2.6.2 Grants**

Besides revenue sharing, Grant which takes different form is an important mechanism of intergovernmental transfers to manage both fiscal imbalances as well as to enhance economic development across the nation which is designed by the central governments to sub-central governments.

### **2.6.2.1 Conditional grants**

These grants usually followed by conditions regarding the use of the funds limiting the discretionary power of local governments not to deviate from the condition. Sometimes the conditions are tied to the performance to be achieved in the program financed through them. Thus, states do not have discretionary power to allocate the transfer other than expenditure areas determined by higher government because, such transfers are, intended to provide incentives for sub-central governments to undertake specific programs or activities.<sup>78</sup> Further, Conditional grants may either be matching or non- matching. Matching grants require grant recipients to finance a specified percentage of expenditure using their own resources. Conditional non-matching transfers provide a given level of funds without local matching as long as the funds are spent for a particular purpose.<sup>79</sup>

### **2.6.2.2 Unconditional Grants**

These are general-purpose transfers from the central government to lower governments without any condition or attachment to the transfer. Hence, states are autonomous on such transfer to allocate it to areas of their preferences because; it places no condition on the allocation of the transfer. In most cases the purpose of providing unconditional grant by the central government is that, such grants can be used to equalize fiscal capacities (both in terms revenue capacity and expenditure needs) of different local governments to ensure the provision of a minimum (or reasonable) level of public services.<sup>80</sup>

These grants in most case are aimed to address horizontal imbalances between local jurisdictions. The purpose of horizontal equalization is to equalize the capacity of local governments to

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<sup>78</sup> See Dahlby, B. (1996, *Fiscal externalities and the design of intergovernmental grants. International Tax and Public Finance* 3: 397-412.

<sup>79</sup> *Ibid.*

<sup>80</sup> Various scholars consider Unconditional grant as own revenue sources of SNGs because once transferred to them they have independent discretionary power over its allocation as it has no condition attached by the center.

provide a ‘national standard’ level of public goods and services.<sup>81</sup> The grants may also have the effect of closing the vertical fiscal gap because, it provides sub- central governments with additional financial resources, thus filling the gap between own tax revenue and expenditure needs. In most countries, the equalization grants are transfers made from the central government to the subnational governments (e.g., Canada, Australia, the United Kingdom, etc.), while in Germany, the equalization transfer is made from states with above-average fiscal capacities to states with below-average fiscal capacities to manage both Vertical and Horizontal imbalances.<sup>82</sup> In other countries, unconditional equalization grants take the form of a general revenue-sharing. The formulas used to allocate the equalization transfers to subnational government are the central element of this grant system, and are subject to intense debate both academically and in practice.<sup>83</sup>

## 2.7. Borrowing by SNGs

In most federations particularly in developing countries SNGs do not have financial capacity to perform capital expenditure. Hence, Local borrowing is an important source for financing long-term development projects such as roads, bridges, and water works.<sup>84</sup> SNGs in many developing countries get much of their capital budget from intergovernmental transfers, but some decentralized governments, typically states, provinces, and large cities, are able to borrow in some countries (Smoke, 2000).<sup>85</sup>

Although borrowing rights of SNGs varies from federation to federation, both domestic and foreign borrowings are not without restrictions.<sup>86</sup> Before borrowing money, it is crucial to determine any restrictions on: the amount of debt which can be incurred, types of debt, maturity dates, and the process to be followed. Constitutional provisions or statutory laws are the most

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<sup>81</sup> Equalization grant in most cases takes into account both revenue power and expenditure needs to maintain balance between the two.

<sup>82</sup> See, Maslove, Allan M. and Stanley L. Winer (1996). “Fiscal Federalism in Canada and Australia: A Brief Comparison of Constitutional Frameworks, Structural Features of Existing Fiscal Systems and Fiscal Institutions”, in Paul Boothe (ed.). *Reforming Fiscal Federalism for Global Competition: A Canada-Australia Comparison*. Western Studies in Economic Policy, The University of Alberta Press, 45-85.

<sup>83</sup> *Ibid.*

<sup>84</sup> It is argued that Local borrowing for such projects is justified on the ground that the benefits of these projects often last decades; thus, future taxpayers should bear the costs of these projects

<sup>85</sup> In Federation like Canada and Switzerland, SNGs have independent power of borrowing both from domestic and international financial institutions.

<sup>86</sup> Allowing SNGs to borrow without any restriction may result in unnecessary competition which in turn causes the overall economic instability.

common means of limiting local government's ability to borrow money. These laws are usually targeted at tax supported obligations because the debt is secured by a pledge of tax revenues.<sup>87</sup>

There may be a limit on the percentage or type of assets that can be pledged. It is prudent financial management to limit the ability to pledge revenues to local government assets through borrowing. Establishing an effective debt management program helps to preserve the local government's long term fiscal viability. Accordingly, effective debt management program helps to:<sup>88</sup>

- Establish parameters that limit the power to borrow money and avoid potential abuses.
- Provide a way to finance capital investments within the local government's capacity to repay the loans.
- Establish sound debt management practices that support creditworthiness.
- Save money on interest charges by selecting appropriate debt instruments and structures

According to Smoke (2000), the approach that a central government takes towards enhancing sub-national government access to loans depends on the fiscal context. In case where decentralized governments are relatively strong, efforts to develop direct access to capital markets make sense, but the central government must regulate municipal bond markets, develop and enforce credit limits, and stop bailing out sub-national governments that default on their debt.<sup>89</sup> In more typical cases, where sub-national government investment responsibilities are smaller and they are fiscally weak, some type of municipal development fund will be generally the correct approach. Municipal credit institutions are initially regulated or managed and substantially capitalized by central governments. This approach gives central fiscal authorities considerable control over borrowing activities of sub-national governments.<sup>90</sup>

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<sup>87</sup> *Ibid.*

<sup>88</sup> *See for example, Ahmed (1999; pp, 104)*

<sup>89</sup> *This argument provides that, in federation where its SNGs fiscal power is strong is better allowed to borrowing than fiscally weak SNGs without much restriction as they have incentive to repay back the loan.*

<sup>90</sup> *Ibid.*

## Chapter Three

### 3.1 Fiscal Decentralization in Ethiopia

Soon after the fall of Derg Regime, the Transitional Government of Ethiopia changed the administrative restructure of the country. Accordingly, the political, administrative and fiscal systems of the country were restructured (Solomon2005:23). Hence, although it was formalized by the 1995 FDRE Constitution, informally Ethiopia started the practice of Federalism during the establishment of Transitional Government (Ibd.P.25). Thus, to enhance the devolution of functions and powers among levels of governments, different proclamations were made based on the Charter.

### 3.2. Functional Assignment under the FDRE Constitution

In the Ethiopian federal system, the FDRE Constitution lists the exclusive powers and functions of the federal government as well as exclusive powers of the state governments.<sup>91</sup> 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.<sup>92</sup>

As in the most Federation, the Constitution assigns the federal government with functions those powers which by their very nature are considered to be the common concern of all the constituent units of the federation. Accordingly, national defence, international or foreign relations, citizenship, immigration etc are the exclusive functions of the Federal government. As far as national defence is concerned, the federal government it is empowered to organize national defence, public security and the federal police force.<sup>93</sup> On the other hand, the exclusive area of the federal government are interstate commerce; postal and telecommunication services; weights and measures; domestic currency coinage and foreign currency usage; and banking, insurance, patents copyright.<sup>94</sup> In the same manner, rail, air and water transports and major roads linking two or more states are listed under the jurisdiction of the Federal government As far as legislative powers are concerned, the

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<sup>91</sup> See Art 51 and 52 of the FDRE Constitution.

<sup>92</sup> *If not in reality the assignment of residual powers to State governments is to broaden the functions of lower government but this does not include residual taxation power as it is determined by the joint session of the Houses (HoPR and HoF)*

<sup>93</sup> See Art. 55 (7) of the Constitution

<sup>94</sup> See the Constitution, Art. 51, 54, 55

federal government through the HOPR has the legislative power over matters concerning electoral laws and procedures, as well as the enforcement of political rights established by the constitution.<sup>95</sup>

With regard to the making of civil and criminal law, the FDRE Constitution provides the enactment of a penal code for the federal government. States however, may enact legislation on matters that are not covered by the penal code. As far as civil law is concerned, the federal government 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.<sup>96</sup>

With regard to states power and functions, the FDRE Constitution, provides the areas of their jurisdiction. These powers include the establishment of state police power, the maintenance of public peace and order, the administration of land and other natural resources based on federal laws, and the employment and working conditions of civil servants. The states also have power over such areas as education, health and agriculture although the federal government has the power to set national standards. In addition, the States have independent power with respect to matters not mentioned in the federal list. However, as far as education health are concerned, the Constitution provides that the federal government shall establish and implement national standards and basic policy criteria.<sup>97</sup>

### **3.3 Revenue Assignment**

The division of taxation power, being an important instrument for the performance of the above discussed functional assignment is an important element of fiscal decentralization under the FDRE Constitution.<sup>98</sup> Accordingly; the FDRE Constitution allocates the taxation power into three categories, namely „the federal power of taxation, the state power taxation, the concurrent power of taxation of both levels of governments. The constitution in other case, mandate the HOF to determine residual taxes (undesigned taxation power).<sup>99</sup> Hence, under the title of exclusive power of taxation, the FDRE Constitution provides that both levels of governments shall levy taxes and collect duties on sources reserved to it in which each tier exercise its legislative and administrative powers within its taxation jurisdiction. However, the practice shows that, the tax rates set by the federal government have been applied throughout the states. In this regard, although, the FDRE Constitution does not clearly provide limitations to that

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<sup>95</sup> *These federal matters are those powers identified as federal matters in different laws.*

<sup>96</sup> *Those civil matters, which are local in nature are left for state governments to ensure their self administration based on their social, cultural etc factors.*

<sup>97</sup> *Ibid. Art 52 (2), 51(3)*

<sup>98</sup> *Ibid. Art. 96, 97, 98 and 99 of the FDRE Constitution*

<sup>99</sup> *Ibid.*

effect; the practice shows the uniformity of tax rate and tax bases throughout the country.<sup>100</sup> Therefore, under the practice of Ethiopian fiscal decentralization, tax autonomy would be a mere Constitutional promise in the absence of an important element of tax assignment.<sup>101</sup> Hence, when compared with Canada and Switzerland, the Ethiopian Constitution equally devolved administrative and political powers among three tiers of government under its Art.51, 52 and by the respective regional Constitutions. However, as far as revenue decentralization is concerned, as opposed to lower governments in Ethiopia, in both federations (Canada and Switzerland) SNGs have various revenue sources under their taxation autonomy to finance their functions. It has been discussed in the general part of this paper that Solomon, (2005) assessed vertical fiscal imbalance in Ethiopia is even higher than in other developing countries. Hence, while Canada and Switzerland have embarked on granting feasible and fair broader local fiscal autonomy, the Ethiopia's Federal Constitution that guarantee Self Administration of Nation, Nationality and People of Ethiopia puts a very audacious promise in which in reality the Fiscal position of the Constituent units are highly dependent on Federal Government.

Besides the categorization of exclusive power, concurrent power and undesignated taxes, the arrangement of revenue raising power in Ethiopia is mainly structured according to the categories of tax payers or particular things as a source of revenue.<sup>102</sup> On the other hand, although the titles refer to the „power of taxation, strictly speaking they do not only deal with taxes as they also include other non-tax revenues like fees, charges, rents and other revenue sources for both levels of governments.<sup>103</sup>

In most cases, customs duties are exclusively given to the federal government as its exclusive taxation power. There are many reasons in relation to international and national trades to this assignment of revenue. A country may have to fulfill international obligations by reducing tariffs or impose restrictions on unfair trading practices to protect the sudden influx of import of specific items (anti-damping measures) and on contrabands, to control importation of prohibited items, etc. In addition in order to protect trade distortions within the country and for efficient tax

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<sup>100</sup> *The practice shows that, State government in Ethiopia, could only determine Land use fee agricultural income tax independently of the federal government.*

<sup>101</sup> *It is alleged that, state government in Ethiopia have no tax autonomy both in terms of insufficient revenue yielding and in terms of lack of the power of determining tax rate and tax base under their jurisdiction*

<sup>102</sup> *For instance income tax assignment is based on categories of employees and ownership of particular thing. Accordingly, income tax from the income employees of federal government and income tax from the profit of things under the ownership of the federal government are under the taxation power of the federal government while the state governments have taxation power over state employees and state owned enterprises*

<sup>103</sup> *. Art. 96 and 97 also assigned both levels of government to fees and other charges under their jurisdiction after enumerating tax revenue sources of them.*

administration the power of custom duties remain in the hand of federal government.<sup>104</sup> Provided the above argument, the same is true in Ethiopia so that import and export duties, taxes and other charges on imports and exports are exclusively levied and collected by the federal government pursuant to Art.96 (1) of FDRE Constitution.<sup>105</sup> Other revenue sources from income tax, sales and excise tax, property taxes and charges and fees are assigned to tiers of governments based on the category of the taxpayers or a particular thing from which the revenue is collected.

### 3.3.1 Revenue Sources of the Federal government

Among revenue sources reserved for the federal government under Art.96, customs duties including import /export tax and other duties on which it has exclusive power of taxation, is its important sources of revenue.<sup>106</sup> Income tax is important revenue source not only for the central government but also for the state governments. The constitution does not exclusively assign income tax to either tier of governments. Thus, as far as personal income tax is concerned, the federal government has exclusive taxation power from employee of federal governments likewise state governments have exclusive taxation power from employees of state governments.<sup>107</sup> For instance, the federal government collects income tax from employees of federal governments wherever they locate across the country. Employment income tax extends to income tax from public enterprises owned by the federal government and of international organizations. This taxation power of the federal government also, includes income or profits of these enterprises or Organizations.<sup>108</sup>

Income taxes from rail, air and sea transport and income from winning of chance from national lotteries are also revenue sources for the federal government under its exclusive jurisdiction (Art.96 (4) and (5)). On the other hand, income obtained as a result of leasing of property and houses under the ownership or registered as federal properties are under the taxation power of

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<sup>104</sup> It is considered as inherent responsibilities of central government to protect the nationwide interests of the country such as interregional equity, redistribution, economic stability. Besides, the central governments have to fulfill international obligations by reducing tariffs or impose restrictions on unfair trading practices to protect the sudden influx of import of specific items (anti-dumping measures) and on contrabands, to control importation of prohibited items, etc. Accordingly taxes such as custom duty( export and import duty) are centralized.

<sup>105</sup> Ibid. Art. 96 of the FDRE Constitution

<sup>106</sup> However, It would raise some question because of the fact that the origination of particularly exports items such Gold Coffee, skin, hides and etc are only from limited regional state like Oromia, without any special share to the region.

