

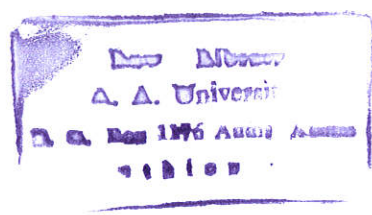
ADDIS ABABA UNIVERSITY

School of Law

Graduate Program

INTERGOVERNMENTAL FISCAL TRANSFERS IN ETHIOPIA:
CHALLENGES AND SOME OPTIONS (A COMPARATIVE STUDY)

By: Getachew Mengeste



November 2011

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A thesis submitted to the law school of Addis Ababa University for
the partial fulfillment of Masters Degree (LL.M) in Constitutional
and Public Laws

By Getachew Mengeste

Advisor: Dr. Solomon Nigusssie (Associate Prof.)



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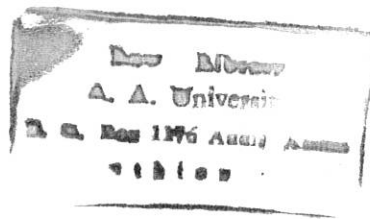
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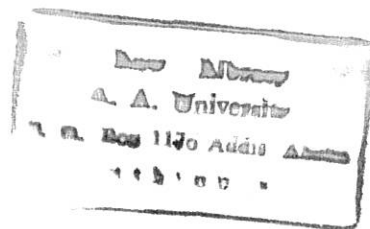
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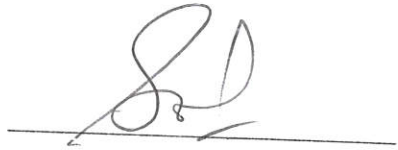
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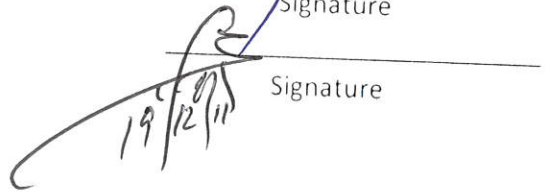
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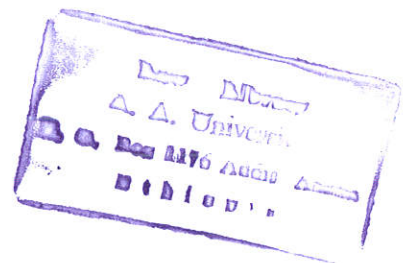
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First and foremost my thanks go to my mother, Virgin Marry, who was always there as a bridge to take my prayers to her Son, God. This paper is one among many that would not have been realized without their priceless backing.

I am also indebted to my advisor, Dr. Solomon Nigussie, who helped me a lot from the inception to the completion of the paper. The substance and the organization, not to mention the title of the paper could not have been well organized as it stands now had it not been for his friendly approach and recommendations. However, I hasten to add that all the blames on the paper should only be pointed at me.

My interviewees in the HOF, MOFED, ERCA, Finance and Revenue Bureaus of Oromia and Amhara Regional States have greatly contributed in providing me the necessary information (interview and documents) for my research. Needless to mention that it is through them the paper has able to reach the practice. Thanks all of them.

Elsi, you deserve to be blessed for all my inspirations and courage in doing this research paper. I am not sure whether just "thank you" can express my intention. My constitutional and public law stream friends, Awel Ahmed and Yemane kassa, should also take some share of my thanks for their genuine friendship during our stay in the stream. Finally, I would like to express my gratitude to all others left in the above lists due only to inadvertence on the part of me.



ABSTRACT

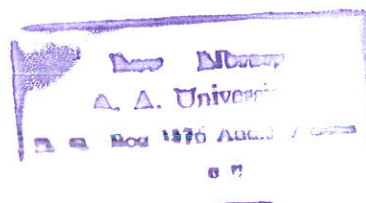
It is a boldly held view that the revenue assignment problem in a federal set up is less challenging than problems witnessed in intergovernmental fiscal transfers from the federal to state governments. The issue of challenges to intergovernmental transfer system and possible alternatives of avoiding them did not, however, attract much attention in Ethiopia as they deserve. This paper is then especially targeted to fill the gap in that regard. Intergovernmental fiscal transfer (in Ethiopia) involves two transfers. First, we have grants (unconditional and conditional) that the federal government devolves to the states. Second, there is revenue sharing where the federal government shares the revenues it has collected from the concurrent jurisdictions envisaged under article 98 of the constitution. Intergovernmental fiscal transfers is especially challenging in those countries where sub national entities are substantially dependent on the federal government to cover the lion's share of their expenditures. Ethiopia is among such countries where one can observe huge fiscal imbalance between the two tiers of government that left the states to expect federal transfers for they could not cover more than 20% of their expenditure through their own sources. After reviewing the existing literatures on fiscal transfers, exploring the experience of three federal countries on the issue, and analyzing the tax assignment and fiscal transfer provisions of the FDRE Constitution with the current practice, the paper would make it clear that the 2007 and 2009 grant formulas, though appreciating in their attempt to rectify the gap between revenue capacity and fiscal need of the states (as data allow), is problematic for they do not employ variables comparable across units of governments and the role of the HOF only commences after the federal government ruled on the share dispersed as a regional subsidy, the organ currently entrusted by the HOF to prepare grant and revenue sharing formula and modify the share of the state as circumstances change is not effective. The paper argues that the prevalent vertical fiscal imbalance of the states in Ethiopia could not only be rectified through fiscal transfers and we should sought some other options to empower the fiscal capacity of the states such as bridging the gap between revenue potential and actual revenue of the states, revisiting the FDRE constitution (including the concurrent jurisdiction) to win more tax jurisdictions to the states, and enhancing their role at least in revenue sources exclusively assigned to them.



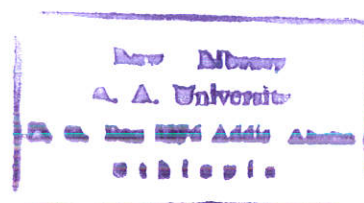
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ACRONYMS

FDRE- Federal Democratic Republic of Ethiopia

HPR-House of Peoples' Representatives

HOF-House of Federation

MOFED-Ministry of Finance and Economic Development

ERCA-Ethiopian Revenue and Customs Authority

EPRDF-The Ethiopian Peoples' Revolutionary Democratic Front

VAT-Value Added Tax

ToT- Turn over Tax

SNNPR- Southern Nations, Nationalities, and Peoples' Region

E.C-Ethiopian Calendar

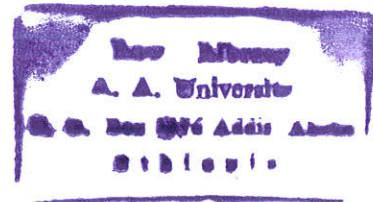
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CHAPTER ONE INTRODUCTION

1.1 Background

Fiscal federalism is essentially the choice and distribution of fiscal decision making power across multi leveled governments.¹ To distribute fiscal decision making power across multi leveled governments, some countries implemented fiscal decentralization where as others opted only for deconcentration of centralized decision making without actual fiscal decentralization.² There appears to be scholarly unanimity on the benefits a country could derive from fiscal decentralization because the negative multiplier effects of fiscal centralism are enormous and above all incompatible with the demands of federalism.

It is now almost two decades since the federal structure is set up in Ethiopia by the adoption of the Transitional Charter in 1991 and the subsequent ratification of the Federal Democratic Republic of Ethiopia (FDRE) Constitution in 1995. The Constitution has also distributed the fiscal decision making powers between the federal government and the nine regional States. The theory of fiscal decentralization, inter alia, involves the assignment of responsibilities and functions between the federal governments and the sub-national governments and the assignment of taxation powers. While the former imposes a duty of expenditure, the latter entitles the bearer for revenue capacity to exercise its expenditure duties.

However, it is usually contended that the expenditure responsibilities imposed up on sub-national governments far more exceed their revenue power which puts them in disadvantageous position by letting them substantially dependent on the central government at the expense of prejudicing their autonomy. In other words, the distribution of the tax base (revenue power) of sub-national governments and the demand for public goods (their expenditure duties) does not follow equal pattern and this gives rise to the emergence of fiscal imbalances, vertical or horizontal.