<sup>107</sup> Art 96 (1) of the FDRE Constitution

<sup>108</sup> Ibid. Art.96 (2), (3)

federal government according to Art.96 (6). Other areas of exclusive taxation power of Federal government are, sales and excise tax those related to sale and services of public enterprise owned by federal government.<sup>109</sup> Also as per Ar. Art.96 (7) of the Constitution, the federal government exclusively determines and collects fees and charges in relation to licenses issued by organs of federal government and also, collect stamp duties from the service provided by the organs of federal government.<sup>110</sup> VAT is another important revenue source for the federal government which was introduced later by the HoF.

Another area of tax which take paramount part of revenue for the federal government are those revenue obtained from public enterprises such as National Bank, rent from government property and residual surpluses from various public enterprises that the government monopolizes. In other way the federal government is entitled to collect taxes from enterprises such as, banks, insurance companies, Telecommunication Corporation, the Electric Power Corporation, the Post Office, the Petroleum Corporation, sugar industries, and government farms those expand more the revenue power of the federal government.<sup>111</sup> Thus, it is clearly observed from the above stated constitutional provisions that types of revenue sources assigned to the federal government are those take the dominant part in revenue generating for the federal government.<sup>112</sup>

### **3.3.2 Revenue Sources of the State Governments**

Even if the FDRE Constitution follow an approach of exclusive listing of taxation power between the center and regional governments, states do not have exclusive tax bases assigned to them on its essence.<sup>113</sup> This is to say that, tax bases listed under Art. 97 of the constitution are those tax bases shared from the federal government on the base of categories of tax payers and things with the exception of custom duties which is solely reserved for the federal government.<sup>114</sup>

As mentioned in the previous section, both tiers of governments are entitled to the collection of income tax based on different categories of tax payers or things. Thus, income taxes from

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<sup>109</sup> *Ibid. Art. 96(3)*

<sup>110</sup> *Ibid. sub (9)*

<sup>111</sup> *Such revenue base yields higher revenue for the federal government. However, while interview with some informants they feel that, the assignment is improper claiming that it disregard the state in which they operate.*

<sup>112</sup> *Ibid.*

<sup>113</sup> *Various taxes are assigned to regional governments after shared by the federal government based on categories of employment and particular things*

<sup>114</sup> *Ibid.*

employees of state governments privately owned enterprises are reserved for state governments under their exclusive taxation power.<sup>115</sup> Besides employment income taxes, states are also entitled to the collect taxes from profit or income from public enterprises those under the ownership of state governments. Furthermore, income or profit from small business activities and sole proprietorships (provided nature of their business activities are determined by the commercial code and other relevant laws) are reserved for states as their exclusive taxation power states.<sup>116</sup>

The Constitution also assigned with the state governments tax on income from individual farmers or cooperative association, income from water transport service provided within the boundary of the state and rental income from properties owned by the state are exclusively taxed by the state.<sup>117</sup> Excise tax and sale taxes from enterprises under the ownership of state governments are exclusively collected by state governments as well as taxes from individual traders within their jurisdiction.<sup>118</sup>

State governments can also levy and collect property tax on houses which are privately owned as well as tax on the use of land within their jurisdiction. In addition, they can collect royalties from the use of forests. They are also entitled to the collection of taxes from small scale mining activities. According to the reading of Art 97(9), state governments can also raise revenue from other non tax sources such as fees and charges from license and services provided by organs of state governments.<sup>119</sup>

### **3.3.3 Concurrent Power of Taxation**

The practice of concurrent powers of taxation is implemented differently from federation to federation. However, constitutionally it can be generalized that, concurrency of taxation power implies that, the center as well as each state has the right to enact laws concerning the subject-matter under its jurisdiction. In USA, for example, both the federal and states are free to impose the same type of tax upon the same subject to taxation.<sup>120</sup>

The FDRE constitution also recognized an approach of concurrent powers of taxation by assigning both tiers of governments jointly to have taxation power over certain tax bases.

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<sup>115</sup> *Ibid.* Art.97 (1)

<sup>116</sup> *Ibid.*

<sup>117</sup> *Ibid.* Art 97 (3), (5), (6)

<sup>118</sup> *Ibid.* (4), (7)

<sup>119</sup> *Ibid.* Art.97 (2), (6) and (10), (Art.97 (8) an (9)

<sup>120</sup> *The power of administering and imposition of concurrent taxation under the Ethiopian practice is exclusively given to the federal government while states are only entitled to its share as opposed to the USA practice.*

Accordingly, concurrent powers of taxation are assigned to both levels of jointly to levy and collect taxes on profit, sales, excise and personal income of enterprises they jointly establish; to levy and collect taxes jointly on the profits of companies and on dividends due to shareholders; to levy and collect taxes jointly on incomes derived from large-scale mining and all petroleum and gas operations, and royalties on such operations.<sup>121</sup> However, as opposed to the practice of concurrent taxation power in USA, state governments in Ethiopia are only entitled to the share of revenue from these tax sources as they do not have legislative and administrative power over these taxes. This is to say that, these joint revenue sources are still under the entire control and appropriation of the federal government. Regional Governments are not in a position to regulate and levy these taxes listed under the title of concurrent taxes. Rather, they are entitled to the share of revenue from these sources with the federal government in the form of revenue sharing.<sup>122</sup>

### **3.3.4 Undesignated Power of Taxation**

The FDRE Constitution does not opt to provide undesignated taxation power to either level of government as opposed to the assignment of undesignated function. Rather, the Constitution under its Art.99 empowers the two Houses to determine in joint session as far as the assignment of undesignated taxes.<sup>123</sup> Critical issue here is that, under Art 52 of the FDRE Constitution functions are given to Regional states unlike taxation power This means, states have residual powers and functions besides their exclusive functions while residual taxation power is left for the determination of both Houses in which whether their decision protect the interests of state governments or not is questionable.<sup>124</sup>

## **3.4. Intergovernmental Fiscal Relation in Ethiopia**

### **3.4.1 Vertical Fiscal imbalance**

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<sup>121</sup> Art.98, of the FDRE Constitution.

<sup>122</sup> Some argue in favor of the domination of federal government in levying and legislating tax laws over these taxes claiming that it avoid unfair tax competition between the federal and state governments and tax overlapping between the two. This is because, if both tiers at the same time legislate and levy on the same tax bases, they may enter into tax competition which will in turn result in conflict between the two.

<sup>123</sup> See Art. 99 of the FDRE Constitution

<sup>124</sup> Taking the decision of the Houses over VAT as an example, some argue that, undesignated taxes are not considered as revenue sources for regional governments claiming that, the Houses do not decide against the interest of the federal government favoring the regional government.

In Ethiopia, Vertical fiscal imbalance dominates its fiscal federalism because of the fact that, the federal government controls all sources of revenue which have national benefit (Solomon, 2005:155). Regional government on the other hands is assigned with sources which are less profitable causing vertical fiscal imbalance between the two. When seen from the perspective of expenditure needs, Regional governments are assigned with various important public services, such as health, education, road etc, while their revenue sources cannot finance half of these expenditures.<sup>125</sup>

The trends of vertical fiscal imbalance in Ethiopia show high dependence of regional state on federal transfer as above half of their expenditure needs are covered by transfer from federal government. For example as it was assessed by Solomon Nigussie, “in the fiscal years of 1993/94, states were only able to finance 26% of their expenditure needs the rest of which was covered by federal government. That time, with their own revenue, only about 45% of their recurrent expenditure was financed while their total expenditure was only 26% which they were able to finance. Because of their revenue incapacity, they were able to claim only 37% of the total expenditure of the government indicating that the bulk of the expenditure is allocated to the central government. On the revenue side, the share of the regions accounts for less than 10% of the total revenue of government during that time.”

Some argue that, vertical fiscal imbalance caused in Ethiopia, not only for the dominance of fertile tax bases by federal government but also, the inefficient tax administrations of the states and inability and unwillingness of the states to discharge their responsibilities. And low level development of the regional states also plays a role in demanding high expenditure needs in the regions contributing for the existence of vertical fiscal gap.<sup>126</sup>

In short the Ethiopian, experience of vertical fiscal imbalance, can be seen in two aspects i.e. revenue aspect and the expenditure aspect (Solomon, 2005:166). In its revenue side, the most dominant and lucrative revenue sources are left for federal government through its exclusive and concurrent power while revenue sources assigned to states yields less revenue.<sup>127</sup> States are assigned with those tax sources such as, land tax and agricultural income tax which yields limited amounts of revenue while taxes such as, custom duties and other charges on imports and

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<sup>125</sup> *If seen strictly these important public services have redistributive impact. However, they require proper revenue sources to be implemented in quantity and quality desired.*

<sup>126</sup> *Ibid.*

<sup>127</sup> *Ibid.*

export which account for 33% of total revenue of the country. On the expenditure side, the low level development in the country leads particularly high expenditure needs in the regions causing mis- match between revenue power and expenditure needs.<sup>128</sup> Below the table summarize trends of vertical fiscal imbalance in Ethiopia (1993/1994-2003/2004)

**Table: 3 1. Trends of Vertical Fiscal Imbalance of Ethiopia (1993/1994-2003/2004)**

Years	Revenues			Expenditures			Vertical fiscal imbalance
	States( in mln)	National (mln Bir)	States share in %	States( in mln)	National (mln Bir)	States share in %	
1993/1994	695.48	3,909.31	17.8	2,324.97	6,427.64	36.2	0.51
1994/1995	886.42	5,787.05	15.3	3,211.22	8,868.12	36.2	0.58
1995/1996	1,129.24	6,822.58	16.6	3,797.03	9,456.76	40.2	0.59
1996/1997	1,360.55	7,476.57	18.2	4,323.44	10,429.23	41.5	0.56
1997/1998	1,593.24	7,856.73	20.3	4,633.08	11,373.33	40.7	0.50
1998/1999	1,538.48	8,702.38	17.7	4,762.66	14,261.96	33.4	0.47
1999/2000	1,767.97	8,953.79	19.7	4,535.36	16,951.92	26.8	0.26
2000/2001	1,874.23	9,949.12	18.8	5,530.46	16,295.31	33.9	0.45
2001/2002	1,875.44	12,058.94	15.6	5,934.93	18,175.32	32.7	0.52
2002/2003	2,118.76	11,053.84	19.2	6,225.78	16,681.78	37.3	0.49
2003/2004	3,088.25	13,936.61	22.2	7,515.25	19,712.85	38.1	0.42
Average	17,928.06	96,506.92	18.6	52,794.18	148,634.42	35.1	0.47

**Source: Tesfaye Mergia(2005:61)**

“1-  $[(R_s/R) / (E_s/E)]$

Where  $R_s$ = State revenues

$R$ = Aggregate revenues (federal plus states)

$E_s$  = State expenditures

$E$  = Total expenditure (federal plus states)”

“Accordingly, if the value (coefficient) is close to one there exist higher vertical imbalance and shows the central governments control over the budget of lower governments. On the other hand if the value is close to zero Vertical fiscal imbalances are low and show SNGs autonomy over their budgets.”

### 3.4.2 Horizontal Imbalance

<sup>128</sup> *Ibid.*

It has been viewed that; horizontal fiscal imbalance is caused when fiscal capacities of States are significantly vary to provide similar minimum national standard public goods and services at comparable tax rate Boadway and Shah, (2009). Accordingly, one of designing Intergovernmental fiscal Transfer is therefore, to ensure that individuals residing in different regions or localities have equal access to public goods and services. However, the sub-national governments may not have equal fiscal capacity to provide public services owing to variation in demography and geography which create variation in endowment of revenue bases, variation in level of urbanization etc.<sup>129</sup> Accordingly, such factors leads to problem of fiscal imbalance which is related to the fiscal disparity between the states usually referred to as horizontal fiscal imbalance.

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 etc. Below the table indicate the existence of horizontal Fiscal imbalance by showing revenue collected by each regional government and the extent to which their own revenue could finance their expenditures.

**Table: 3. 2. Expenditure financed from Regional own Revenue (2006).**

<b>Regions</b>	<b>Total Exp.</b>	<b>Own Revenue</b>	<b>% share of (2)</b>	<b>%share of total Regional revenue</b>
	1	2	3	4
Tigrari	695.7	194.9	28.0	12.0
Afar	332.0	38.0	11.4	2.3
Amhara	1899.7	380.3	20.0	23.5
Oromia	2958.3	624.3	21.1	38.5
Somali	506.2	31.0	6.1	1.9
Benishangul Gumuz	229.0	22.1	9.7	1.4
SNNPR	1626.4	262.8	16.2	16.2
Gambela	156.2	12.4	7.9	0.77
Harari	119.0	20.5	17.2	1.3

<sup>129</sup> In most federation therefore, to protect the imbalance the central governments centralizes some unevenly distributed natural resources and through tax harmonization.

Dire Dawa	153.9	153.9	22.3	2.1
Averages	8676.4	1620.6	18.7	100

**Source: MoFED with some own computation**

The table indicates that, horizontal imbalance ranges from 6.1% to 28.0% by Somali Regional government and Tigray Regional Government. In between the two also the table indicates horizontal imbalance from 22.3 to 7.9 by Dire Dawa and Gambela Respectively.

### 3.5 Fiscal Transfer in Ethiopia

It is now two decades since Ethiopia has embarked on a federal arrangement with the adoption of the Transitional Charter in 1991. The subsequent FDRE Constitution has also formalized the federal arrangement *de jure* and devolved power between the federal and state governments and mechanisms where the federal government should give subsidies and share revenues to the states.<sup>130</sup> It could be generally contended that there are two organs responsible for intergovernmental fiscal transfers in the Constitution. While the rule is that the HOF is the principal organ for this purpose, there are also cases when the federal government may directly involve in the fiscal transfers to the states without, in fact, transgressing the conditions attached thereto.<sup>131</sup>

For being composed of members who are representatives of each Nations, Nationalities, and Peoples (which are founding blocks of the Ethiopian federation), the HOF is entrusted with various vital powers and is also considered the ultimate guardian of the Constitution itself. Among the fundamental powers conferred to the house, article 62 (7) of the Constitution stipulates that it would determine the formula on which the federal government gives subsidies (grants) to the states.<sup>132</sup> It also provides that it is the HOF that determines the proceeds of the federal and state governments on the revenues collected from the concurrent taxes. Accordingly, the two aspects of fiscal transfers, revenue sharing and grants, are undertaken by the HOF.

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<sup>130</sup> See, Art 62(7), 89 (4) and 94(2)

<sup>131</sup> Ibid.

<sup>132</sup> Ibid, Art.62 (7)

On the other hand, the Constitution has also provided the possibility when the federal government could give direct assistance (and loans) to the states.<sup>133</sup> To this end, Article 94 (2) of the Constitution clearly reveals that the federal government could render states assistance and loans for emergency, rehabilitation, and development purposes. This seems to be especially targeted for those states which are least advantaged in development.<sup>134</sup>

### 3.5.1 Revenue Sharing

As it was introduced above and discussed in the previous chapter, one aspect of fiscal transfer in Ethiopia is revenue sharing where the federal government is expected to share the proceeds of the taxes it has collected from the concurrent taxes.<sup>135</sup> The amount of the proceeds of each order of government is determined by the HOF. It is also one means of bridging the fiscal gap between the federal and state governments. In fact, it is difficult to label revenue sharing as a fiscal transfer of the federal government to the states. This is because the federal government is not the sole owner of the concurrent taxes that are objects of the revenue sharing.<sup>136</sup>

As far as revenue sharing in India and Nigeria is concerned, it involves the sharing of proceeds from the income of federal government it obtained from its own sources of revenue.<sup>291</sup> However, revenue sharing in Ethiopia concerns only those taxes which article 98 of the Constitution declared as concurrent to entitle both orders of government to jointly levy and collect them. Thus, since the states are also the owners of such taxes, it is a misnomer to consider such transfers of the federal government to serve the same purpose of revenue sharing in other jurisdictions.<sup>137</sup>

Although, the Constitution is silent on the manner of sharing, the practice of the Ethiopian Revenue and Customs Authority reveals that the respective shares of the regional states is distributed on a derivative basis.<sup>138</sup> This arrangement is beneficial if practically implemented in that the states government in the effective collection of those taxes in their respective region. This is because they now realize that they have guaranteed legitimate share in the proceeds of the

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<sup>133</sup> See Art.94 (2)

<sup>134</sup> *Ibid.*

<sup>135</sup> *In India and Nigeria etc the federal government shares to the state revenue it obtained from its own sources of revenue.*

<sup>136</sup> *Some argue that, revenue share from source under the concurrent taxation power does not amount to fiscal transfer because; states obtain the share of their own they are entitled to it by the constitution*

<sup>137</sup> *Ibid.*

<sup>138</sup> *Ibid.*

taxes.<sup>139</sup> Some however, argue against the principle viewing that on the apportionment of revenue from companies, the system only takes the place of incorporation of the company without due regard to the different transactions and undertakings of the company in other parts of the country that makes the system neither derivative nor redistributive in this regard.<sup>140</sup>

That means, if a company is incorporated in Addis Ababa and it operates in different parts of the country, the federal government would only share the proceeds of all the taxes from the undertakings of the company with the Addis Ababa City Administration even if the actual undertaking of the company or source of the tax is in different parts of the country.<sup>141</sup> On companies of such mobile natures, other arrangement such as population size of a region, adopting mechanisms to benefit those regions where the company has branch undertakings, or at worst abandoning the derivative principle altogether seem to produce a better result than the system we have now.<sup>142</sup>

### **3.5.2. Grants**

Above, it is discussed that there exists both vertical and horizontal fiscal imbalances which cannot be addressed by state own revenue or through revenue sharing. Hence, grants (both conditional and unconditional/ are important fiscal policy of Ethiopia to narrow both imbalances and to increase the revenue capacity of states.<sup>143</sup> Some federations adopt an approach of distributing federal grant without formula based on negotiation or on the base of ad hoc mechanisms.<sup>144</sup> This is mechanism of grant distribution, in which the federal government, decides on the aggregate pool of federal grants and then distribute among the respective lower sub-national governments. Such mechanism enhances discretionary power for the federal government on distribution of grant among states.<sup>145</sup> Thus, 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. The use of the federal grant formula to

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<sup>139</sup> Derivation principle, in theory but rarely practical claim the share revenue based on where the revenue locate. For instance, revenue sources generated from enterprises are assigned to the States owing to the enterprises are located within the States' territory as well as irrespective of form of business organization, PIT on employees of private companies is assigned to the States.

<sup>140</sup> Ibid.

<sup>141</sup> This is because; the company does not achieve its purpose, if its business transaction is limited to that specific region. Nationwide transaction with the company highly contributed to its function

<sup>142</sup> Ibid.

<sup>143</sup> While I was undertaking interview with tax officials in ORG Revenue Bureau, they viewed that, about five hundred company operating in Oromia Regional government but for the mere fact that, their head offices were registered in Addis Ababa, their revenue share is between the Federal government and Addis Ababa rarely benefiting Oromia Regional government.

<sup>144</sup> It has been discussed that, state government in Ethiopia are unable to finance even half of their recurrent expenditure without the transfer from the federal government in which formula based grant is the major policy option of the country to fill the gap

<sup>145</sup> In this case, Intergovernmental Relation plays a great role.

distribute fiscal resources between the federal and regional governments and between the regional and local governments would serve as a guiding instrument in an attempt to allocate limited funds to competing regional and local expenditure requirements.<sup>146</sup>

Ethiopia preferred formula based grant distribution under the practice of fiscal transfer. However, various arguments against grant formula of Ethiopia have been forwarded. For instance asserting that, grant distribution is sole discretion of federal government because, after the federal government has determined and reserved the amount necessary to cover its expenditure responsibilities, it would leave the remaining amount to be distributed to the regional states based on the applicable grant formula adopted by the HOF.<sup>147</sup>

Before the introduction of the 2007 grant formula, previously, much attention was given for socio- economic variables such as size of population, differences in level of development, revenue collection effort and sectoral performance.<sup>148</sup> However, previous formulas were unable to indicate the actual expenditure needs of state governments because of the subjectivity of the formulas. There exists also an argument that, previous 2007 much attention was given to capital expenditures without much focus on recurrent expenditures. On the other hand, some claim that, previous formula was unable to indicate difference between actual revenue collection and potential revenue raising capacity of states.<sup>149</sup> Accordingly, the HoF has necessitated in adopting the 2007 grant formula that mainly takes the fiscal gaps between revenue means and expenditure needs, the earlier formulas were concerned with equalizing expenditure needs and considering fiscal performance of the regions as a basis to distribute the pool to the states. Hence, this formula was adopted with the aim of addressing these problems in the previous formula to enable regional governments to provide public services based on their relative expenditure need assessments and revenue raising capacities. Thus, the 2007 grant formula was

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<sup>146</sup> *The Federal government in this case has discretionary power to determine the extent and the manner of grant to be transferred to states*

<sup>147</sup> *Ethiopia has recognized formula based Grant distribution aiming equitable allocation of resource and enabling the whole state to provide minimum standard public service for their constituents considering their revenue capacity and expenditure needs.*

<sup>148</sup> *Previous formulas are criticized that, variables attached in designing grant distribution were subjective which create difficulty of identifying actual expenditure needs actual revenue capacity of state governments.*

<sup>149</sup> *Ibid.*

designed to equalize expenditure needs and revenue capacity than considering socio –economic variables which was the case in previous formula.<sup>150</sup>

Generally, instead of attaching subjective percentage to the above mentioned variables, the 2007 designed the distribution of grants by measuring expenditure needs and revenue capacities of the regions to compensate, those regions that have significant expenditure needs than the average need of the regions and or regions with less revenue capacities than the average capacity of all regions.<sup>151</sup>

**Table: 3.3 Regional Share of Federal Grant (1993/94-2003/04)**

Regions	% of population	Shares of regions		
		1993/94	1997/98	2003/04
Tigray	5.8	8.83	7.66	7.63
Afar	1.8	3.70	5.04	3.62
Amhara	25.6	22.12	19.20	22.38
Oromia	35.2	28.14	25.29	31.34
Somale	5.8	4.36	7.57	6.32
Benishangul Gumuz	0.8	2.70	3.63	3.05
SNNP	19.8	15.41	15.90	20.28
Gambela	0.3	2.05	2.80	2.25
Harari	0.3	0.77	1.78	1.45
Addis Ababa	3.9	10.99	10.04	-
Dire Dawa	05	0.93	1.08	1.58
Total	100.00	100.00	100.00	100.00

**Source: Solomon, 2005:223**

The above table indicates that before the adoption of new grant formula (2007 formula) that much emphasis was given to population size. Accordingly most populous regions such as Oromia and Amhara received greater share of federal grant. However on per capita basesthey would receive the least share than the least populous regions.

The 2009, new grant formula was also adopted by the HoF without much change to the 2007 formula in its structure and methods but, argued that it was more transparent as it was made by

<sup>150</sup> *Ibid.*

<sup>151</sup> *However, it does not mean that, the 2007 grant formula was without any problems. Various argue that the formula was still lack transparency and population size was still influencing its design. Accordingly in more participatory manner, but without substantial change, the 2009 new grant formula was adopted.*

the participation of both federal and state stakeholders.<sup>152</sup> This formula has also taken revenue capacities and expenditure needs into account so that it seeks to balance differences regarding capacities and needs.<sup>153</sup>

### **3.6. Borrowing in Ethiopia**

Borrowing is the other possibility by which states may supplement their financial constraints. Under the Ethiopian decentralized fiscal system, sub-national governments in most cases are restricted to domestic borrowing and they may even be subject to direct control by the central government.<sup>154</sup> The main reason for participation and control by the centre is that monetary and fiscal policies are centralized. Accordingly the federal government has statutory control over states' borrowing in which sub-national borrowing has a very limited application.<sup>155</sup>

The Constitution empowers the federal government shall determine by law the conditions and terms under which states can borrow money from domestic financial institutions. On the one hand, it affirms the possibility that states can borrow from domestic sources and, on the other, grants the regulatory power to the central government. Hence, Regional governments are required to provide all the necessary information to determine the amounts to be borrowed by individual regions.<sup>156</sup> Accordingly, the states have to fulfill the obligation to submit to the MoFED, the loan amount required 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.<sup>157</sup> Generally, the FDRE Constitution does not recognize the states' right to borrow from international institutions. Even, domestic borrowing is barely implemented for the above discussed reasons.

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<sup>152</sup> *Ibid.*

<sup>153</sup> *Ibid.*

<sup>154</sup> *Some argue that, the practice of the Ethiopian fiscal decentralization does not only avoid the states' governments from international financial institutions but also domestic borrowing by imposing various restrictions/ requirements to be fulfilled before borrowing is to be effected.*

<sup>155</sup> *Ibid.*

<sup>156</sup> *States borrowing seems that it is a sole discretionary power of the central government under the Ethiopian practice.*

<sup>157</sup> *There is no clear law that identifies which organ is responsible on the side of state governments to cooperate with the federal government or financial institution to effect the borrowing.*

## **Chapter Four: Data Presentation and Analysis**

### **4.1 Description of general overviews of the Study Area**

Oromia is the largest and most Populous Regional State in the Country. It has a land area of 359,620 square kilometers. Its population was estimated 31,179,949 in 2012 which account over 35 percent of the population of the country based on the 2007 Population and Housing Census. Oromia accounts for a large proportion of Ethiopia's agricultural exports: coffee, hides and skins, pulses and oil seeds. The Region also has significant water (lakes, rivers, energy, mineral, wildlife and historical and cultural resources. Oromia accounts for nearly 100 percent of Ethiopia's hydro power generation and has considerable potential for further hydro developments. Administratively, being the largest region in the country, it accounts about 34.3 percent of the total area of the country.<sup>158</sup>

The Oromia Regional Government (ORG) is administratively divided into 18 administrative zones, which function as de-concentrated agencies of the regional bureaus (Bureau of Finance and Economic Development (BOFED) which has equivalence with Ministry of Finance and Economic Development (MoFED) at Federal level and 35 sector bureaus headquartered in Addis Ababa with their offices in the Zones which have equivalence with sector ministries of federal government. Within the geographical area of each zone administration fall about 304 woreda governments and out of which 39 are towns structured with the level of woredas, which having their own governing councils. Woreda governments form the level of government immediately below the regional government level while; the zonal administrations in effect act as an intermediary (for example, for the channeling of budget performance reports) between the woreda governments and the ORG bureaus.<sup>159</sup>

### **4.2. Fiscal Decentralization in ORG**

The 2001 current regional Constitution has been revised two times with the aim creating close relationship between the service provider and the user on the base of devolved governance. Accordingly, powers and functions of different tiers of government in the state are provided in various provisions of the Constitution.

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<sup>158</sup> *The description shows that, the study region is both demographically and geographically vast. On the other hand, it is apparent that it is rich in natural resources.*

<sup>159</sup> *Administratively the region is highly devolved for the purpose of creating close relationship between the government and the people but without, enabling revenue assignment.*

### 4.2.1 Functional Assignment the Region

The 2001 revised Regional Constitution, under its Art. 45 emphasize on the devolution of power and functions among Regional Government, Zonal Administration District Government and Kebeles mandating the Regional council to create additional administrative structure when necessary. Accordingly, powers and functions of the regional government including taxation powers are provided under Art 47 of the regional Constitution. On the other hand, Zonal Administration being administration unit below the region, is assigned with some powers and functions (Article70 (1) and71 (1-3) while Article (76) recognizes Districts Administration as a council organized below Regional council. Accordingly, Districts are empowered to approve plans and programs with regard to Economic Development, Social Services, public Administration and Mobilization of Populace for development activities, maintenance of peace and security and others. Kebeles are also, assigned with some functions having Kebele Council, Administrative Council and Social Courts but not assigned with revenue sources to execute these functions.<sup>160</sup> However, although, both the Federal and Regional Constitutions emphasize on expanded functional assignment, these devolved functions do not followed by sufficient revenue sources.

As it has been discussed in the general part of this paper, the accountability of lower- level governments to local clients is enhanced if sub-national governments have access to own-taxes with the right to adjust tax rates. Indeed, the service delivery incentives facing sub-national Governments may improve if, at the margin, they have to raise their own revenues through tax increases rather than relying on central transfers or bailouts that soften the budget constraint. This is why Jorge Martinez-Vazquez (2013) asserted that, if fiscal decentralization is to be a reality, SNGs must control their "own" sources of revenue because, Local governments will generally be more accountable and responsive to citizens' needs and preferences in Public Service provisions. An important objective of enhancing fiscal decentralization process is to shift fiscal decision making closer to the citizens as the final user of public functions. However, it is apparent that, its fiscal system of Ethiopia is characterized by highly centralized taxation power and high decentralized function a in which, the whole regional governments are highly

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<sup>160</sup> See, Art 45, 46, 70, 71 and 90 of the regional Constitution

dependent on federal transfer for the delivery of public services and goods for their constituencies.