A vertical fiscal imbalance occurs when own revenue and expenditure capacity of varies levels of government within a federation are unequal.³ It is the result of an allocation of expenditure

¹ Abu Moges, Fiscal Federalism and its Discontents, available at [http://www.fiscalnotes.com](#), last visited on 15/10 2010

² Ibid

³ Notes on Fiscal Federalism, Service Delivery and Capacity Building: The Case of Ethiopia, available at [http://www.fiscalnotes.com](#), last visited on 15 10 2010.

responsibilities with higher cost than the source of revenue assigned to sub-national governments. Horizontal fiscal imbalance, on the other hand, occurs when the own fiscal capacities of sub-national governments of the same level differ.⁴ It emerges usually as a result of tax base due to uneven distribution of economic resources and activity across regions where as expenditure requirements are spread more evenly.⁵

One of the principal objectives of the laws and policies on fiscal federalism is then to at least minimize, if not get rid of, these fiscal imbalances that occurred between the federal government and regional governments on one hand and among regional governments on the other. As such, the problem of fiscal imbalance requires measures that include the provision of subsidies as well as policies that promote balanced growth of regional economies and their taxation bases. The most common practice is providing federal fiscal transfers or subsidies to bridge the fiscal gaps in the regional governments.

Intergovernmental fiscal transfer is, therefore, an allocation by the federal government as a means of bridging the fiscal imbalances (vertical or horizontal). Intergovernmental fiscal transfers involve two main decisions: the federal government needs to decide on the aggregate pool of federal grants and the pool has to be distributed among the respective lower sub-national governments.⁶ The federal government may use different parameters both to decide on the aggregate pool and the amount that is going to be distributed to sub-national governments. It is submitted that the most conventional way to distribute the pool among sub-national governments is the use of some grant distribution formula that takes in to account different factors. The grant formula is, however, one of the most contested issues of fiscal federalism in many, if not most, federations and is usually subjected to frequent revisions through avoiding, modifying the weight attached or including certain criteria which are helpful to rule on the grant that will be devolved on each sub-national government. Many scholars of fiscal federalism, therefore, agree that intergovernmental fiscal transfers are accompanied by multi dimensional challenges that hamper devolution of grants through formulas amenable to all parties.

⁴ Ibid

⁵ Abu Moges, Internet Source, supra note 1

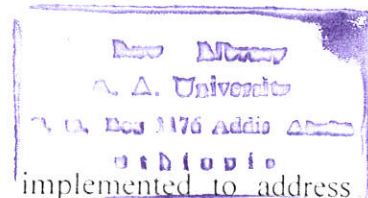
⁶ Ibid

Ethiopia is not an exception to these challenges of intergovernmental fiscal transfers given the substantial dependence of all the nine regional states on the federal government⁷ and the regional inequalities of resource endowments. The challenges of intergovernmental fiscal transfers in Ethiopia, then, revolve around these factors of fiscal imbalances. Further, the weights attached to different variables, the justification for inclusion or not of same is also challenging. The absence of explicit constitutional provisions to specify the absolute or relative magnitude of aggregate budgetary pool for the federal grant is also there to take some share in the challenges of Ethiopian intergovernmental fiscal transfer. The practice of the House of Federation of frequently revising the grant formula is one illustration that signifies how challenging the fiscal transfer in the present Ethiopia is.

In the Ethiopian context, intergovernmental fiscal transfers also involves revenue sharing generated through the federal administration of taxes which are the concurrent powers of both the federal and regional states as per article 98 of the FDRE Constitution. Besides the ambiguities rose, these provisions have been put in to effect in the form of shared taxes where the federal government levies and collects the taxes, while the states are entitled to the proceeds arising from the taxes. This federal administration of the shared taxes is also with its own threats and challenges.

1.2 Statement of the Problem

It is contended that the grant formula of Ethiopia has been implemented to address the expenditure needs of regional states and the provision of services and development benefits to all Ethiopian in an equitable and fair manner as stipulated in the FDRE constitution.⁸ On the other hand, as I have mentioned it above, the degree of decentralization of expenditure is higher than the degree of decentralization of revenue thereby causing a great divergence between source of revenue and functional expenditure obligations of regional states of Ethiopia. Accordingly, one can deduce that the current practice of intergovernmental fiscal transfers (which represents both



⁷ It is alleged that in Ethiopia, revenue decentralization is by far narrower than expenditure decentralization the apparent consequence of which is the emergence of vertical fiscal imbalances. Numerically, the regional governments have a combined expenditure responsibility of about 34% of total consolidated government expenditure where as their share of own revenue was just about 17%. Ibid.

⁸ Notes on Fiscal Federalism, Service Delivery and Capacity Building: The Case of Ethiopia, Internet Source, supra note 3

revenue sharing of concurrent taxes and federal grants) in Ethiopia is accompanied by multi faceted problems. This study, therefore, revolves around such existing challenges and inconsistencies in the practice of intergovernmental fiscal transfers in Ethiopia and options of bridging the huge fiscal dependence of the states on federal transfers.

1.3 Research Questions

To feed on the problem statement that is put previously, the research would answer, at least, the questions which are listed here under illustratively. Accordingly, the thesis is committed in responding for the following preliminary questions.

- What are the peculiarities of the 2007 and 2009 grant formulas from the earlier formulas?
- What are the pros and cons of the 2007 and 2009 grant formula of the House of Federation? What factors hindered the successful adoption and/or implementation of the grant formulas?
- What are the experiences of Nigeria, India and Germany on intergovernmental fiscal transfers? What lesson could Ethiopia derive from those experiences?
- What advantages and potential problems could be anticipated from the federal administration of the taxes concurrently given by the FDRE constitution to the federal and state governments of Ethiopia? Is the formula currently being applied for sharing the tax revenues worthy of buying by the regional states? Are there some concurrent tax assignments that should have exclusively been reserved for the states? How do we evaluate the current tax assignment under the FDRE Constitution in light of the general theories of fiscal federalism?
- Could the size of the aggregate pool devolved to the federal government be justified for being fair and proper? What principles are there to determine the pool? Are the regional states worse off/better off by the size of the aggregate pool that is going to be devolved among them? What role should the HOF play in this regard?
- How effective is the organ entrusted with fiscal transfers in Ethiopia?
- How do we go away with the huge fiscal dependence of the states on the federal transfers? Are there necessities to study the disparity between the revenue potential and actual revenues of the states, to revisit the FDRE Constitution, to evaluate the income tax laws, to evaluate the autonomy of the states on fixing their tax rates and bases, for the HOF to recommend the general pool that should be dispersed to the states, and so on?

1.6 Significance of the Study

The research, being specifically devoted to intergovernmental fiscal transfers of Ethiopia, is hoped to add on the existing literatures for it is specifically targeted. Since the research revolves around the grant formula which is currently being applied by the House of Federation, it is believed that it contributes to serve as a reference for the efficient adoption and/or implementation of sound grant formula. This is evident from the fact that the experience of three federal countries on intergovernmental fiscal transfers would be reviewed that serve as a means of comparing and contrasting the Ethiopian fiscal practice which is helpful to conclude whether it is devoid of criticisms and to take a remedial action accordingly.

Further, the discussions on pros and cons of the 2007 and 2009 grant formulas is hoped to add an input for future formulas of the house. It is also beneficial in familiarizing the different alternatives that could effectively boost the fiscal capacity of the states so that they would be relieved of the federal transfers. Generally, the study would be vital for readers on the means of eradicating fiscal imbalances through intergovernmental fiscal transfers and the challenges in attaining that very end. On the other hand, the study would play a pivotal role in grasping the problems associated with the federal administration of the concurrent taxes, the formulas devised by the HOF, tax sources made concurrent in the Constitution and the possible solutions to go out of these messes.

1.7. Research Methodology

The study will employ a mixed method research. Accordingly, it will descriptively analyze the theoretical and practical challenges of intergovernmental fiscal transfers in federations the principal focal point being the Ethiopian fiscal system. Further, some numerical considerations would also be made to, inter alia, signify the extents of fiscal imbalances, respective share of the states from the general pool, and revenue sharing formula devised by the HOF. The study is principally based on reviewing the relevant literatures on intergovernmental fiscal transfers.

The experience of Nigeria, India and Germany on intergovernmental fiscal transfers would be given special emphasis. The Nigerian experience will be reviewed because it is Africa's longest standing example of a federal system of governance and there are also stiff challenges on its fiscal system-a challenge which may even exceed than the same that Ethiopia faces.⁹ Indian

⁹ Edmond J. Keller, *Ethnic Federalism, Fiscal reform, Development and Democracy in Ethiopia*, available at [http://www.africaworld.com](#), last visited on 15/10/2010

system of intergovernmental fiscal transfers is also going to be studied where the basic need approaches and method of allocation of grant system of Ethiopia was explored from for the first time in 1994 and it is a country that is cited as effective to accommodate different interests.¹⁰ The experience of Germany, a historical federal country with well defined financing systems of sub-national government which however continue to be subjected to periodic reforms¹¹, is also considered.