Oromia in this regard, has been one of the regions in implementing decentralization of various functions from region to Local Governments. Accordingly, after the devolution of functions to the lower unit of government by the revised Constitution in 2001, besides regional government, Wereda governments in the study region are performing various functions. As it has been discussed above, Wereda governments are assigned with various responsibilities particularly undertaking functions of social, economic, administrative, security and social court affairs. For instance in social sector wereda governments establish and administer primary and secondary schools; primary health care and clinical services in health posts and health centers. They provide extension services to farmers in relation to agricultural activities; develop small springs on spot, hand pump; construct community road and so on in the area of economic sector.<sup>161</sup>

This is however, does not mean that these functional devolution to lower units of governments are followed by sufficient financial sources. Data shows that, both at the Regional level and Wereda in the Study Region are highly dependent on block grant from the federal and state government respectively to finance their expenditure responsibilities in the absence of their own sources of revenues (See annex two and table seven). As it has been described in the preceding section, the study region is more populous and vast in its geographic situation. Hence, its dependence on its meager own revenue sources and relying on Federal subsidy, would be one challenge to accountability of both levels of governments in the Region toward service provision in quality and quantity required. Interviews made with selected key official from some Wereda and Regional level revealed that, insufficient own sources of revenue and reliance on block grant from federal and state government create disincentive to provide services in the quality and quantity required as well as creating variation of service provision among districts in the state. Thus, although, an important objective of decentralization is considering local Administrations as responsible institution for meeting services delivery and interaction point between services provider and citizens, lack of financial instrument undermines the performance of these functions.

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<sup>161</sup> *These functions are in most cases are not directly financed by the revenue collected at Wereda governments but through block grant by the regional governments. This implies that, these functional assignments are not followed by assignments of revenue source to be used by the lower governments.*

For instance, in relation to this, I have conducted question both for questionnaires and interviewees. Accordingly, from the total of 40 informants, 35 of them which is about 86% respond that, quantity and quality of public services would not be delivered by the grant transferred from the federal government. This can be analyzed that, grant particularly conditional grant may impose condition on the region as far as its allocation is concerned. Hence, the region could not allocate the budget as its choice matching it with the needs and preference of the people in the region. On the other hand, grant would be rarely incentive for local governments to deliver public services in efficient and effective manner.<sup>162</sup>

#### **4.2.1.1 Expenditure Trends of the Region**

As data from BoFED indicates, Regional Revenue envelope involves Regional Revenue, Federal Block Grant and specific purpose grant, foreign grant and loan through the federal government. While interview has been conducted, informants viewed that; the Region in some cases may obtain revenue from NGOs and community contributions. Thus, Regional functional execution or expenditure performance would be analyzed taking these Revenue sources as a tool in different fiscal years. Accordingly, post the revision of Regional Constitution, Function as well as some Revenue Sources were decentralized to Districts based on the objective of ensuring close relationship between the government and citizen. Hence, the above mentioned revenue sources are devolved between the region and districts for the performance of Recurrent and Capital expenditures of both levels.

Firstly, trend of recurrent expenditures performance both at Regional and Districts government has been analyzed. Accordingly, data reveal that, in all fiscal years from 1998 to 2002 the trend of recurrent expenditure is high and increasing at Wereda level than Regional Government. However, it would be better to see the composition of each component of recurrent expenditures such as, Administrative & General Services, Economic Services and Social Services. With regard to expenditure for Administrative and General Services, from 1998 to 2002 fiscal years, the highest recurrent expenditure of the regional government under this service heading was

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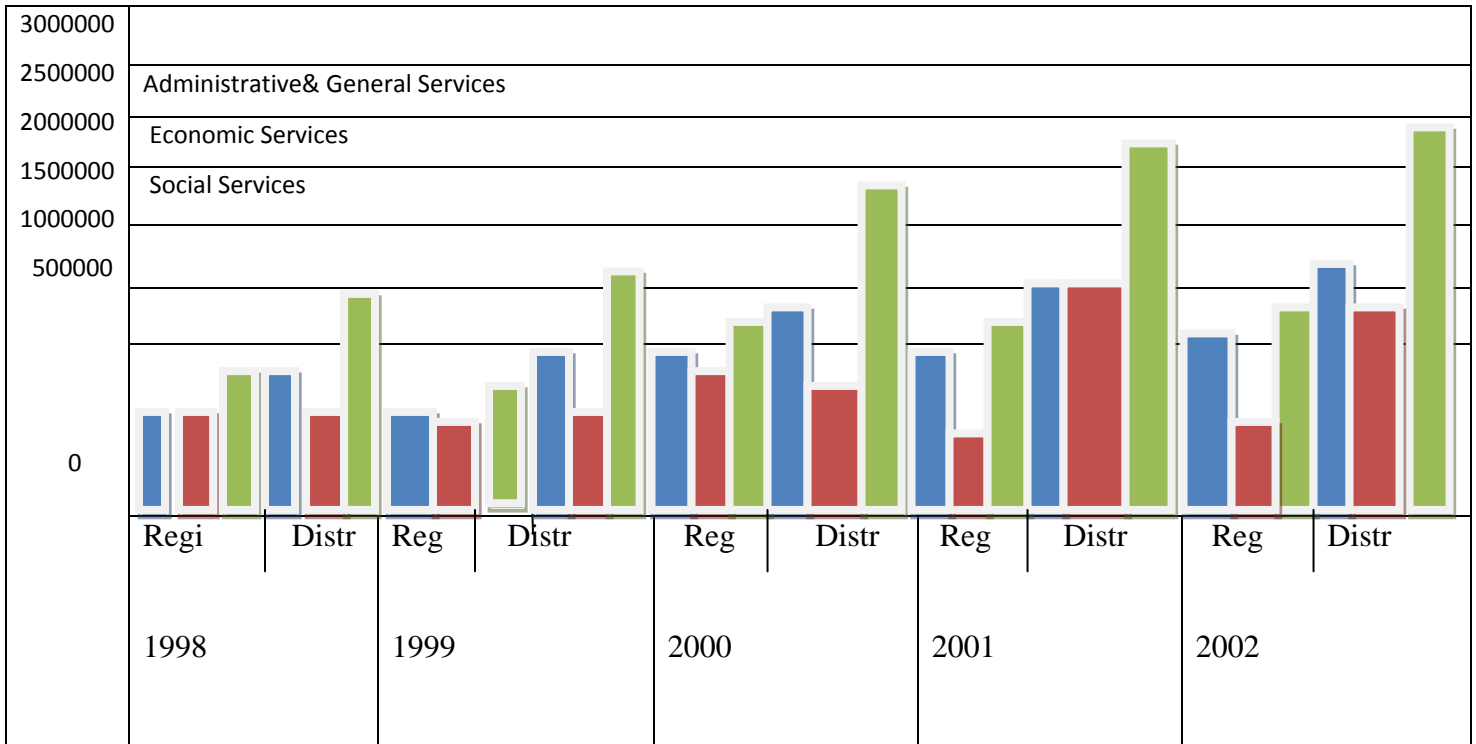
<sup>162</sup> *The question posed is Can the provision of public goods and service in ORG be properly performed matching the needs of the region in the presence of high dependence of the region on federal subsidy (see annex two)*

expenditure in Justice and security sectors accounting 63% in 1998 while the highest expenditure of Wereda was expenditure for organs of Government and general services accounting 75% and 79% for General services and service for governments organ respectively in the fiscal year of 1998 which was higher than other recurrent expenditure of Weredas and Regional government.

To generalize the analysis, the trend of Regional expenditure in administrative and general services declined slightly from 39% in 1998 to 34% in 2002 while it show slight increase compared to other recurrent expenditure of regional government i.e. from 29% in 1998 to 36% in 2002. In other way the trend of Districts expenditure for Administrative and General Service show an increase from 22% in 1999 to 27% in 2002 within other recurrent expenditure. As far as Economic service is concerned, in the fiscal year of 1998, Regional government's highest expenditure is 73% and 72% in trade, industry, tourism and urban development (73%) and construction sector (72%) in total recurrent expenditure respectively. However, the overall trends of recurrent expenditure of regional government with regard to economic service was decreased showing the only higher 69% of construction service in 2002 while the expenditure trend in District was, on Agriculture and Natural Resources (77%), water resources (66%), trade industry and tourism (63%) and mines services (69%) in the same fiscal year. With regard to expenditure for social services, it took relatively large amount of recurrent expenditures of District/Wereda governments because; the delivery of social services such as education, health etc are the most decentralized functions.

Accordingly, the trend from 1998 to 2002 show that, both Regions and districts allocate majority of their recurrent expenditure for social services. However, the trend shows that the role of Regional Government in total social expenditure slightly declined from 27% in 1992 to 24% in 2002. From the above analysis, it can be implied that, while the trend of total recurrent expenditure of the Regional government showed decrease for instance, from 35% in 1998 to 28% in 2002 the trend of District expenditure on recurrent expenditure showed an increase.

**Figure: 4.1 Total recurrent expenditures of both Regional government and District governments**

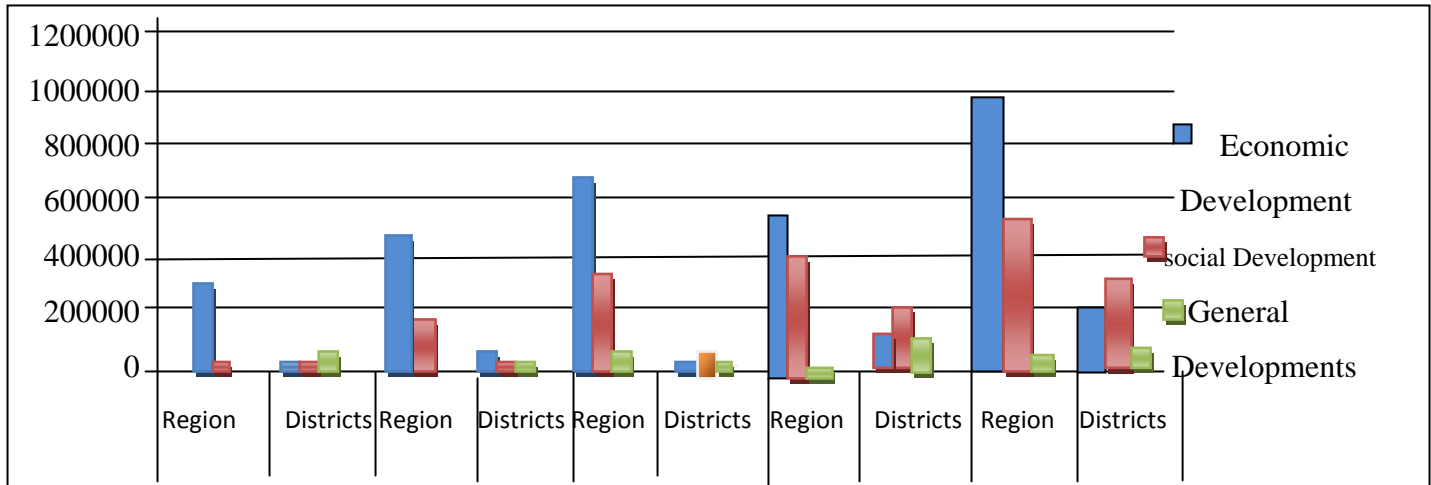


Source: BoFED)

Further, the analysis show that, the Region under the study devolve substantial share of its total revenue for the performance of recurrent expenditure which has no long term benefit for the overall Development of the Region. This could be emphasized that, recurrent expenditure is operating for current expenses such as payment of wages, salaries etc.while capital expenditure is expenditure, other than pre-production costs, incurred for operations the useful life or the benefits of which extend beyond the accounting years in which the expenditure is incurred. Accordingly, Capital expenditure is expenditure the allocation of which is for Economic development, total social development and total general development of Regional Government. With regard to Capital expenditure the trend in the mentioned fiscal years show that relatively high performance of capital expenditure particularly expenditure for economic development has been undertaken at Regional level while revenue at Districts level is spent on the execution of recurrent expenditures. However, although the Region took the leading position in capital expenditure the trend show decreasing even at regional level. For instance, the role of Region fall from 94% to 82% in economic expenditure, from 84% to 65% in social expenditure, and increased from 7% to 38% for general development in recent year

(2002) than early years. Generally role of Region decreased in total capital expenditure from 77% and 89% in 1998 and 1999 respectively to 73% in 2002 EFY. It is apparently observed that, General development remained the least of all capital expenditures as indicated below.

**Figure:4.2 Capital expenditure performance of both Regional and District Governments (1998- 2002)**



Source: Regional BoFED

However, although the trend shows variation of performance of capital and recurrent expenditures at both levels, the overall composition of Regional and District expenditures from 1998 to 2001, shows increasing trends in its performance. Hence, in the mentioned fiscal years, the region’s expenditure performance has never been lower than 90% and has been improving up to 95% in 2001.

#### 4.2.1.2 Spending Autonomy of the Region

As discussed in the general part of the paper, the amount and share of Regions expenditure (expenditure ratio) based on quantitative indication alone would not fully indicate the expenditure autonomy of Regions. Thus, there should be both proper devolution of decision making responsibility to Sub-national governments as well as political decentralization as a means of holding local decision makers accountable.

Besides, as it has been discussed in the general part of this paper, an argument goes that, an important element in the area of Fiscal decentralization is that Sub-national Governments should have the Autonomy to prioritize particular functional and economic expenditure areas of their

own based on revenue under their jurisdiction (own Revenue). Accordingly, as it has been discussed in literature review part under the title “Fiscal autonomy”, some scholars define spending autonomy quantitatively as the share of SNG’s expenditure. However, I have discussed in the above mentioned section that, quantitative measure could not indicate actual spending autonomy. Thus, spending autonomy is better indicated by measuring the capacity of SNGs to finance its expenditure needs by the revenue under its jurisdiction. This would imply that, allocation of budget requirement based on own revenue source without the influence of the central government. In line with these assertions, spending Autonomy of Oromia National Regional State would be qualitatively indicated and analyzed. Accordingly, data shows own expenditure coverage ratio of the Region, by its own revenue sources remained below 17% in the years 1998 to 2001 EFY. The expenditure trend of the region show that, its Revenue from own Sources, even could not cover half of its expenditures. For instance, in the fiscal year of 1998, the region could collect only 27% from its source of revenue assigned to it from its total revenue in which the rest was covered by transfer from federal government. This implies that, the Regional Governments ability to cover its mandated expenditure responsibilities by own assigned revenue sources is very low because of Hence, in the absence of sufficient own revenue source and in the presence of dependence on federal government, it would be less practical to adjust the provision of public services in a required quality and quantity with needs and preferences of the people in the Region.