On the other hand, semi-structured interviews would also be made with the concerned parties and officials at the federal level (such as the House of Federation, the Ministry of Finance and Economic Development, and the Ethiopian Revenue and Customs Authority) and state level. An appraisal of data reported on the fiscal transfer trends through years in Ethiopia would also be given special care. Above all, the FDRE Constitution and other relevant laws on fiscal transfer would be analyzed and tested against the practice.

1.8 Limitations of the Study

Probably the most important limitation of this study is a comprehensive study and interviews may not be made with the officials or any other concerned parties of all the regional states of Ethiopia owing to the time and financial constraints that is faced in doing this research. Accordingly, an interview is only made with the Revenue and Finance Bureaus officials of the Oromian and Amhara states and Addis Ababa City Administration and it is only their documents that is used in the study. There was also a problem associated with the non-availability of recent data on some considerations that forced the writer to depend his analysis on earlier data. Non-availability and involuntariness of concerned interviewees both at federal and state level is also there to take some share in the limitations of the paper.

¹⁰ Notes on Fiscal Federalism, Service Delivery and Capacity Building: The Case of Ethiopia internet source. Supra note 3

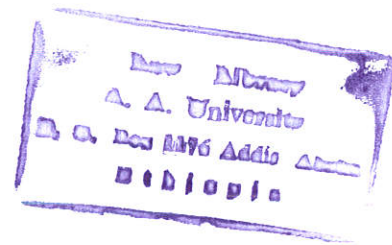
¹¹ Nuria Bosch and Jose M. Duran(Eds), Fiscal Federalism and Political Decentralization: Lessons from Spain, Germany and Canada, Edward Elgar Publishing Limited, UK, USA, 2008, P.1

1-9 Organization of the Paper

The paper is divided into six chapters. After this introduction, chapter two is there to review the existing literatures that signify the need for intergovernmental fiscal transfers. It is particularly interested in introducing the theoretical points on intergovernmental fiscal transfers that would be discussed in a better detail in the subsequent chapters with practical considerations. Fiscal transfer is mostly there to bridge the vertical and horizontal fiscal imbalances and the chapter would discuss them together with the two mechanisms of fiscal transfer: revenue sharing and grants (both conditional and unconditional). Before directly discussing the need for intergovernmental fiscal transfers, it would give a brief picture of fiscal federalism and principles of expenditure and revenue assignments.

Chapter three is particularly concerned in reviewing the experience of three federal countries (Germany, India, and Nigeria) on intergovernmental fiscal transfers. A separate chapter is given for this experience because it is helpful in getting a clear picture of fiscal transfer of the countries in one area. The chapter discusses in brief expenditure and revenue assignments, fiscal imbalances, borrowings, intergovernmental fiscal transfers and challenges of each of the three federal countries and ends in indicating the comparative lessons that Ethiopia could draw from the foreign experiences. It is beginning from chapter four that the paper directly considers the Ethiopian fiscal system as it is stipulated in the FDRE constitution. The chapter is totally devoted on discussing the expenditure and revenue assignments. An attempt is also made as to whether the Ethiopian revenue assignment is in conformity with the principles of revenue assignments.

Chapter five directly concerns the challenges to the fiscal transfer systems of Ethiopia and some options to reduce the huge dependence of the states on fiscal transfers. Specifically, the chapter would discuss the legal frameworks for fiscal transfer in Ethiopia, how fiscal imbalance is prevalent in Ethiopia, revenue sharing and its problems, the variables of the 2007 and 2009 grant formulas and their peculiarities from earlier formulas, institutional frameworks and some options of empowering the states. The final chapter (chapter six) would communicate the findings of the study and some recommendations there from.



Needless to mention that a discussion on the challenges of intergovernmental fiscal transfers in Ethiopia could not be addressed effectively without clearly understanding the preliminary theories underlying fiscal federalism and the need for fiscal transfers, and soliciting for the experience of other federal countries in the issue at hand. It is in this perspective that this and the next chapters are organized. This chapter is particularly relevant in laying a *sine-qua-non* ground for the most important issues that would be discussed in a better detail with practical considerations in the subsequent chapters of the paper.

The chapter would make it clear that a federal form of government that is principally concerned with dividing power between the central and the sub national government is considered as efficient both from economic and political justifications so long as it devises mechanisms to avoid the risks of decentralization such as erosion of accountability. On the other hand, it is also alleged in this chapter that because it is imperative to assign the federal government with more revenue raising powers than its expenditure responsibilities for reasons of efficiency in tax collection, influencing local priorities, and setting minimum standards through fiscal transfers, it is inevitable that the sub national governments are dependent on the fiscal transfers from the federal government principally for bridging the fiscal imbalance.

It is at this point in time that this chapter would commit itself to discuss the need for the two means of fiscal transfer: revenue sharing and grants (both conditional and unconditional). It ends in emphasizing the need for institutions and procedures that would be called to follow up and make necessary recommendations on the ever changing status of the horizontal and fiscal imbalances that exist between the federal and the sub national governments and among the latter.

2.2. Essence and Necessity of Fiscal Federalism

It is contended that federalism could be one tool of decentralizing power to sub national entities. As such, the economic and political justifications that are forwarded for decentralization can also hold true in federal arrangements that are primarily concerned in devolving powers mainly from

the central to the sub national governments.¹² This may also involve assigning expenditure and revenue responsibilities between the federal and regional governments and the need to rectify the fiscal gaps arising there from. The international community is well aware of federalism these days probably than any other time in human history. Federalism is alleged to serve various purposes that could not be effectively handled by other forms of state formation structures.

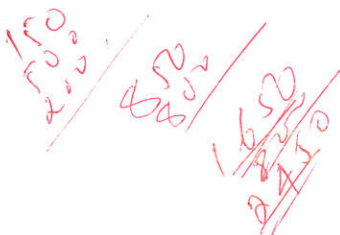
It is a gainsaying that the federal arrangement is chosen for driving a benefit from a strong union without compromising regional autonomy. We may safely involve both the central and regional governments in a way we are benefiting from decentralization and without undermining the vital role to be played by the central government. In order to do so, we need to understand which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government. This is the subject matter of fiscal federalism.¹³

Through its basic feature of dividing power between the two tiers of government, federalism may also encompass dividing its expenditure and revenue responsibilities. Fiscal federalism is in general dividing the fiscal aspects of the functions of government (expenditure and revenue assignments) and the subsequent need for intergovernmental fiscal transfer between the tiers of government. It is principally concerned in allocating expenditure responsibilities, the revenue raising power, and rectifying the fiscal imbalances between the central and sub national governments through intergovernmental fiscal transfers. One of the important elements of fiscal federalism from the beginning has thus been recognition of the probable need for intergovernmental grants to close the revenue gap. Considerable attention has been devoted to the appropriate design of such grants in different federations.

One aspect of fiscal federalism is assigning responsibilities between the national and sub national governments following both economic and political parameters. The common understanding in this regard is that among the allocation, redistribution and stabilization roles of the government, it is wise to give the sub national governments the allocation role (save for those allocations such

¹² For more on decentralization, readers are referred to Jonathan Rodden, Gunnar E. Eskeland, and Jennie Litvack (Eds), *Fiscal Decentralization and the Challenge of Hard budget Constraints*, Introduction and Overview, the MIT Press, London, England, 2003. Eshetu Chole, 'Issues of Vertical Imbalance in Ethiopia's Emerging System of Fiscal Decentralization', in Eshetu Chole (ed), *Fiscal Decentralization in Ethiopia*, AAU Press, 1994; Kibre Moges, 'the Conceptual Framework for Fiscal Decentralization', in Eshetu Chole (ed), *Fiscal Decentralization in Ethiopia*, AAU Press, 1994; Wallace E. Oates, an Essay on Fiscal Federalism, *Journal of Economic Literature*, Vol. 37, No. 3, . 1999

¹³ Wallace E. Oates, an Essay on Fiscal Federalism, *Journal of Economic Literature*, Vol. 37, No. 3, . 1999, P. 1121



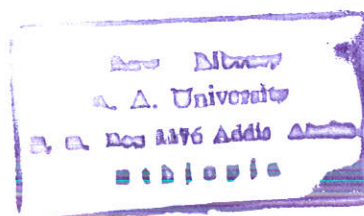
as defense that provides services for the entire population of the country) reserving the other two to the central government. The role of government in maximizing social welfare through public goods provision came to be assigned to the lower tiers of government. The other two roles of income distribution and stabilization are regarded as suitable for the central government. Each assignment has its own justifications.