### **4.3. Revenue Sources of the Region.**

As it is discussed in the general part of this paper, an important legal document base for Revenue Assignment and Revenue sharing between the federal and state government was the Constitution of the 1995 Federal Democratic Republic of Ethiopia. Hence, the FDRE Constitution, t define Revenue Assignment in the form of tax base sharing and revenue sharing between the two levels of governments with the aim of enabling regions to perform their responsibilities, encouraging regional initiatives, narrowing development gap and promoting activities that are common interest of the whole regions. It can be implied from the Constitution, that in the Assignment of Revenue and Revenue sharing, it adopted the criteria of ownership of sources of revenue, the national or regional character of the revenue sources, convenience of tax

levying and collection, levels of development and considerations of the integrated and balanced development of the economy.

Hence, based on the proclamation and the FDRE Constitution the same with the rests of regional states, Oromia National Rgional state was assigned the with those tax sources on the base of the above criteria and general principles of revenue assignment among levels of governments. Thus, the following are those tax and non tax sources of revenue for Oromia National Regional State:

- ✚ Personal income tax collected from employees of the regional government and employees of private enterprises;
- ✚ Rural land use fee;
- ✚ Agricultural income tax collected from farmers not incorporated in an organization;
- ✚ Profit and sales tax collected from individual traders;
- ✚ Tax on income from inland water transport;
- ✚ Taxes collected from rent of houses and properties owned by the regional governments;
- ✚ Profit tax, personal income tax, sales tax collected from enterprises owned by the regional governments;
- ✚ Income tax, royalty and rent of land collected from mining activities; and
- ✚ Charges and fees on licenses and services issued or rendered by the regional governments; and
- ✚ Forest royalty.

The above listed Revenue Sources are those assigned to the Region exclusively under its jurisdiction as per Art 97 of the FDRE Constitution as it is also true for the rests of the regions in Ethiopia. The Region is also entitled to tax sharing with federal government as per Art 98 of the FDREC constitution. Accordingly, Thus, Oromia National Regional State jointly with the federal government are entitled to taxes from:

- Profit tax, personal income tax and sales tax collected from enterprises jointly owned by the federal government and regional states;
- Profit tax, dividend tax and sales tax collected from organizations that carry out business activities; and

- Profit tax, royalty and rent of land collected from large scale mining, any petroleum and gas operations.

However, critical issue is that, although the proclamation (No 33/1992) laid down the criteria for the assignment of revenue sources, the study region is rarely benefited from the Assignment criteria as it is more of in favor of the Federal government. For instance, there are various Business Organizations operating in different part of Oromia while the Federal government dominates their taxes exclusively or concurrently with Addis Ababa solely because of the head quarter of these revenue bases are registered in Addis Ababa without consideration to places of their operations.

On the other hand, Art. 98 of the Constitution is mere constitutional statement as the practice of tax sharing is invisible in reality in that Regional Governments are only entitled to the share of these taxes as its regulation and imposition of these taxes are exclusively exercised by the Federal government qualifying revenue sharing rather than tax sharing. Therefore, States least benefited to expand their Revenue Capacity from such arrangement.

Provided, the above mentioned and discussed problems, , taxes are the major Revenue Sources of Oromia National Regional state than other non Revenue Sources. This is however, does not mean that, Tax Revenue of the Region is higher and could finance its expenditure needs, rather it is to mean that Revenue from tax take higher share from total Revenue of the Region. Further, not all tax bases yield the same revenue. Thus, the importance of tax sources (items) varies in terms of revenue generation. For instance, foreign trade taxes are the most revenue sources for the federal government as it is evidenced from 1993/94 and 2003/04 fiscal years constituting 40% and 48.6% of the total revenue of the federal government respectively. For Oromia National Regional State in the same fiscal years, direct taxes which include personal income tax, rental income tax, business profit tax, agricultural income tax and rural land use fee are important sources of revenue constituting 60.5 and 58.2 percent respectively. Among these revenue sources, Oromia National Regional State generate major revenue from business profit taxes in 1993/94 fiscal year while in the 2003/04 fiscal year the major revenue for the state was generated from personal income taxes.

**Table: 4.1 Composition of Regional Revenue (2003-2005)**

Revenue sources	2003	2004	2005
<b>Direct Taxes</b>	<b>31,662,224</b>	<b>61,018,476</b>	<b>122,856,412</b>
<b>Taxes on salaries</b>	<b>26,181,831</b>	<b>47,064,940</b>	<b>100,741,576</b>
Taxes from employees of state government	4,545,720	4,841,171	15,246,996
Taxes from salaries private employment	21,636,111	42,223,770	85,494,580
Rental Taxes	684,518	1,122,179	3,062,981
Profit tax from individual traders	3,277,392	11,957,521	17,821,994
Profit taxes from private enterprises	875,697	739,304	612,423
Capital Services	611,230	68,755	589,516
Agricultural income tax	<b>31,557</b>	<b>65,776</b>	<b>27,922</b>
Agricultural income tax from individual farmers	31,557	65,776	27,117
Agricultural income tax from investors	-	-	805
<b>Indirect Taxes</b>	<b>20,100,327</b>	<b>34,442,617</b>	<b>46,011,363</b>
Business Taxes	-	-	-
Excise Taxes	250	-	30,186,200
<b>TOT from internally manufactured goods</b>	<b>14,294,293</b>	<b>30,069,032</b>	<b>9,785,062</b>
TOT from business goods	9,288,162	23,527,006	121,495
TOT from Agricultural products	566	7,956	3,317
TOT from forest/trees/ and its products	-	31,366	28,820
TOT other goods	5,005,565	6,502,704	9,631,430
TOT from services	124,845	417,562	198,573
Charges/fees/ and stump sales	5,680,940	3,956,023	5,841,528
<b>Non tax revenue</b>	<b>2,194,880</b>	<b>4,246,599</b>	<b>5,109,334</b>
^ Fees for Administrative services	1,489,472	3,289,607	4,214,541
Services add public goods	131,805	218,105	344,485
<b>Revenue from government investment</b>	<b>180,825</b>	<b>297,260</b>	<b>80,863</b>
Profit Taxes	2,432	-	2,500

Revenue from different investments	150,082	270,089	41,949
<b>Rural Land use fees</b>	<b>28,310</b>	<b>27,171</b>	<b>36,290</b>
Rural land use from farmers	28,310	27,171	35,105
Rural land use from investors	-	-	1,185
Urban land lease	-	-	124
Others	392,778	441,628	469,444
<b>Total revenue</b>	<b>53,957,431</b>	<b>99,707,691</b>	<b>173,977,109</b>

**Source: Oromia Regional Bureau of Revenue**

The above table in other way enhances the analysis of less revenue capacity of the Region under the Study indicating that, the trends of composition of Revenue of the Region, shows that the Region tend to be increasingly reliant on grant. For instance the share of Federal transfer, from the total regional revenue increased from 75% in the fiscal year of 1998 to 79% in the 2001 fiscal year. This Regional reliance even persists to the present. For example, in the fiscal year of 2006, while, the budget of the region is about 27 billion birr the revenue collected from taxes and non tax revenue sources is about 7 billion birr which is only about 27% of the total regional revenue. As it is discussed above, the trend shows that, second to Federal subsidy, the largest share of regional revenue is tax revenue from its assigned sources accounting for example 19% in 1999 fiscal year. With regards to non tax revenue, it accounts the minimum share of the total revenue of the region accounting 6.4% in 1998 to 4.8% in 2000 while; Capital revenue also took minor share of total revenue which accounted 0.3% in the 1999 fiscal year.

**4.3.1. Revenue Autonomy of the Region**

In the general part of this paper under the topic, “Fiscal Autonomy of SNGs”, different literatures are reviewed that there exist different ways of measuring Fiscal Autonomy of sub-national governments. Some scholars such as Daffilon and Madies,(2009), argue that fiscal autonomy of Sub-national governments can be measured by the extent of SNGs control over own revenue sources through their taxing power and the extent of their capacity to match it with their expenditure without the influence of other level of government. In other way it can be measured on the bases of their revenue importance or the extent of revenue generated by specific SNG for total revenue of the Nation. However, it has been observed that, much focus is given to measure the Fiscal autonomy of SNGs on the base of whether; they have capacity of setting tax rates and

tax bases independently of higher level governments as well as having the ability of matching the provision of services to the needs of their constituents (Bahil, R, 2009).

Hence, the tax Autonomy of Oromia National Regional State would be analyzed on the bases of the above mentioned elements of measures of Fiscal Autonomy. Accordingly, as far as determination of tax rates and tax bases are concerned, what observed from Art 97 of the FDRE Constitution is that, although it lists those tax bases under the jurisdiction of Regional governments, other than agricultural income tax and rural land use fee most of these taxes are reserved for them after the shared by the federal government on the base of difference in employee (employees of federal government or employees of state government) and ownership of property. This means, the same with the whole regional state, Oromia National Regional state have independent legislation and administration power on agricultural income tax and rural land use fee. Thus, in relation to such taxes, the Region have the power of determining tax bases, tax rates as well as exclusive Administration power over them because, these sources of revenue are exclusively assigned to them. However, they least influence the revenue capacity of the region as they yield less revenue as such, the full power of region on these taxes has no significant effect in determining the level of its spending.

As far as, other taxes such as, personal income tax, business profit taxes and etc are concerned, the power of the region is limited by the FDRE Constitution particularly Art 100 and other proclamation such as Proclamation No. 57/1997 (Financial administration Proclamation) in which under its Art 58 put that, tax systems at the Federal and Regional levels shall have harmonized and standardized tax bases. This can be emphasized that, according to sub-Articles (1) and (2) of Art. 100 of the FDRE Constitution, both levels of governments have the obligation to ensure that any tax related to the source of revenue taxed; that tax should be determined up on proper consideration and tax imposed by them should not adversely affect their relationship. If any tax imposed by the state affects interstate commerce, the central government intervenes since the power is reserved to it. Thus, in relation to the above mentioned taxes, tax rate set by the federal government is applied uniformly across the whole regions. Hence, regional governments in practice are unable to set tax rate and introduce new tax bases to expand their revenue capacity.

Besides the inability of determining the tax rate and tax bases, revenue autonomy of the region would be influenced owing to the fact that, the region is substantially dependent on federal grant

provided that, it seems “take and give back”. In is regard, interviews made with those informants indicated as data sample in the introductory part of this paper, reveal that, high financial dependence on federal government would highly influence the manner of delivery of quantity and quality of public services. This would be emphasized that, the incapacity of the region to cover the costs of service provision by revenue from sources of revenue implies absence of Revenue autonomy. This why, (Dafflon and Madies, (2009) viewed that the capacity of states (LG) to decide independently of other level of government, the categories, quantity and quality of services that it intends to offer its residents would highly influenced by their financial dependence. Further, interviews with the above mentioned sources have pointed out that, the mere Tax Autonomy of the Region under study over land use fee and agricultural income taxes would not expand the revenue capacity of the Region owing to the fact that, such Revenue bases yield the least Revenue compared to its expenditure requirements. Thus, insufficient revenue sources and high degree of financial dependence negatively affect its Autonomy. Less revenue from own sources and dependence of the ORG for instance, can be observed from budget and financial sources of the Region in 2006 the table below.

**Table: 4.2 Budget Requirement and Financial Sources of ORG (2006)**

	<b>1. Expenditures</b>	
<b>1.Recurrent Expenditures</b>	Birr	Birr
Administrative and General Services	1,279,249,113.00	
Economic Services	871,216,309.00	
Social Services	<u>1,930,804,712.00</u>	
<b>Total Recurrent Expenditures</b>		<b>4,081,270,134.00</b>
<b>Capital Expenditures</b>		
Administrative and General Services	181,355,860.00	
Economic Services	4,207,787,763.00	
Social Services	<u>1,267,962,128.00</u>	
<b>Total Capital Expenditures</b>		<b>5,657,105,751.00</b>
3. Block grants for Weredas and city Administrations		<b>11,756,556,143.00</b>
4. Grants for Projects		<b>4,875,000,000.00</b>
5. Others		<b>100,000,000.00</b>
6. Reservation		<b>250,000,000.00</b>
<b>Total Expenditures</b>		<b>26,719,932,028.00</b>
	<b>2. Financial sources</b>	
<b>1) Regional Revenues</b>		
Revenue from Taxes	5,980,281,530.000	
Revenue from Direct Taxes	4,001,284,976.000	
Revenue from Indirect Taxes	1,978,996,554.000	
Non Tax Revenues	882,784,500.000	

Capital Revenue	2,933,970.000	
<b>Total Regional Revenue</b>		<b>6,866,000,000.00</b>
2) Grants/subsidy/ from Federal government		13,815,498,571.00
3) Foreign Assistance		149,979,187.00
4) External/foreign/loan		13,454,270.00
5) Internal revenue from public sectors		642,005,000.00
6) Budget for millennium projects		4,875,000,000.00
7) Others		357,995,000.00
<b>Total Revenues</b>		<b>26,719,932,028.00</b>

### Sources: Oromia Regional BoFED

Hence, as it is observed from the table above, substantial share Regional Expenditure has been financed by the Subsidy from the Federal Government. This is because; while the Total Regional Revenue is only about 7 Billion birr its total Expenditure is about 27 Billion birr. This means, the Region could finance only about 27% of its total expenditure while about 73% of its expenditure is to be financed by the Federal Government showing severe dependence of the Region on Federal Grants. The above analysis shows therefore, that ORG has bare Revenue autonomy owing to the fact; there exists unified tax system and high dependence of the Region on the Federal Grant. To enhance the analysis, primary data has been collected on the above discussed issue (revenue autonomy of the region). Accordingly, from the total of 40 informants of questionnaires, 34 (about 85%) respond that, the region under the study do not have revenue autonomy as it can only determine tax rates and bases on minor revenue yielding revenue bases such as rural land use fee and agricultural income taxes.

### 4.3.2 Further Analysis

Actual revenue collection by the regional government would be an indicator of its revenue capacity. However, according to Martinez Vazquez & Jameson Boex (1997) actual revenue collection is a poor indicator of SNGs revenue capacity. Hence, they relate the revenue capacity of SNGs with potential ability to raise revenue from sources under their jurisdiction. With regard to this, I have conducted discussion with planning directors both in the regional BoFED and Revenue bureau whether, commitment of revenue collection influences the revenue capacity of the region or not. Accordingly they have responded that, the regional revenue collection performance is highly increasing even, many years the region collects beyond its plan. However,

this does not improve the revenue capacity of the region from its essence because, the revenue sources under the region (ORG) is less progressive. Hence, the revenue collection performance would not be actual indicator of the region as revenue sources constitutionally left for the regional government matters in this regard.