For instance, to understand the fact that the allocation function should be taken care of by the central government, it is better to consider what will happen if it was regulated through the sub national governments. If the sub national governments were assigned with the responsibility of redistribution function, the rich would migrate to those sub national entities that have not yet embarked such functions. However, if this task is given for the central government, it would successfully accomplish the task of redistribution of income from the rich to the poor across all the citizens of the federation.¹⁴ We could also cite the incapacity of the sub national entities to carry out the stabilization function of the government as one of the reasons to assign such responsibility to the central government.

After the assignment of the expenditure responsibilities is done, the next area of emphasis is to assign the revenue responsibilities, the means through which the governments could perform their expenditure responsibilities. Following the assignment of functions, the tiers of governments are conferred of taxing powers in a way that possibly reduce distortions and that best fit their assignment of functions as it would be made clearer in the fourth section of this chapter.

The other aspect of fiscal federalism is devising intergovernmental fiscal transfers that is, *inter alia*, meant to bridge the horizontal and vertical fiscal imbalances that is inevitable to exist between the federal and regional governments and among the regional governments. This is the exclusive domain of section 2.5 of this chapter. It is to be remind that how the expenditure and revenue assignments and the subsequent fiscal transfer is being undertaken in Ethiopia is not considered here as they are matters covered under chapter four and five of the paper.

¹⁴ Peter Ozo-Eson, Fiscal Federalism: Theory, Issues And Perspectives, available at [http://www.fiscalcommission.gov.ng/pubs/FFTP.pdf](#), last visited on 16/05/2011



2.3. Expenditure Assignments

The assignment problem or the allocation of expenditure, regulatory, and tax functions to various orders of government is the most fundamental issue in a federation.¹⁵ Any type of federal arrangement involves a division of functions between the federal and state governments (expenditure assignment) as well as assignment of different sources of revenue to different tiers of government (revenue assignment). The literature on fiscal federalism argues that finance should follow function.¹⁶

That is to say, assigning responsibilities for spending, including the exercise of regulatory functions must precede the assignment of responsibilities for taxation because tax assignment is generally guided by the spending requirements of the different organs of government and cannot be determined in advance. It may also be said that expenditure assignment is more important than revenue assignment for there are fundamental justifications to decentralize expenditure assignments than same of revenue assignments. There are principles of expenditure assignments that if followed properly would result in efficient delivery of public services. In this section I am particularly committed in discussing such principles before dealing with the constitutional division of legislative- executive responsibilities.

2.3.1. Principles of Expenditure Assignments

On **efficient provision of public services**, public services are provided most efficiently by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision.¹⁷ Nevertheless, some degree of central control or compensatory grant may be warranted in the provision of services in some cases. These cases include spatial externalities, economies of scale, and administrative and compliance costs. Spatial externalities arise when the benefits and costs of public services are realized by non residents and should be rectified by compensatory grants. In economies of scale, certain services are larger than a local jurisdiction for cost effective provision. On the other hand, centralized administration generally leads to lower administrative costs associated with financing public services.

¹⁵ Anwar Shah (ed), *Global Dialogue on Federalism Volume IV, the Practice of Fiscal Federalism: Comparative Perspectives*, Introduction, Principles of Fiscal Federalism, Published for Forum of Federations, Mc Gill- Queen's University Press, London, 2007, P. 9

¹⁶ Ibid

¹⁷ Ibid

On **redistribution role** of the public sector, it is commonly argued that effective redistribution is possible only through national programs by means such as progressive tax systems.¹⁸ On provision of quasi-public goods (services provided by the public sector but they are by virtue of their technologies essentially private goods such as health and education) given that benefit accrue mainly to residents of separate jurisdictions, such services would be provided by sub national entities. Here, the national government's involvement is justified to ensure horizontal and minimum standards of service in all jurisdictions.

As far as the **preservation of internal common market** is concerned, it is argued that the federal government is best suited to regulate economic activities such as inter- state commerce and investment.¹⁹ On **economic stabilization** function, it is customary to argue that the federal government should be responsible for stabilization policies because such policies cannot be carried out effectively by local jurisdictions.²⁰ On the other hand, public services whose benefits are considered national in scope such as defense and foreign policy can only be provided by the federal government.²¹ In general, although such principles may seem correspond with what is realized in many countries with federal structures, it is gainsaying that minor differences due to country- specific factors might prevail.

2.3.2. Constitutional Division of Legislative- Executive Responsibilities

Among the many features of federalism, one is both the federal government and state governments have their own legislative, executive, and judiciary powers. It is usually the federal constitution that demarcates the jurisdiction of each power. In principle, the responsibility for expenditure in federal states corresponds to the extent of the legislative and executive responsibilities distributed to the federal government and state governments.²² That is to say, the manner of the division of expenditure responsibilities will be affected by the design of the federal system, particularly the division of legislative and administrative powers.

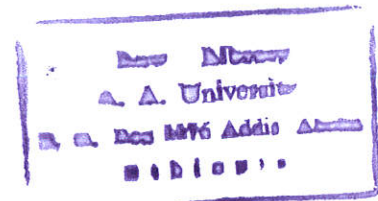
¹⁸ Id., P. 10

¹⁹ Id., P. 11

²⁰ Ibid

²¹ Kibre Moges, 'the Conceptual Framework for Fiscal Decentralization', in Eshetu Chole (ed), *Fiscal Decentralization in Ethiopia*, AAU Press, 1994, P. 4

²² Solomon Nigussie (PhD), *Fiscal Federalism in the Ethiopian Ethnic based Federal System*, Wolf Legal Publishers, 2006, P. 57



In general terms, the division of legislative powers and responsibilities may fall under **exclusive, residuary, concurrent, framework, and implied powers** whose detailed considerations are beyond the reach of this thesis.²³ It is usually witnessed in many federal countries that expenditure responsibilities are not provided in the federal constitution in a clear manner unlike the assignment of legislative and executive responsibilities.²⁴

It is the executive division of power between the federal and the state governments that is more worthy of considering while discussing expenditure responsibilities. Although the general principle expects each tier of government to bear the responsibility to administer all matters on which it has legislative power, it may be sometimes the case that one tier may administer the activities whose laws are enacted by the other tier. In this regard, there are dominantly two approaches for the allocation of executive functions in federal countries.²⁵ The first approach is dual federalism advocated by older federations such as USA whereby each tier of government has the responsibility to execute those matters on which it has legislative responsibility. Compatible with recognizing the autonomy of each other, this approach reserves for each tier of government to execute those matters on which it has enacted legislations.

The second approach is integrated federalism where one tier of government has the bulk of legislative power while reserving the bulk of the responsibility of the administration to the other tier. Germany is usually cited as the principal advocate of such approach. In Germany, the federal government is primarily concerned with policy initiation, formulation and legislation and the Lander (states) are required to do the bulk of the administrative business of such policies and legislations. By way of conclusion, it could be said that a clear appreciation of such issues is also important in addition to the principles of expenditure assignments to devise the expenditure responsibilities of each tier of government in effective manner.

²³ For clear appreciations of such classifications under the Ethiopian Constitution see Solomon Nigussie, *Fiscal Federalism in the Ethiopian Ethnic based Federal System*, Wolf Legal Publishers, 2006, Chapter 3).

²⁴ George Anderson, *Fiscal Federalism: Comparison of Experiences of Federations* (Amharic), Forum of federations, 2010, P. 12

²⁵ Ronald Watts, *Comparing Federal Systems*, Third Edition, McGill- Queen's University Press, Montreal & Kingston, London, Ithaca, 2008, P. 87

2.4. Revenue Assignments

As it was previously reflected, finance follows function. The logical extension of assigning expenditure responsibilities to different tiers of government is assigning revenue powers for the government needs revenue sources to accomplish its functions or revenue responsibilities. In addressing the issue of the allocation of revenue raising powers, the main question is how the taxation power is distributed between the tiers of government in federal system. The principle of tax assignment involves issues such as what type of taxes should be levied and collected by which level of government, and on what principles?²⁶

2.4.1. Principles of Revenue assignments

A number of sometimes conflicting principles are involved in the effective assignment of revenue raising powers among governments in federations. Some principles advocate for the desirability of federal assignment and some for assignment to the constituent units. Among the principles that favor assigning taxing power to the federal government, one is the **administrative advantage of centralizing** certain kinds of revenue levying and collection.²⁷ Another is **avoiding tax competition** among constituent units that would influence mobile companies and individuals to locate in a particular region. Another consideration is **equity**. This requires a concentration of revenues in the federal government in order that it may play a redistributive role to avoid sharply different tax levels among constituent units with varied wealth.

Ronald Watts has also indicated instances when sub national entities could be favored to raise revenue sources. These instances are the need to promote **accountability, tax competition for better policies and for ensuring regional autonomy**.²⁸ To enhance accountability of governments to their electorates, it is often argued that governments should be responsible to raise most of the revenues they spend. Furthermore, some economists favor a measure of tax competition as a positive encouragement for better policies among governments. Ultimately, there is also the desirability of states' autonomy rather than dependency on federal transfers.

Anwar Shah, on his part, emphasized that four general principles require consideration in assigning taxing powers to various governments.²⁹ First, the economic efficiency criterion

²⁶ Kibre Moges, supra note 21, P.5

²⁷ Ronald Watts, supra note 25, P. 96

²⁸ Ibid

²⁹ Anwar Shah, supra note 15, P. 20

dictates that taxes on **mobile factors** and tradable goods that have a bearing on the efficiency of the **internal common market** should be assigned to the federal government. Second, national equity considerations warrant that **progressive redistributive taxes** should be assigned to the federal government. Third, the **administrative feasibility** criterion suggests that taxes should be assigned to the jurisdiction with the best ability to monitor relevant assessment. This criterion minimizes administrative costs as well as the potential for tax evasion. Fourth, the fiscal need or revenue capacity criterion suggests that, to ensure accountability, **revenue means** (the ability to raise revenues from own sources) should be matched as closely as possible to **expenditure needs**. It is to be noted that decentralizing revenue assignments is not as compelling as decentralizing expenditure responsibilities. This is because regional and local taxation can introduce inefficiencies in to the allocation of resources across the federation and cause inequities among people in different jurisdictions.³⁰

2.5. The Need for Intergovernmental Fiscal Transfers

2.5.1. Fiscal Imbalance: Vertical and Horizontal

Adopting the principles of expenditure and revenue assignments cannot by itself guarantee a balanced budget at all levels of government. Some degree of mismatch between expenditure needs and revenue means at various levels of government is likely to occur. This mismatch is known as fiscal imbalance. It is alleged that it is inevitable to have fiscal imbalance for it is necessary to retain some taxing powers at the federal government. It is to affirm this allegation that Boardway and Shah contend that:

Matching revenue means with expenditure needs as closely as possible for various orders of government is a desirable goal to strengthen accountable governance. In practice, such a goal is not realized because of difficulties in decentralizing taxing powers than expenditure responsibilities and the desire to leave the federal government with some room for the use of spending power to influence sub national policies to achieve national objectives.³¹



³⁰ Ibid
³¹ Robin Boardway and Anyar Shah, Fiscal Federalism Principles and Practices of Multi Order Governance, Cambridge University Press, 2009, p. 293

In allocation of taxing powers, there are conflicting compromises made between administrative efficiency and fiscal independence.³² While the federal government is best suited to administer the tax effectively, fiscal independence requires each order of government to raise adequate revenues to efficiently accomplish their expenditure responsibilities. In many, if not most, of the federal countries, weighting has always been in favor of the efficiency criterion which allows for the concentration of more taxing powers in the hands of the federal government.

The fiscal imbalance may either be **vertical or horizontal**. Vertical fiscal imbalance occurs when constitutionally assigned federal and state government revenues do not match their constitutionally assigned expenditure responsibilities.³³ The federal government usually collects revenue either from tax or foreign aid and borrowing which exceed its direct expenditure responsibilities.³⁴ This will create a vertical fiscal imbalance when the revenue of the federal government is compared with the same of the regional states which do not have substantial taxing power and borrowing power from foreign sources.

The second form of imbalance is horizontal fiscal imbalance. Regional variations in the correspondence between revenue bases and expenditure requirements exist in most federal systems. This inconsistency between revenue raising responsibility and fiscal needs of government as the same level in a federation is known as horizontal fiscal imbalance.³⁵ Accordingly, horizontal fiscal imbalance has two components. First, it involves the **variation of revenue capacities** of different sub national entities so that they are not able to provide their citizens with services at the same level on the basis of comparable tax levels. Second, it involves **expenditure needs** of different sub national entities because of variations in socio- demographic characteristics of their populations, such as population dispersion, urbanization, social composition and age structure and the cost of providing services affected by such factors as the scale of public administration and the physical and economic environment.³⁶

³² Akpan K. Ekpo. 'Federal Republic of Nigeria', in Anwar Shah (ed), a Global Dialogue on Federalism Vol IV, *the Practice of Fiscal Federalism: Comparative Perspectives*, Published for Forum of Federations, McGill-Queens University Press, Montreal and Kingston, London, Ithaca, 2007, P. 214

³³ Ronald Watts, supra note 25, P. 103

³⁴ George Anderson, supra note 24, P. 64. It would, however, made clear in chapter five that there is no such a surplus in the revenue of the federal government in Ethiopia and vertical fiscal imbalance in Ethiopia only concerns when the revenue of the federal government is compared with the same of the states.

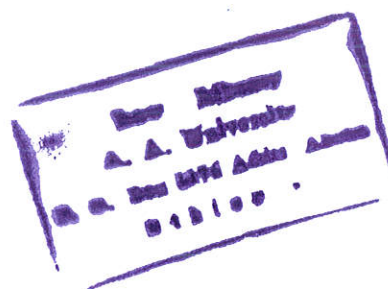
³⁵ Kibre Moges, supra note 21, P. 9

³⁶ Ronald Watts, supra note 25, P. 104

Ronald Watts pointed out that vertical fiscal imbalance occurs mainly for two reasons.³⁷ Firstly, it has usually been found desirable to allocate the major taxing powers to the federal government because they are closely related to the development of the customs union and more broadly to an effective economic union. That means, when the federal government is assigned revenue power, it ends in its winning the lion's share of the revenue. The second reason is that, no matter how carefully the original designers of the federation may attempt to match the revenue sources and the expenditure assignments of each order of government, over time the significance of different taxes change and the costs of expenditures vary in unforeseen ways.

2.5.2. Intergovernmental Fiscal Transfers and their Types

Once we have ascertained that the possibility of horizontal and vertical fiscal imbalance is inevitable, there has to be a mechanism devised to bridge the fiscal gaps that occur between the federal and state governments or among the latter. Such gaps can be mitigated through a transfer of a predetermined share of, in most cases, the revenues collected by the federal government. It is at this juncture that the issue of intergovernmental fiscal transfer is raised. Different scholars of fiscal federalism propagated that these fiscal imbalances have to be rectified by devising different means. Boadway and Shah contended that there are two broad ways through which fiscal gaps are rectified.³⁸ The first is revenue sharing while the second falls under the general rubric of federal- state transfers. Revenue sharing and grants (transfers) are therefore the two main means through which fiscal imbalances are handled. This sub- section is particularly interested in discussing such essential means.



³⁷ Ibid

³⁸ Boadway and Shah, *supra* note 31, P. 293

2.5.2.1. Revenue Sharing

Revenue sharing is a means of addressing vertical fiscal imbalance whereby one order of government has unconditional access to a specified share of revenues collected by another order.³⁹ The fact that it is unconditional renders the state the autonomy to use it in the priorities they set. Quite common in developing countries, revenue sharing addresses multiple objectives such as bridging the fiscal gap, promoting fiscal equalization and regional development and stimulating tax efforts by state and local governments.⁴⁰ An issue may be raised as to whether revenue sharing could be regarded as the states' own revenue or as transfer from the federal government. It is sometimes noted that revenue sharing is the states' own revenue. However, this understanding is labeled as misleading because the states do not control the amount of the proceeds especially when the federal government levies these taxes and set the rates.⁴¹

Revenue sharing structures are three fold: "the type of federal revenues to be shared, the proportion of those revenues that will go to the states as a whole, and the allocation of the shared revenues among the states".⁴² The revenue source to be shared could either be single or combination of several federal taxes. It is commonly understood that single or narrower tax bases do not get enough revenue sources to the states and are less likely to yield a secure source of revenue so that it is usually argued in favor of broad-based taxes. Further, the proportion of the shared revenue that will be devolved to the states is expectedly based on the expenditure needs and the own revenue means of the states.