Thus, is apparent that, the legal base governing the levying and collection of taxes and non tax sources by the federal and states government is the FDRE Constitution in its Art.96,97,98and 99. Accordingly, based on the two legal documents, the Oromia regional state has provided with a right to collect income taxes; taxes from profit and sales taxes on business; agricultural income tax and land use fee; personal income tax from employees of the regional government, royalty from forestry activities. The total collection of revenue from these sources however accounts less than 30 percent of the regional budget. Thus, as it has been discussed in different sections of this paper, the Revenue Sources defined for the State are very low in Revenue generation affecting the its potential ability of Raising Revenue (Revenue). Thus, the in accessibility of important Revenue yielding tax bases (revenue sources) affects the revenue capacity of the region than other factors such as tax evasion, corruption, less commitment in tax collection etc (annex two).

**Table: 4.3 Budgeted and Actual Revenue of ORG, in ETB (2006/07- 2008/09)**

	2006/07	2006/07	%	2007/08	2007/08	%	2008/09	2008/09	%
	Budget	Actual	Diff.	Budget	Actual	Diff.	Budget	Actual	Diff.
<b>Domestic Revenue</b>	<b>600,000,000</b>	<b>762,837,938</b>	<b>27.1</b>	<b>700,000,000</b>	<b>1,088,221,678</b>	<b>55.5</b>	<b>950,000,000</b>	<b>1,357,905,433</b>	<b>42.9</b>
<i>Tax revenue</i>	<i>476,628,147</i>	<i>560,805,589</i>	<i>17.7</i>	<i>565,698,147</i>	<i>806,872,544</i>	<i>42.6</i>	<i>780,858,285</i>	<i>935,390,803</i>	<i>19.8</i>
<i>Direct Taxes</i>	<i>446,909,604</i>	<i>519,454,802</i>	<i>16.2</i>	<i>503,554,550</i>	<i>748,144,294</i>	<i>48.6</i>	<i>737,164,372</i>	<i>864,448,858</i>	<i>17.3</i>
Income, Profit & Capital Gains	446,909,604	519,454,802	16.2	503,554,550	748,144,294	48.6	737,164,372	864,448,858	17.3
Other direct taxes									
<i>Indirect Taxes</i>	<i>29,718,543</i>	<i>41,350,787</i>	<i>39.1</i>	<i>62,143,597</i>	<i>58,728,250</i>	<i>-5.5</i>	<i>43,693,913</i>	<i>70,941,945</i>	<i>62.4</i>
Excise locally made goods(lmg)	593,718	685,742	15.5	606,069	1,604,357	164.7	867,723	121,904	-86
Sales turnover tax	9,865,430	12,879,597	30.6	15,339,489	17,437,308	13.7	14,187,238	19,194,057	35.3

on lmg									
Services sales tax	5,128,741	20,473,590	299.2	24,566,183	32,197,645	31.1	23,021,274	41,583,110	80.6
Other indirect taxes	14,130,654	7,311,858	-48.3	21,631,856	7,488,940	-65.4	5,617,678	10,042,874	78.8
<b>Non-tax revenue</b>	<b>123,371,853</b>	<b>202,032,349</b>	<b>63.8</b>	<b>134,301,853</b>	<b>281,349,134</b>	<b>####</b>	<b>169,141,715</b>	<b>422,514,630</b>	<b>149.8</b>
Recurrent	122,570,234	191,784,273	56.5	132,657,764	278,265,884	109.8	169,141,715	356,348,297	110.7
Capital revenue	801,619	10,248,076	1178.4	1,644,089	3,083,250	87.5	66,166,333	-	#DIV /0!

### Sources: Oromia BoFEd

The, above table shows slight increase in actual revenue collection of the Region implying that, revenue bases of the region are not progressive. This can be more emphasized that, the general income of the region to finance its total expenditure is the Block Grant from Federal Government, Tax Revenue of the Region and Non tax Revenues. Accordingly, when the composition of each are compared, for instance, in the fiscal year of 2001, the share of the three component of Regional Revenue was 79%, 16% and 5% respectively with capital Revenue accounting only 0.05% of the total revenue. Hence, based on measures of revenue capacity discussed in the general part of this paper, Revenue Capacity of ORG would be analyzed both in terms of revenue and expenditure.

Thus, as far as ORG Revenue Capacity is concerned, informants from both Regional BoFED and Revenue Bureau provided that, although the study Region, because of geographic factors composes various revenue bases, they are not accessible for the region because of the control by the federal government over these sources. Hence, in line with the assertion of the above mentioned scholars, the potential ability or revenue capacity the region under the study, is influenced much not for less tax collection performance, tax evasion, corruption and the like but for insufficient tax sources owing to centralization by the federal government. Further, data show that, although there is no express recognition to the practice of horizontal fiscal transfer under the

Ethiopian Fiscal federalism, in reality it is apparent that, Grant is that collected from revenue sources located in limited Regional governments through control by the Federal government. Here however, the researcher, do not ignore the need of Economic Stabilization, protection of Interregional equity and Redistribution by the Central government through centralization of some dominant tax bases, but, the fiscal aspect of Ethiopian Federalism better to consider principles in the Constitution guarantying freedom of Regional governments to administer their internal affairs independently of the Federal Government, as Grants may not effect this Constitutional Promises.

#### **4.4 Analysis of Vertical Fiscal Imbalance**

Discussions and interviews have been made with informants in Regional BoFED to describe the extent and cause of vertical fiscal imbalance between Oromia Regional Government and Federal Government and within the Region and Local Government. Thus, they have viewed that, Oromia composes much Revenue bases in which the Federal Government through its exclusive and concurrent power is entitled to collect much revenue from these Revenue bases. Thus, they have further viewed that, owing to its general functions such as economic stabilization and redistribution, the federal government is entitled to collect various revenue sources in the region. For instance while discussion, informants have provided me that, because of geographic factor the region is endowed with various natural resources. Among these resources, they have raised as an example, minerals controlled by the federal government. Accordingly, they have viewed that, the federal government obtain higher revenue from Gold mining operating at “Lega Dami and Shakiso” barely benefiting the region of its location (ORG). In this regard, I have asked informants of questionnaires, whether domination of the federal government over natural resources is contributing in vertical imbalance in the region or not. Accordingly, from the total of 40 informants 36 (about 90%) responded that, the entitlement of the federal government on some natural resource as its revenue bases is an important cause of the imbalance (See annex 2, Question 11).

Enhancing the above analysis, data obtained from officials of Regional Bureau of Revenue further shows that, much of public enterprises are operating in the region owing to vastness of the region and proximity to capital city. Hence, profit taxes and personal income taxes of employees of these enterprises go to the federal government irrespective of their location without

or rarely contributing to the revenue needs of the region. Further, Ato Kebede Zegeye added that, for instance, as far as profit tax from Company (both Share Company and P.L.C) is concerned, about 500 are operating in Oromia Regional state in which much of their head offices are registered in Addis Ababa. Hence irrespective of their operation in the region, the federal government either exclusively collects or shares it with Addis Ababa City Administration claiming ownership for the mere place of registration. On the other hand, huge amount of VAT is collected from these companies in which the federal government alone has exclusive power of administration entitling regional government only to the share of 30% while 70% of the share for the federal government. Hence, on one hand, for administration incapacity of the states, the federal government is delegated to administer on their behalf. Hence, it is rarely possible for the region to control the amount collected by the federal government which create difficulty of estimating the amount on which the 30% is computed. On the other hand, the manner and the time of the payment of this share are not clearly provided in which its practicality is rarely implemented. Thus, these caused the region unable to cover even half of its recurrent expenditures leave alone capital expenditures. Therefore, as it has been observed from trends of regional revenue, almost in all fiscal years, Federal subsidies take substantial share of Regional total revenue in all fiscal years.

Tax assignment under the FDRE Constitution shows that, sources which have nationwide benefit, mobile tax and taxes which have redistributive and economic stabilizing effect are considered as a sole revenue sources for central governments. This assignment may share the practice of tax assignment in other federations although; ways of protecting the fiscal gap between the centre and SNGs varies. However, because of Demographic and Geographic factors, the origins of these Sources of Revenues are not located in the whole Regional States, rather located in limited Regional States.

Hence, as far as the reality in the study Region is concerned, it composes various Sources of Revenue having Stabilization, Redistributive element. Besides, taxes which have nationwide benefit such as, Enterprises, Companies, custom duty (imports and exports items), huge mining undertakings etc are apparently originating from the study Region relative to the other Regional Governments. Therefore, although small percent of data shows that there exist, less performance in revenue collection, tax evasion and corruption contributing in slight decrease in actual revenue

collected from budgeted revenue in some fiscal years, higher percent of data revealed that, the inaccessibility of profitable revenue bases in the Study Region has been the cause of Vertical Fiscal imbalance (See also annex two). As far as fiscal relation between the Region and Districts is concerned, it has been discussed in the preceding sections that, the Constitution of ORG decentralized various functions and some revenue sources. However, as far as assignment revenue is concerned Weredas are rarely entitled to collect revenues from such sources on their own behalf but, it goes to the region and provided for them in the form of block grant. This therefore, shows that despite their vast functions, both levels of Governments face the problem of insufficiency revenue for the execution of these functions.

#### **4.5 Extent and Importance of Intergovernmental Fiscal Transfer in ORG**

It has been discussed that, the phenomena of centralization of dominant revenue sources in the study region by the federal government, obliges the region to be unworthy of covering its expenditure responsibilities by the Revenue from sources under its jurisdiction.

Generally, almost the whole Fiscal years, Federal Subsidy financed substantial share of Expenditure Needs of the Region. In this regard, both primary and secondary data show that subsidy has paramount importance in which above 85 % of informants respond in favor of its importance (See annex two). For instance, data obtained from ORG BoFED (tablefive) show that, in the fiscal year of 2006, while the plan of revenue from its own sources is only about 7 billion birr the budgeted expenditure needs are about 27 billion. Thus, while the Region's Revenue from its own sources is only to cover 27% of its expenditure, the remaining share is to be covered by the Federal Subsidy. The trends of all previous fiscal years also show the same phenomena as Regional own Revenue to the share of Federal Subsidy has been barely changed. Hence, although, not in reality, higher share of the Expenditures of the study region have been financed by Federal Subsidy. This however, does not mean that, Federal Subsidy (Grant) is sufficiently enabled the State Government and without negative implication as it has been discussed in various sections of this paper. Below the table summarize the existence of high degree of Vertical Fiscal Imbalance and dominant share of Federal Subsidy over Regional Revenues.

**Table: 4.4 Total Regional Revenue, Expenditure and Federal Subsidy (1999, 2000 and 2001 EFY)**

ETB millions	1999 EFY	1999 EFY	2000 EFY	2000 EFY	2001 EFY	2001
	Budget	Actual	Budget	Actual	Budget	Actual
<b>Total Financial Resources</b>	<b>3728</b>	<b>3739</b>	<b>5519</b>	<b>5829</b>	<b>6724</b>	<b>7250</b>
Region's Revenues	<b>7250</b>	763	700	1088	950	1358
Federal Government Subsidy	2975	2975	4600	4601	5571	5656
External Assistance & Loans	153	2	181	103	203	203
Subsidy from Loan			37	37		4
<b>Total Expenditures</b>	<b>3803</b>	<b>3803</b>	<b>5626</b>	<b>5480</b>	<b>6932</b>	<b>7161</b>
<i>Recurrent</i>	3083	3196	4491	4412	5218	5401
Admin. & General Services	770	864	1180	1258	1438	1594
Economic Services	510	522	739	783	767	941
Social Services	1637	1810	2118	2370	2839	2866
Contingency	165	0	455	0	174	0
<i>Capital</i>	721	607	1135	1068	1714	1760
Admin. & General Services	40	44	42	89	125	146
Economic Services	469	374	698	566	961	929
Social Services	212	189	394	413	628	685

**Source: Regional BoFED**

## **4.6 Importance and Implementation of Borrowing in the Region**

The borrowing power of Subnational governments varies from federation to Federation. For instance, under the practice of Ethiopian fiscal system, State Governments are limited only to borrow from Domestic financial Institutions. As far as external borrowing is concerned, the State governments are not allowed to borrow or get financial grant directly from external financial institutions; external finance always comes through the federal government as part of the federal transfer. External loan is not transferred as a loan to the regional government; the regions receive only in the form of federal grants without any increase to revenue capacity of Regional governments.

Data shows that, leave alone external borrowing, domestic borrowing has not been fully implemented because; the legislative body has not yet enacted modality law to this effect. Nor the States initiate a law for the implementation of the Constitution in this respect. Furthermore, procedural constraint as well as dominant discretionary power of the federal government to that effect makes Regional government barely benefited from borrowing right. For instance, Article 10 of Proclamation No.33/1992 put that, when in need of borrowing, Regional Governments are required to submit to MoFED the amount they want to borrow together with: the relation of the requested amount to their revenue forecast, Economic indicators of their Region, their consolidated budget and the feasibility study of the project for which the loan is requested. After the submission, all most the power to determine whether to allow or not is decided by the MoFED without much negotiation with the concerned Regional Government (on this issue, interview has made with interviewees in the Regional BoFED and enhanced the above discussion). The above entitling law however, does not provide in clear manner the role of regional government and which organ of the region decides to that effect. Further, it does not provide in clear manner the mechanism and instrument of borrowing and which organ is a lender. Thus, owing to the above restrictions and constraint Regional Governments rarely exercised borrowing right to adjust their revenue needs.

As far as Oromia Regional Government is concerned, Proclamation No 156/2010 under its Art. 39 entitle the Region to borrow domestically on the issuance of security on behalf of the Regional Government. Accordingly, the Region is entitled to borrow domestic currency or foreign currency after consultation with bank although this right is seldom exercised for the

above procedural difficulty. The Proclamation in its Art.52 further put that, instances where the head of regional BoFED, provides to loan for Districts and Municipalities the amount of which is deducted from their subsidy budget. However, the power of Districts or Municipalities to borrow on their own behalf does not provided in the proclamation or other laws which make the lower unit of government to continue with their budget insufficiency affecting the provision of quality, quantity and accessible public services.

Therefore it can be observed that, there exists legal base to borrow domestically at regional and District level on the base of Proclamation No 33/1992 and Proclamation No 156/2010 respectively in the absence its implementation in the Region under the study. Thus, besides, Regional meagre revenue sources and lack of power of determination of tax rates and tax bases, absence of proper implementation of borrowing both at Region and District level have negative impacts on its Revenue and Expenditure autonomy. To analyze this comparing with that of Indian practice of fiscal decentralization, although alleged to be experienced centralized fiscal system, it allow state government to borrow externally besides domestic borrowing although it require the approval of the federal government. Hence, one can argue that, the Ethiopian fiscal system implies that, the federal government opted to make Regional Government to be fiscally dependent units while at the same time making them as its agent to facilitate political dimension of Decentralization.