As far as the means of distributing the revenue amongst the states is concerned, there are two rules: **principle of derivation and equity considerations**.⁴³ In the former case, revenues are transferred to the states in accordance with where the federal revenues were raised. In the latter, 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. The rule to adopt is dependent up on the purpose to be achieved through other forms of fiscal transfers such as grants. Boadway and Shah also affirm that:

³⁹ Anwar Shah, supra note 15, P. 21

⁴⁰ Ibid

⁴¹ Ronald Watts, supra note 25, P. 104

⁴² Boadway and Shah, supra note 31, P. 293

⁴³ Id., P. 294

Which of the formulas is appropriate depends on what other federal- state transfers exist alongside with revenue sharing. If revenue sharing is the main means for getting unconditional funding to the states, it ought in principle to be designed to meet the objective of federal- state transfers, which include some equalization component.⁴⁴

Federations have assigned different organs with the power to determine the share to be disbursed to the states.⁴⁵ The most guaranteed form of determination for revenue sharing for the states is if it was provided in the federal constitution as it is the case in the Federal Republic of Germany. Revenue sharing structures may also be determined by the advice and recommendation of quasi-independent bodies that exist in some federations such as India and Nigeria. The usual practice in this regard is to assign the federal government to decide on the amount of the revenue to be shared with the states and making it accountable for the system at the expense of affecting the interest of the states for the federal government may change the formula frequently.

Revenue sharing is praised for it promotes the autonomy of the states through its lump sum and unconditional awards, for its flexibility to serve as an equalizing factor, and preserving a fully harmonized tax system.⁴⁶ They are sometimes even preferred to unconditional grants since the amount of the revenue sharing increases in proportion to the growth in the federal tax while the unconditional grant may need the express decision of the federal government to increase the share of the states in such instances.⁴⁷ Revenue sharing has also its own risks.⁴⁸ Among others, it gives no discretion to the states to have a say on the amount to be dispersed to them. Further, the formula may not reflect the actual expenditure needs of the states. Moreover, it may also expose the states to the risk associated with unanticipated changes in the federal tax base. Moreover, given that revenue sharing essentially leave the states with little taxing power, it is presumably suitable only for those taxes that are otherwise deemed to be unsuitable for decentralization.

2.5.2.2. Grants: Unconditional and Conditional

The second means of dealing with fiscal imbalance is grant or transfers. They could broadly be classified in to two categories: unconditional and conditional grants. Unconditional (general purpose) grants are provided as general budget support with no conditions attached. Such

⁴⁴ Ibid

⁴⁵ Id., P. 295

⁴⁶ Id., P. 297

⁴⁷ Ronald Watts, supra note 25, P. 105

⁴⁸ Boadway and Shah, supra note 31, P. 297

transfers are intended to preserve local autonomy and to enhance inter jurisdictional equity.⁴⁹ "General purpose grants are termed block transfers when they are used to provide broad support in a general area of sub national expenditures (e.g. education) while allowing recipients discretion in allocating the funds among specific uses".⁵⁰ Accordingly, block grants fall in the grey area between general purpose and specific purpose grants as they provide budget support with few strings attached in a broad but specific area of sub national expenditures. On the other hand, it is common to witness formula- based general purpose grants.

Conditional grants (specific purpose transfers), on the other hand, are intended to provide incentives for governments to undertake specific programs or activities. It is easy to discern that the purpose of conditional grants is to influence the fiscal decisions of the state governments expectedly with the express intent of achieving some objective of the federal government. Accordingly, while unconditional grants are useful in the reduction of horizontal disparities, conditional grants are used for fostering national priorities and to serve specific, efficiency enhancing goals. Unlike unconditional grants, conditional grants are not awarded based on formula which leaves the matter on the discretionary power of the federal government.⁵¹

Conditional grants may either be matching or non- matching.⁵² 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.

Arguments are raised for and against unconditional and conditional grants. To begin with those arguments that favor conditional grants, it is justified on the allegation that it promotes the accountability of the federal government to the tax payers by attaching conditions on how to spend the tax collected from them.⁵³ This argument is especially dominated in the US where conditional transfers accounts for 100% of federal transfers to the states. The classical argument for unconditional grants is that it enhances the autonomy of states by allowing them to use the transfer in areas they deem proper. Further, it is contended that in those federations where the

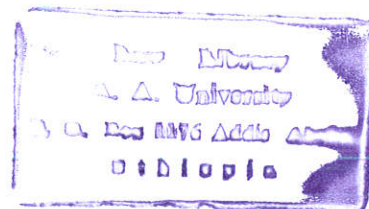
⁴⁹ Anwar Shah, supra note 15, P. 25

⁵⁰ Ibid

⁵¹ Boadway and Shah, supra note 31, P. 339

⁵² Anwar Shah, supra note 15, P. 26

⁵³ Ronald Watts, supra note 25, P. 107



regional units of government have parliamentary executives responsible to their own legislatures, it has been argued that these governments can be held responsible for the use of unconditional transfers through their accountability to their own legislatures and hence electorates.⁵⁴

2.5.2.3. The Grant Formula and its Variables

There are two important issues in apportioning fiscal transfers from the federal to state governments: deciding the general pool to be dispersed to the states and apportioning the general pool among the states. This inevitably involves complex issues. As far as the organ determining the general pool to be dispersed to the states is concerned, there are different organs across federations entrusted with such a duty.⁵⁵

First, the ratio may be stipulated in the federal Constitution as it is the case in Germany and is determined with the participation of states in the second chamber of the Federal Houses (*Bundesrat* in Germany). Second, it could also be determined by the federal government up on the recommendation of independent commissions as is done in India. Thirdly, it could be determined by an ad hoc negotiation between the federal and state governments as it is the case in Russia. Finally, it might be determined by the unilateral act of the federal government.

Once the general pool is determined, the next important issue is apportioning the pool among the states. As we have already said, it is usually the case that such business is carried out through grant formulas. It must be pointed out that the appropriateness of a formula or the constituent criteria thereof depends heavily on the type of transfer instrument and the objectives sought to be achieved.⁵⁶ It is expected that we need to take different variables in to account to devise the grant formula. The variables used should have the necessary qualities to drive the best out of it. Sen and Trebesch have enumerated the conditions for the valid incorporation and implementation of a given variable in the grant formula.⁵⁷ They contend that the variable should, *inter alia*:

- Be statistically sound and compiled using common principles.

⁵⁴ Id., P. 108

⁵⁵ Solomon Nigussie (PhD), 'Ethiopia's Fiscal Federalism: a Constitutional Overview', in Assefa Fiseha and Getachew Assefa (Eds), *Institutionalizing Constitutionalism and the Rule of Law: Towards a Constitutional Practice in Ethiopia*, Ethiopian Constitutional Law Series, Vol.III, 2010, P. 110

⁵⁶ Tapas K. Sen and Christoph Trebesch, Use of Socio-Economic Criteria for Intergovernmental Transfer, *Economic and Political Weekly*, Vol. 39, No. 26 (Jun. 26 - Jul. 2, 2004), p. 2749

⁵⁷ Id., P.2751

- Be available and comparable across units of governments,
- Be as up-to-date as possible and regularly reviewed.
- Come from an independent source to the extent possible so that they cannot be manipulated by the different levels of government, and
- Be different in effect from other variables.

2.5.3. Rationales for Fiscal Transfers

Anwar Shah has discussed six objectives of fiscal transfers.⁵⁸ The first and probably the principal purpose of transfer is bridging the fiscal gap. To deal with the vertical fiscal gap, however, we should not hasten to use transfers which should only be used as a last resort. It is wise to exhaust other alternatives as reassignment of responsibilities, tax decentralization, and tax base sharing (by allowing sub national governments to levy supplementary rates on a national tax base). Only as a last resort should revenue sharing or formula based transfers be considered in order to deal with this gap. This is because the latter have the tendency to weaken accountability to tax payers.

The other objective of fiscal transfer could be bridging the fiscal divide through fiscal **equalization transfers**. This purpose is to deal with the **horizontal fiscal imbalances** persisted among the sub national entities. The main purpose here is bringing the equal treatment of citizens nationwide irrespective of their place of residence. Such transfers are made with the purpose of redistributing revenues from better-offs to less-well-off states. In such cases, much emphasis is given to equality across the federation than fiscal efficiency.⁵⁹

This is a case even when the scheme is a gross one financed by the federal government because the financing itself comes from federal general revenues that are drawn predominantly from relatively well-off states.⁶⁰ Here, grants from the federal government to states/local governments can eliminate differences in net fiscal benefits if the transfers depend on the tax capacity of each state relative to others and on the relative need for and cost of providing public services. However, it is argued that it is better if fiscal equalization programs take in to account the fiscal capacity of the states leaving the fiscal need consideration to be filled by conditional grants. In this connection, Boadway and Shah argue that:

⁵⁸ Anwar Shah, supra note 15, P. 28

⁵⁹ George Anderson, supra note 24, P. 80

⁶⁰ Boadway and Shah, supra note 31, P. 341

...in the interest of simplicity, transparency, and accountability, it would be better for such programs to focus only on fiscal capacity equalization to an explicit standard... Fiscal need compensation is best dealt with through specific purpose transfers for merit goods, as is done in most industrial countries".⁶¹

All in all it could be said that more than the redistributive functions of fiscal transfers to bridge the vertical fiscal gap, transfers to sub national governments are also typically highly redistributive horizontally in the sense that they compensate for differences in fiscal capacity of the recipient jurisdictions.⁶² In general equalization transfers are, to use the words of Robin Boadway, **the life blood of federations** that facilitate the decentralization of fiscal responsibilities by addressing the inequities and inefficiencies that would result from decentralization of spending and revenue raising responsibilities.⁶³

Thirdly, fiscal transfers could also help to **set national minimum standards**. This is achieved through conditional non- matching output based conditional grants that reflect national efficiency and equity concerns. Fourthly, fiscal transfers could be used to **compensate for benefit spillovers**. For regional and local governments face the proper incentives to provide the correct level of services that yield spillover benefits to residents of other jurisdictions, the federal government provides matching conditional grants.

On the other hand, fiscal transfers could also serve as a tool to **influence local priorities**. As different tiers of government inevitably have their own area of priorities, the federal government could only induce state and local governments to follow priorities established by the national or state governments by using its spending power to provide matching transfers. Also, fiscal transfers may be vital to deal with infrastructure deficiencies and creating micro economic stability in depressed regions. This is usually done through capital grants. They often create facilities that are not maintained by sub- national governments, which either remain unconvinced of their utility or lack the means to provide regular upkeep.

It is usually contended that poorly assigned grant systems can create perverse incentives for sub national governments on diligently pursuing their revenue and expenditure responsibilities and

⁶¹ Id., P. 375

⁶² Robin Boadway, 'Intergovernmental Redistributive Transfers: Efficiency and Equity', in Ethisham Ahmad and Giorgio Brosio (Eds). *Hand Book of Fiscal Federalism*, Edward Elgar Cheltenham, UK. Northampton, MA, USA, 2008, P. 355

⁶³ Boadway and Shah, supra note 31, P. 376

on their efficiency. To go away with this problem of perverse incentive, it is argued for the fiscal transfer endeavors for the enhancement of tax effort and expenditure efficiency.⁶⁴ In addition to these objectives, fiscal transfers may also be used to achieve political goals.⁶⁵ This is especially true when the fiscal decentralization is made to fit or serve political decentralization. Then, to live with the reality, there may be a case of transfer of some resources “simply to keep some economically non- viable local governments alive for political reasons.”

2.5.4. Institutions for Intergovernmental Fiscal Transfers

It is usually contended that because the values of the expenditure and revenue assignments changes over time, there have to be institutions and procedures that regularly entertains the changing vertical and horizontal fiscal imbalances. There are four distinct patterns across federations to deal with such matters. In some countries such as Australia and India, independent expert commissions established by the federal government are entrusted to determine the intergovernmental fiscal transfer formulas as a purely decision making or mere advisory body.⁶⁶ While Australia has an ad-hoc commission, the Indian commission is constitutionally entrenched. Instead of impartial body, the commission could also be representative body of both the federal and state governments.⁶⁷

The second pattern follows a constitutional stipulation to the effect that such matters should be resolved through an intergovernmental council of the federal and state governments as it is practiced in Malaysia.⁶⁸ In the third pattern, the transfers are decided by the second chamber of the Federal Houses but states are formally represented in those chambers to participate in the approval process.⁶⁹ The classic case here is Germany. Canada is one of the many countries that follow the fourth pattern where the determination of the equalization transfer and other transfers are determined by the federal government where there are no state representatives.⁷⁰ An obvious problem with this pattern is its potential to jeopardize the autonomy of the states as the federal

⁶⁴ Ehtisham Ahmad and Bob Searle, ‘On the Implementation of transfers to Sub National Governments’, in Ehtisham Ahmad and Giorgio Brosio (Eds), *Hand Book of Fiscal Federalism*, Edward Elgar Cheltenham, UK. Northampton, MA, USA, 2008, P. 381

⁶⁵ Kibre Moges, supra note 21, P. 12

⁶⁶ Ronald Watts, supra note 25, P. 115

⁶⁷ Anwar Shah, supra note 15, P. 36

⁶⁸ Ronald Watts, supra note 25, P. 115

⁶⁹ Ibid

⁷⁰ Ibid

government greatly involves in the matters of the states. This problem could in some extent be overcome by imposing constitutional restriction on the federal government not to override the state decisions.⁷¹

There is also another pattern known as an **all inclusive** that uses an intergovernmental- cum- legislative-cum- civil-society committee with equal representation from all the constituent units but chaired by the federal government.⁷² Although it has an advantage of being all inclusive of the stake holders and being simple and transparent, it has also a disadvantage of deadlock because of its unanimity requirement. However, such pattern may be more important than determination through independent commissions. This is because politics is internalized in such institutions unlike the grant commissions that do not allow for political input and therefore tend to opt for complex and non-transparent solutions.⁷³

⁷¹ Anwar Shah, *supra* note 15, P. 36

⁷² Boadway and Shah, *supra* note 31, P. 387

⁷³ *Id.*, P. 391

CHAPTER THREE- FOREIGN EXPERIENCES ON INTERGOVERNMENTAL FISCAL TRANSFERS

3.1 Introduction

Federations may devise their own system to regulate the business of intergovernmental fiscal transfers. Soliciting the experience of some federal countries on the issue at hand is important to compare the matter with the Ethiopian system and help to make necessary modifications, if any. For this purpose, the experience of Germany, Nigeria, and India will be discussed in this chapter. A separate discussion of the experiences of such countries in this chapter is believed to give a better picture of the experience of a given country on fiscal transfers at a time so that we could see what lessons to extract for Ethiopia.

To give a somehow comprehensive system of the experience of each country, an attempt is made to briefly discuss how expenditure and revenue responsibilities are assigned, how far prevalent is fiscal imbalance, how far state borrowings are being treated and how it is trying to prevent soft budget constraints, how is it undertaking intergovernmental fiscal transfer be it grant or revenue sharing, and what are the challenges persisted in the fiscal transfer system of the country and how is it progressing to fix same. After this is communicated, the chapter also has a final important section to deal with the possible lessons that Ethiopia could draw from the comparative experiences.

3.2 Federal Republic of Germany

3.2.1 On Assignment of Expenditure and Revenue Responsibilities

As per article 70 (1) of the Basic Law of Germany, the Lander have legislative powers as long as the Constitution does not assign a legislative competency to the federal government. The competence of the Lander on law making is non-existent or compromised if the federal government is given an exclusive jurisdiction on the matter, in which case Lander would only have law making power if they are expressly authorized by the federal law (article 71), or if the matter falls under their concurrent jurisdiction where the federal government would only have legislative competence "to the extent that the establishment of equivalent living conditions

throughout the federal territory or the maintenance of legal or economic unity renders federal regulation necessary in the national interest⁷⁴

The long history of dominance of the federal government over the Lander which is strengthened by the federal government winning most of the concurrent jurisdictions and that established a peculiar unitary federal state is described in the following manner:

*The strong federal role as laid down in the Constitution and the strong emphasis on the equality of living conditions in Germany, together with a historically rooted skepticism about decentralized solutions have led to Germany's cooperative model of (fiscal) federalism. The range of Land responsibilities is limited because the federal government has used concurrent legislation extensively and thus expanded its responsibilities across time.*⁷⁵

On the other hand, there are different areas where both orders of government have common financial responsibility over matters provided in the Basic Law. For instance, article 91a of the Basic Law enunciates that in cases of *joint tasks*, where the federal government participates in the discharge of the responsibilities of the Lander in areas that are beneficial for all citizens in the federation and are necessary for improvements of living conditions, the federation is required to finance at least half of the expenditures of such responsibilities in each *Land*.