#### **4.7 Implication of Revenue Capacity of the Region**

The FDRE Constitution defines and 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. Besides, they can formulate and execute economic, social and development policies, strategies and plans. Further, they are empowered with administration of land and other natural resources in their jurisdiction as well as levying and collecting some taxes under their jurisdiction etc. Thus, the Constitution is designed by creating dual Federal system in Ethiopia in which, both level of Governments have their own Executive; Judicial and Legislative branch of Government to ensure further the self governing of Regional Governments.

Accordingly, Regional Governments are entitled to develop their, Administrative Capacity, Judicial System and Legal System in their jurisdiction. However, it has been apparently observed

that, Administrative and Political dimensions of decentralization are accompanied with centralization of fiscal power at the center. This is to say that, the assignment of revenue sources and expenditure responsibilities between the federal and the Regional government is such that almost all of the regional governments cannot generate enough revenue from own sources to cover their expenditure responsibilities. This is true even in Regions such as ORG where most of the sources of federal government revenue are concentrated. Accordingly, the absence of explicit consideration and recognition to such vital Regions and the dominance of the central government in the fiscal power deprive it off fiscal autonomy and the capacity to address the development priorities of its jurisdiction.

Therefore, how could it be practical for the region to determine and develop all its internal affairs which emanates from the FDRE Constitution while, the Federal Government is financing its expenditure needs? For instance, Solomon Nigussie (2005) argue that, high degree of Vertical fiscal imbalance and dependence of lower governments on central government affects the efficiency of these lower governments in service provisions and their autonomy. This is because, lower governments official have no incentives to deliver Public services in efficient manner and also the autonomy of these governments is dependent on the federal government.

Accordingly, based on scholarly asserted views and data, below this paper has analyzed the implication of Revenue Capacity of ORG, referring to Regional Autonomy, Service Provision, Accountability and the Overall Development (GDP) taking these components as important elements for the fulfillment or non fulfillment of internal Self Administration of the Region.

#### **4.7.1 Implication on its Autonomy**

Based on the right to self administration, the study region adopts its own constitution to govern its socio-economic and political affairs under its jurisdiction. However, this paper observes that, the state under focus is dependent even for its recurrent expenditure. This dependence, of the region therefore implies that, the federal government through the design of grant influences the manner of its budget allocation rarely matching with the needs of the jurisdiction. This is therefore, against the principle of self administration which claim “right of each member of the community in a federation to choose in full freedom the governments that will implement the

genuine will of the people”. This principle is theoretically enshrined in the FDRE Constitution, in which in reality, it is invisible owing to fiscal incapacity.

This could be more explain that, decentralization is meant to assist; regional governments develop their regions on their own initiative through administering their internal socio- economic and political development. However, the states both at regional and local level do not have sufficient income to undertake their constitutional functions toward the citizens under their jurisdiction. Thus, this implies that the Federal Government is tend to determine the budget process of the Regional Government as the dominant share (about 70%) of Regional expenditure has been financed by the Federal subsidy. For instance, Martinez (1998) puts that, the increased accountability associated with decentralization can only be assured when sub-national governments have an adequate level of autonomy and discretion in managing their budget expenditures as well as in raising their own revenues. In relation to this assertion, data utilized in this paper shows that, Revenue bases left for ORG could only finance about 30% of its Expenditure affecting the power of the Region to prioritize the peoples’ needs and Preferences owing to the mis-match between own sources of revenue and Expenditure. On the other hand, the revenue, the Region share with the Federal Government or concurrent taxation are very similar with block grants as the arrangement give very limited fiscal autonomy the region. The discussion further reveals that, even if revenue collected in the Region is gone to the Federal Government and given back through transfer, the federal government may still be able to limit the degree to which this fiscal autonomy is exercised by attaching different condition on the area to be distributed. Thus, such phenomena, affects the Regional autonomy to exercise its self administration being under the influence of financial domination of the Federal Government.

For instance, Watt, Ronald (2005), argued that:

*“Autonomy of Constituent units relates to the degree of freedom from external control by other level of government within the polity. This is important because an authentic federal system involves combination of shared rule for certain common purpose while self rule for other purpose by the constituent government. In such context, the extent to which the financial arrangement contribute to the genuine autonomy of the regions in their areas of constitutional responsibilities or constraints such autonomy gives an indication of the degree to which the political system in practice genuinely practical. The extent to which the constituent units have access to own sources of revenue or are dependent upon Transfer from the central government*

*and further more the extent to which these transfers generally unconditional or conditional can seriously affect their degree of autonomy”.*

From the above assertion, it could be observed that, the existence of high dependence of regional government on federal government to finance their constitutional assigned function, made them guardians of the interest of the federal government without meaning full socio economic development of their jurisdictions. The fact that regions depend on central government to a large extent for their revenue implies that; they do not have complete freedom and power over their socio-economic development. As far as Oromia Regional government is concerned, its expenditure and revenue trend show that there exist great difference between total regional budget and its own revenue. Hence, as it has been discussed above, the region can finance only a very small portion of its recurrent expenditure from its own revenues leave alone its capital expenditure. Such phenomena thus, resulted in high degree of dependence on federal government for its substantial portion of its expenditure at the cost of its autonomy. Hence, the unwillingness of the federal government to allow the state sufficient revenue *autonomy* to influence its revenue capacity affects the decision making of the region on expenditure prioritization according to the preferences and needs of its people. This analysis however, does not ignore improvement with regard to economic and social development seen in the region. Rather, it claim that, political and economic symmetry across the states adopted by the Ethiopian federal system, made the region under the study equally dependent irrespective of its geographic and demographic vastness. Even in case of fiscal transfer from the federal government, the region obtains the least when seen on the base of per capita income than others (Solomon, 2005:266).

#### **4.7.2 Implication on Accountability**

Various scholars argue that, the accountability of lower- level governments to local clients is enhanced if sub-national governments have access to own-taxes with the right to adjust tax rates. This implies that, when sub national governments are assigned with sufficient revenue source, officials are more promoted and accountable toward the people under their jurisdiction in delivering Public Services. However, data shows that, access to very limited tax bases leads lower potential of cost recovery negatively influencing the accountability of Local government’s officials in service delivery. In this regard, interview has been conducted with officials in the Regional BoFED. Thus, they have viewed that, although the Federal government designed

revenue sharing and subsidy to avoid the problem, it is rarely incentive for the state government to act toward the citizens efficiently in service provision. This is because, the income to be obtained from revenue sharing with the Federal Government is barely implemented in required time and manner as it has been discussed above. Besides, its amount is very small in which it could not enable to prioritize the needs of the constituents. On the other hand, exclusive reliance on federal transfers creates conditions for lack of accountability as local governments may shift blame and responsibility for service delivery to higher tiers of government that control the bulk of government revenues. Thus, the local population may not hold the local government accountable either because they perceive them as having no financial power for public services provision, or because they are not as informed or vigilant about monitoring resources that arrived from external sources outside the community.

#### **4.7.3 Implication on General Development of the Region**

On the base of self government states' power involves, local economic development, land use planning and management, and public safety as well as development of public health, social protection, education, and environmental protection under their jurisdiction. However as it has been touched in different sections of this paper, these tasks however, effected if there exist sufficient revenue as an important instrument. When the contribution of regional revenue of Oromia to GDP is analyzed, for instance, in the fiscal year Of 1998 to 2001 its ratio remained below 1% while the Regional total expenditure to GDP ratio remained below 4% and even decreased from 3.6% in 1998 to 2.7% in 2001. Regional revenue to GDP ratio also decreased from 0.6% in 1998 to 0.3% in 2001. This is attributed by lack of revenue sources to adjust with capital expenditures which can influence the GDP of the region. An argument goes that, economic development relates to the extent to which the specific decentralized fiscal arrangement contributed to the improvement of economic efficiency which involves efficiency in allocation of public and private resources as well as efficiency in the provision of public services. In this regard, an interview has been made with different experts in different sectors in Oromia regional government. Accordingly, they have viewed that, both at national and state level it is the plan of government, to ensure sustainable development in the country. However, domestic government revenue particularly at regional level apparently has recently been barely enough to cover recurrent government expenditure let alone to generate resources for financing capital

expenditure. Hence, the absence of revenue to be allocated for financing capital expenditure made invisibility of ensuring sustainable development. With regard to Oromia, data revealed that, although the region is claimed to be composition of various revenue sources, the revenue sources constitutionally left for its functional performance as its own revenue could not finance its recurrent expenditure leave alone capital expenditure which could directly affect the economic as well as social development of the region.

Further, some respondent of the interviews added their views by stating that, Constitutional centralization of revenue sources at the federal government forced the regional government to finance higher share of recurrent expenditures than capital expenditures. Hence, allocation of major revenue on recurrent expenditure, would negatively affect development across the region, to deliver accessible service across the region in quality and quantity required. This does not however, mean that, the region under the study is totally undeveloped as the reality shows some change both in economic and social service developments. However, while discussion have made with informants in the regional BoFED, they have provided that, because of the regions' vastness both in terms of Geography and Demography, the region could not make provision of economic and social services equally across the whole districts in quality and quantity desired.

## **Chapter five: Conclusion and Recommendations**

### **5.1 Conclusion**

The post 1991 new fiscal arrangement (decentralization) was designed by assigning various responsibilities and revenue raising power upon the regions by the decentralization legislation. Accordingly, the regions have been entrusted with various responsibilities for the provision of goods and services of particular interest to them and in which they had very little role in the previous Regimes. They, in particular are to provide health and education services, build roads, establish and manage industries, provide housing and other amenities, and exploit indigenous resources. These functional assignments were followed by revenue assignment, revenue sharing, Intergovernmental fiscal transfer and domestic borrowing to allow the states to finance these responsibilities. This means, the new fiscal arrangements proposed show- that regional expenditures are to be met through revenue sharing, central government transfers, external loans and grants channeled to regions through the budgetary process and/or domestic borrowing by the regions.

However, with respect to Revenue Assignment between the two levels of Governments, it was shown that, the Sources of Revenue such as, fees for land usufructuary rights, agricultural income taxes and royalty for use of forest resources etc. left to Regions appear to be less productive while every significant internal Revenue sources such as total control of taxes on foreign trade (that accounts nearly half of the total tax revenue in the country) and two-third of revenue sources from indirect taxes and non-tax revenue sources in the countrywide are assigned under the jurisdiction of the Federal Government. This high degree of vertical fiscal imbalance shows that the States' overall share in total government revenue could be little changed from its historical level still as there exist centralized fiscal policy by Federal government determining their budget and its allocation.

Further, the study has revealed that, Vertical Imbalance in Ethiopia is higher than many Federal Systems in Developing Countries. Thus, the regional states are totally dependent on the federal transfers (or a budget subsidy) to carry out their Responsibilities and Tasks. Thus, irrespective of variation in Natural Resource Endowment, Revenue Generating Capacity apparently exist in Ethiopia; the phenomena of centralization of countrywide Tax and Revenue Sources in the hand of Federal Government cause all the Regions severely dependent on the Federal Transfers.

With regard to ORG data shows that, if not for centralized tax system under the Ethiopian Fiscal system, the state is better endowed with Natural Resources such as Minerals, Coffee, Skin, Hides etc which would be substantial share of revenue for federal government being major export items. Thus, the study point out that, domination of taxes on such items by imposition of export/export duty by the Federal Government directly affects the Revenue capacity of the Region. On the other hand as far as income tax is concerned, for the proximity of region to the Capital city, various Public enterprises and companies are located in the region in which the Federal Government concurrently or exclusively collects profit taxes from the income of these enterprises and personal income tax from employees of these enterprises and VAT irrespective of where they found. Thus, the paper has found that, the focused Regional State is barely benefited from these Revenue bases although they are located in its jurisdiction.

Accordingly, from the overall work of this paper:

- ✚ Firstly the author comes up with the conclusion that, revenue assignment in Ethiopia does not enable Regional governments to exercise their full self governments which include developing one's regional socio-economic and political affairs under its jurisdiction. Data in this paper show that, the study Region is almost equally dependent on federal subsidy owing to centralization of revenue sources in the Region by the Federal government.
- ✚ Second, as far as cause of less revenue capacity on the side of Regional government is concerned, although some claim that, tax evasion, corruption, less commitment by tax collectors etc are the cause, in reality they are not the cause. Although such factors would influence revenue collection performance, they barely affect the potential ability of revenue raising capacity in essence. Accordingly, data reveal that, had it been not for centralized assignment of revenue source in the hands of the Federal government, the study Region would have not qualified for subsidy.
- ✚ Thirdly, although the Ethiopian Federal system seems the most devolved system, it does not allow Regional Governments to have tax autonomy. Accordingly, besides concentration of revenue source at the center states do not have an important element of tax autonomy (Determination of Tax rate and Tax bases independently of the federal government) to increase their revenue capacity to adjust with their expenditure needs.
- ✚ Fourthly, as far as Revenue sharing is concerned, primary data reveal that, revenue sharing is rarely expands the revenue capacity of the study region as its implementation is

questionable in practice. For instance as far as the allocation of revenue from VAT is concerned, both Primary and Secondary show that, on one hand, no clear justification is provided why regional governments are entitled only to 30% of revenue from VAT. On the other hand, since, the administration of VAT is under the federal government, regional governments do not know the amount of VAT collected. This shows that, from how much amount the regional governments are entitled to 30% is unclear. Further, even the above mentioned share itself is rarely paid in time. Accordingly, practically revenue sharing would not expand the revenue capacity of the state and be incentive for public services provision in accordance with the needs and preferences of the subjects.

- ✚ Fifth, data shows that, the less revenue capacity of the Study Region has negatively affected its autonomy, accountability of official in service provisions for their subjects creating under quality and quantity of public services. Generally, the full self government, which includes developing and determining of socio-economic and political affairs under one's own jurisdiction which is the main principle of the FDRE Constitution, is influenced because of financial incapacity to execute these rights.

Accordingly, as the main finding of the study, this paper has pointed out that, while Canada and Switzerland have embarked on granting feasible and fair broader local fiscal autonomy, the Ethiopia's Federal Constitution that guarantee Self Administration of Nation, Nationality and People of Ethiopia puts a very audacious promise in which in reality the Fiscal position of the Constituent units are highly dependent on Federal Government. Thus, this high dependence of Regional governments on the Federal Subsidy could erode local legitimacy and weaken local accountability, because the regional officials may become more concerned to fulfill and respect the demand and command of the Federal Government that finances their spending which eventually makes local people and officials of lower Governments to consider themselves as agents of Federal government. Further, this paper revealed that, centralized taxation system under the Ethiopian Fiscal Federalism could undermine local needs and priorities in favor of Policies and Directions of the Federal Government.

## 5.2 Recommendations

Fiscal decentralization has been an important subject in the policy option both in unitary and in federal political system as well as in developing and developed countries because effective and efficient service delivery would not be effective through centralized fiscal system as the central government is far from its constituencies and unable identify their preferences and needs. However, in Federation like Ethiopia, Subnational Governments are financially highly dependent on Central Government to finance their constitutionally assigned Functions. Given this understanding and on the basis of the findings of this paper, the following Recommendations are proffered by the writer:

- ✚ Ethiopia, adopted a dual form of federal system in which the States have their own legislative, Executive and judicial organs which are guaranteed both by the Federal and state constitutions. Further, they are provided the right of full self administrations which include the determination of their internal socio-economic and political development. However what is apparent from its fiscal federalism is that states are not self reliant even to finance their recurrent expenditure without federal transfer:
- ✚ Thus, it needs to decentralize some revenue bases which are under the dominance of the federal government in order to re-establish a true federal system is to be strongly recommended. Therefore on the base of this recommendation, all the stakeholders and concerned bodies need to work together to ensure that each tier of government is self sufficient and independent in the delimited sphere of authority to exercise their constitutional promise of self administration which enables them to develop their socio-economic and political affairs of their Region.
- ✚ Making the whole regional states highly dependent on federal grant should be reconsidered because it affects the accountability of officials of state governments in delivering quantity and quality of public services and create disincentive. Therefore, government should reconsider and make Regional Governments such as Oromia, where relatively more public revenue originates to be self reliant by granting some revenue bases equitably emplace of providing it with grants.

- ✚ It is important that fiscal decentralization in Ethiopia be rearranged to improve the quantity, quality and accessibility of public services, to ensure fiscal discipline, to enhance democratic and effective institutions and in the process to contribute to address the fundamental economic, social and political challenges of the country. Particularly, effective transfer of expenditure responsibilities and subsequent efficiency gains from it depends particularly on the arrangements of revenue assignment and transfers. This is to say that regions should have sufficient revenues under their control and be free from undue central government control in allocation of their resources.
- ✚ The own Revenue of state and local government is very low compared with Federal Transfer because; the types of taxes assigned to these levels of government are minor taxes which, unfortunately, have low yields. Thus, for each tiers of government to execute the responsibilities assigned to it, federal subsidy should not be a sole policy option. Thus, they have to secure revenue from assigned revenue sources which can enhance their revenue capacity than to be dependent on transfers from Federal Government.

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## Annex One: General Information about the Respondents

No	Description	MoFED	ORG BoFED	ORG Revenue authority	Master Student at AAU	Lectures at AAU	Total
1	No of Respondents	8	10	15	5	2	40
2	Sex: Male	7	10	13	5	2	37
	Female	1	-	2	-	-	3
3	Age: 18-30 yrs	1	-	1	1	-	3
	30-45 yrs	6	9	13	4	2	34
	Above 45 yrs	1	1	1	-	-	3
4	Level of education:						-
	Diploma	-	-	-	-	-	-
	Degree	7	8	12	-	-	27
	Masters	1	2	3	5	-	11
	Above Masters	-	-	-		2	2

**Source: Own**

## Annex two: Questions provided and Data collected

No	Questions	MoFED					Regional BoFED					ORG Revenue Authority					Lecture & MA student at AAU				
		No of informant	Yes	%	No	%	No of informant	Yes	%	No	%	No of informant	Yes	%	No	%	No of informants	Yes	%	No	%
1	Do you think Self administration/ autonomy/ of Sub-national governments is equally provided in Countries of Federal Political System?	8	2	25%	6	75%	10	1	10%	9	90%	15	2	23%	13	87%	7	-	-	7	100%
2	Do you think under the Ethiopian Federal system, States' revenue capacity enable them to exercise full measure of self administration which is constitutionally guaranteed?	8	1	12%	7	88%	10	-	-	10	100%	15	3	20%	12	80%	7	-	-	7	100%
3	Do you think that fiscal decentralization/ fiscal freedom of states/ matches with political decentralization in Ethiopia?	8	3	27%	5	63%	10	2	20%	8	80%	15	1	7%	14	93%	7	-	-	7	100%
4	Do you think that centralization of fiscal power particularly revenue power at the federal government/revenue dependence of states on Federal government/ affect the exercise of self governments of the states?	8	4	50%	4	50%	10	7	70%	3	30%	15	12	80%	3	20%	7	6	86%	1	14%
5	Do you think that the provision of the FDRE Constitution providing the Nations Nationalities and People of Ethiopia with full measure of self government expanding up to secession practically visible in the absence of revenue capacity to internalize the cost of public services? OR are federal transfers/ grant and revenue sharing/ be incentive for sub-national government to fully provide public service which matches the needs of the jurisdiction?	8	3	38%	5	62%	10	9	90%	1	10%	15	11	73%	4	27%	7	2	29%	5	71%
6	Do you observe that revenue assignment under Ethiopian decentralized fiscal system has its own problem and cause of states' less revenue capacity?	8	5	62%	3	38%	10	8	20%	2	20%	15	15	100%	-	-	7	6	87%	1	13%
7	Do you think that fiscal decentralization in Ethiopia shows that the federal government is surplus in its revenue while States are deficit units? Or revenue of federal government from	8	4	50%	4	50%	10	9	90%	1	10%	15	12	80%	3	20%	7	5	71%	2	29%

	taxes and non tax source is more than its expenditure responsibilities?																					
8	Do you think that the source subsidy/grant/ that the federal government transfers to the States is Revenue from taxes and non taxes Constitutionally assigned to it?	8	5	63 %	3	27 %	10	8	80 %	2	20 %	15	11	73%	4	27%	7	5	71%	2	29 %	
9	Do you think that the assignment of revenue sources/ taxes/ to the federal government which is dominant in revenue generating is appropriate assignment?	8	5	63 %	3	27 %	10	6	60 %	4	40 %	15	10	67%	5	33%	7	4	57%	3	43 %	
10	Is incapacity of tax administration and less potentials of revenue generation of Oromia National Regional State cause of its less revenue capacity?	8	4	50 %	4	50 %	10	9	90 %	1	10 %	15	1	7%	14	93%	7	2	29%	5	71 %	
11	Do you think centralization of dominant tax/revenue source/ for the purpose of interregional equity affect regions those relatively have better Natural resource endowment and tax bases?	8	8	100 %	-	-	10	9	90 %	1	10 %	15	15	100 %	-	-	7	7	100%	-	-	
12	Do you observe that under Ethiopian fiscal decentralization, instances of horizontal fiscal transfer from relatively rich regions to backward regions?	8	5	63 %	3	37 %	10	8	80 %	2	20 %	15	13	87%	2	13%	7	5	71%	2	29 %	
13	Do states in Ethiopia; have the power of determining tax rate and tax bases freely?	8	1	12 %	7	88 %	10	2	20 %	8	80 %	15	4	27%	11	73%	7	1	14%	6	86 %	
14	Do Regional state In Ethiopia have tax autonomy/ sovereignty/?	8	3	37 %	5	63 %	10	4	40 %	6	60 %	15	-	-	15	100 %	7	-	-	7	100%	
15	Does Oromia National Regional State have tax autonomy according to the theory of fiscal decentralization which claims that sub-national governments have the power to determine tax rates and tax bases under their jurisdiction?	8	2	25 %	6	75 %	10	3	30 %	7	70 %	15	1	7%	14	93%	7	-	-	7	100%	
16	Do you think that, all expenditure needs of Oromia Regional state can be financed by the revenue collected from its tax sources and non tax sources under its jurisdiction?	8	-	-	8	100%	10	-	-	10	100%	15	-	-	15	100 %	7	-	-	7	100%	
17	Do you think that Oromia National Regional State is benefiting from federal subsidy/ Grant/ because the region/state/ gets additional revenue which it could not raise from its tax bases?	8	6	75 %	2	25 %	10	5	50 %	5	50 %	15	7	47%	8	53& %	7	4	57%	3	43 %	

18	Can the provision of public goods and service in ORG be properly performed matching the needs of the region in the presence of high dependence of the region on federal subsidy?	8	3	37 %	5	63 %	10	1	10 %	9	90 %	15	-	-	15	100 %	7	1	14%	6	86 %
19	Do you think/ do you observe/ that, low political commitment for revenue raising and lack of skilled man power for proper administration of taxes causes less revenue capacity of Oromia National Regional State?	8	4	50 %	4	50 %	10	3	37 %	7	63 %	15	4	27%	11	73%	7	3	33%	4	57 %
20	Do you observe that, revenue sharing particularly VAT is properly implemented and Oromia is benefiting from this transfer system?	8	1	12 %	7	88 %	10	4	40 %	6	60 %	15	-	-	15	100 %	7		29%	5	71 %
21	do you think that, VAT, Profit tax from PLC and share company custom duty etc are improperly centralized by the federal government disregarding the interest of the Regional governments?	8	4	50 %	4	50 %	10	7	70 %	3	30 %	15	13	87%	2	13%	7	4	57%	3	43 %
22	Do you think that expenditure needs/ responsibilities/ which should be the responsibilities of federal government is assigned to the Region than its revenue power , thus unable to cover the cost of such responsibilities?	8	1	13 %	7	87 %	10	3	30 %	7	70 %	15	6	40%	9	60%	7	-	-	7	100%
23	Do tax payers and tax collectors have contributed to region's/ Oromia's/ less revenue capacity?	8	4	50 %	4	50 %	10	3	30 %	7	70 %	15	3	20%	12	80%	7	3	43%	4	57 %
24	Do you observe that revenue generating capacity of ORG is improved?	8	7	88 %	1	12 %	10	9	90 %	1	10 %	15	11	73%	4	27%	7	5	71%	2	29 %

### Annex Three: Contacted Informants for Interviews

No	Name	Office	Interview day
1	Tesema Bekele	ORG BoFED	April 16/2014
2	Aschenaki Disasa	ORG BoFED	April 16/2014
3	Hussien Seid	ORG BoFED	April 16/2014
4	Kebede Zegeye	Regional Bureau of Revenue	April 10/2014
5	Tadesse Kenei	Legal Expert in ORG S. Court	April 18/2014
6	Abdissa Dashura	Master Student at AAU	April 20/2014

## Annex Four: Interview questions provided for the interviewees above

1	Do you observe some problem with fiscal decentralization particularly with revenue assignment among levels of governments in Ethiopia relating it with theory of fiscal decentralization and experience of other federation?
2	What do you think is a real cause of vertical fiscal imbalance between federal and the state governments?
3	Do you think under the Ethiopian decentralized fiscal system revenue assignment is centralized against the principles and theory of tax assignment?
4	What are the impacts of centralizing taxes from unevenly distributed Natural resources on regions endowed with these resources? Does it mean penalizing them while benefiting the other?
5	What if certain tax bases previously owned by the federal government would be decentralized to states as a policy option to narrow vertical fiscal imbalance?
6	Do you think that States in Ethiopia would fully exercise constitutionally guaranteed self government in the presence of high dependence on federal governments for financial support to perform their responsibilities?
7	Do you think that Revenue sharing and federal grants are the only ways of managing both vertical and horizontal fiscal imbalances? And are they properly implemented to affect their purpose?
8	Does Oromia National Regional State have tax autonomy according to the theory of fiscal decentralization which claims that the sub-national government to determine tax rates and tax bases under their jurisdiction?
9	On which tax bases can Oromia National Regional State determine its bases and rates freely?
10	What do you think is the practical cause of less revenue capacity Oromia National State?
11	Do you think that Oromia National Regional State is benefiting from federal transfer/ Grant/ because the region/state/ gets additional revenue which it could not raise from its tax bases?
12	Is incapacity of tax administration and less potentials of revenue generation of Oromia National Regional State cause of its less revenue capacity?

- |    |  |
|----|--|
| 13 | <p>As it is true also for the rests of states in Ethiopia, Oromia National Regional State is highly dependent on federal government for financial support to perform its constitutionally assigned functions.</p> <ul style="list-style-type: none"><li data-bbox="211 262 1549 336">✚ The question here is, do you think that such dependence affects the autonomy and self government which include development of political, economic and social development within the region?</li><li data-bbox="211 336 1549 451">✚ Do you think federal grant is sufficient to be incentive for officials of the region to perform the above motioned tasks particularly to provide public service which matches the needs of the people?</li></ul> |
|----|--|

## Annex Five: Budgeted Revenue and Expenditure of ORG (2006)

	<b>1. Expenditures</b>	
<b>1.Recurrent Expenditures</b>	Birr	Birr
Administrative and General Services	1,279,249,113.00	
Economic Services	871,216,309.00	
Social Services	<u>1,930,804,712.00</u>	
<b>Total Recurrent Expenditures</b>		<b><u>4,081,270,134.00</u></b>
<b>Capital Expenditures</b>		
Administrative and General Services	181,355,860.00	
Economic Services	4,207,787,763.00	
Social Services	<u>1,267,962,128.00</u>	
<b>Total Capital Expenditures</b>		<b><u>5,657,105,751.00</u></b>
3. Block grants for Weredas and city Administrations		<b>11,756,556,143.00</b>
4. Grants for Projects		<b>4,875,000,000.00</b>
5. Others		<b>100,000,000.00</b>
6. Reservation		<b>250,000,000.00</b>
<b>Total Expenditures</b>		<b><u>26,719,932,028.00</u></b>
	<b>2. Financial sources</b>	
<b>1) Regional Revenues</b>		
Revenue from Taxes	5,980,281,530.000	
Revenue from Direct Taxes	4,001,284,976.000	
Revenue from Indirect Taxes	1,978,996,554.000	
Non Tax Revenues	882,784,500.000	
Capital Revenue	2,933,970.000	
<b>Total Regional Revenue</b>		<b><u>6,866,000,000.00</u></b>
2) Grants/subsidy/ from Federal government		13,815,498,571.00
3) Foreign Assistance		149,979,187.00
4) External/foreign/loan		13,454,270.00
5) Internal revenue from public sectors		642,005,000.00
6) Budget for millennium projects		4,875,000,000.00
7) Others		357,995,000.00
<b>Total Revenues</b>		<b><u>26,719,932,028.00</u></b>

## Annex Six: Powers and Functions of Regions

All power not given expressly to the federal government alone or concurrently to the Federal Government and the states are reserved to the states.
Consistent with sub-article 1 of this Article, states shall have the following powers and functions.
a) To establish a state administration that best advances self government, a democratic order based on the rule of law; to protect and defend the federal constitution;
b) To enact and execute the state constitution and other laws;
c) To formulate and execute economic, social and development policies, strategies and plans of the state;
d) To administer land and other natural resources in accordance with federal laws;
e) To levy and collect taxes and duties on revenue sources reserved to the states and to draw up and administer the state budget;
f) To enact and enforce laws on the state civil services and their condition of work; in the implementation of this responsibility it shall ensure that educational; training and experience requirements for any job title or position approximate national standards;
g) To establish and administer a state police force, and maintain public order