As far as the revenue assignments between the federal and the Lander government are concerned, we could discern that each order is somehow restricted from unilaterally changing its tax revenue without the consent of the other though the restriction is more lenient for the federal government. The federal government has some autonomy to change the tax revenues on some taxes without the need to secure the consent of the other compared to Lander tax revenues, whose bases and rates are passed by the federal parliaments owing to its concurrent jurisdiction (except for real estate purchase tax whose tax rate could be fixed by the *Lander*).⁷⁶

Article 108 of the Basic Law specifies the allocation of responsibilities for collecting, handling, and spending taxes. The *Lander* have the principal responsibility for tax administration. While the federal government administers federal taxes, the *Lander* are responsible not only for

⁷⁴ Article 72 (2) of the Basic Law of Germany

⁷⁵ Lars P. Feld and Jurgen Von Hagen, 'Federal Republic of Germany', in Anwar Shah (ed), a *Global Dialogue on Federalism Vol IV, The Practice of Fiscal Federalism: Comparative Perspectives*, Published for Forum of Federations, McGill-Queens University Press, Montreal and Kingston, London, Ithaca, 2007, P. 133

⁷⁶ Article 105 (2a) of the Basic Law of Germany

administering state taxes, but also the common taxes. Generally, it is provided that the federal government accounts for almost half of total government spending in Germany followed by the *Lander* that spend more than one-third and the local governments 17% of the total government spending.⁷⁷ Even if this figure signifies that the federal government covers greatest share of the spending, the *Lander* and the local governments are still unable to effectively finance their expenditure responsibilities. This creates a vertical fiscal imbalance.

3-2-2 On Vertical Fiscal Imbalance

It is asserted that the *Lander* could not derive enough revenue sources required for their expenditure responsibilities and spending creating a vertical fiscal imbalance between them and the federal government. This fiscal imbalance is attributed to many factors. First, the most important taxes as measured by their revenue: the personal and corporate income taxes as well as the value added tax are joint taxes (while 66% of the federal tax revenue comes from such shared taxes, 85.4% of the *Lander*'s tax revenue and 64.2% of their total revenue comes from same source) the revenue from which is shared among the federal, *Lander*, and local governments.⁷⁸ Second, it is attributed to the disproportional tax revenue which is accompanied by the inability to fix the tax base and rate (save for determining the rate of the tax for acquisition of real estate as per article 105 (2) of the Basic Law) for ensuring uniformity of tax-base and tax-rate across the *Lander* resulting in weak tax performance of the *Lander*. It is contended that the federal government collects up to 65% of all the revenues of the federation.⁷⁹

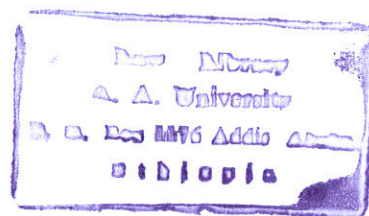
3-2-3 On State Borrowing and Soft Budget Constraints

The fact that the *Lander* are not autonomous either in the revenue and expenditure side that requires them to provide minimum public services forces them to rely on transfers and to use borrowing as a means of financing their expenditure responsibilities. The borrowing on its part creates a high burden on the *Lander* that they could not pay it from their own sources. As a result, some *Lander* sued the federal government before the Constitutional Court for a bailout which

⁷⁷ Feld and Hagen, supra note 75, P. 138

⁷⁸ Article 106 (3) of the Basic Law of Germany

⁷⁹ George Anderson, supra note 24, P. 37



was provided by the federal government in the form of vertical conditional grants mandated to reduce the public debt of the *Lander*.⁸⁰

Some argue that this bailout creates a soft budget constraint on the *Lander*.⁸¹ This result for *Lander* officials to face strong incentives to finance public expenditures via debts because they know that, in the end, there will be a bailout.⁸² In 2006, the Constitutional Court of Germany rules that a bailout is only given when the federal government declares a state of emergency.⁸³ Accordingly, it is made clear that it is difficult in the future for a single *Land* to bring a suit for a bailout against the Constitutional Court.

3.2.4 On Intergovernmental Fiscal Transfers

As a means of bridging the vertical and horizontal fiscal imbalances, the German fiscal equalization system provides for four steps.⁸⁴ First, the *Lander* would collect taxes from the revenue sources assigned to them (article 106 (2) of the Basic Law). The revenue of the *Lander* is particularly important from the joint taxes where the Federation and the *Lander* shall **share equally** the revenues from income taxes and corporation taxes (article 106 (3) of the Basic Law) on the principle of residence and the revenue from the value added tax shall accrue to the individual *Lander* on a per capita basis (population based) (article 107 (1) of the Basic Law). The *Lander* as a group receive 42.5% of the revenue from the income taxes, 50% from the corporate income taxes (in both cases equal with the share of the federal government) divided among the *Lander* on the basis of the amount of taxes collected by revenue authorities within the territory. 48.4 of the revenue from the VAT would be devolved to the *Lander* in general and apportioned among them on an equal per capita basis which is a simple form of equalization.⁸⁵

The second step in the equalization system is that up to 25% of the revenue of the VAT is used to increase the fiscal position of the poorer states. This step does also have a constitutional basis

⁸⁰ Feld and Hagen, *supra* note 75, P. 139. bailout is the kind of an additional funding that is provided when an entity would otherwise be unable to service its obligations

⁸¹ Soft Budget Constraint describes a situation where an entity can manipulate its access to funds in undesirable way. With a soft budget constraint, the marginal benefit exceeds the marginal cost of additional spending by the *Lander*, with the result that they can externalize part of the cost to the tax payers in the other states.

⁸² Beate Jochimsen, 'Fiscal Federalism in Germany: Problems, Proposals and chances for Fundamental Reforms', in Carolyn Moore and Wade Jacoby (Eds), *German Federalism in Transition*, Routledge, London and New York, 2010, P. 85.

⁸³ George Anderson, *supra* note 24, P. 24

⁸⁴ Feld and Hagen *supra* note 75, P. 143

⁸⁵ Boadway and Shah, *supra* note 31, P. 199

under article 107 (1) of the Basic Law. Accordingly, while three quarters of VAT are apportioned to the Lander according to population, another quarter is reserved for those states that are considered financially weak. They receive supplementary transfers from VAT in order to foster their fiscal potential.

The third form of the fiscal equalization in Germany is “the horizontal fiscal equalization between the Lander where the states with a measure of fiscal capacity below the measure of equalization receive grants from those states with a measure of fiscal capacity above the measure of equalization.” It is important to note that state-state equalization is a second-tier equalization process. That is, states’ fiscal capacities include revenues from the VAT which are already “equalized”. With this method of usually unconditional nature, the fiscal capacity of the poorer *Lander* is lifted up to 90% of the national average. One could as such note here that the equalization system only concerns on fostering only the fiscal capacity of the *Lander* with little or no regard to expenditure needs. This form of equalization arrangement accounts for 62% of the equalization among the *Lander*.⁸⁶ Its unconditional nature is imperative for the *Lander* in conferring some level of autonomy on the manner of spending on the fund. The costs of this solidarity are yearly transfers of resources from West to East the volume of which is enormous: it corresponds to more than twice the official development aid of all industrialized countries to all developing countries in the world.⁸⁷

In the fourth step we would find a vertical grant system where some *Lander* are entitled to receive funds from the federal government as per article 107 (2) of the Basic Law. The *Lander* that could get this, usually conditional, fund should either be those in need of assistance to further lift their fiscal capacity or the new *Lander* to reduce specific burdens before the unification and to deal with high structural unemployment. This step is expected to lift the fiscal capacity of the *Lander* to 97.5% of the national average. In addition to such steps, specific grants may flow from the federal government to the Lander for projects under the joint tasks category for reimbursement of Lander for federally mandated expenditures, and for specific projects related to the creation of uniformity of living conditions.⁸⁸ One surprising feature of the system

⁸⁶ Ronald Watts, *supra* note 25, P. 110

⁸⁷ Paul Bernd Spahn, *Maintaining fiscal equilibrium in a federation: Germany* available at [http://www.wiso.uni-wuerzburg.de/germany/germany.htm](#), last visited on 08/05/2011

⁸⁸ Article 91a cum article 104a of the Basic Law of Germany

in this regard is that on average the federal government only covers 13.3 of the expenditure responsibilities of the Lander.⁸⁹

One problem of the equalization system in Germany is that it has perverse incentive effect in that it leads to higher borrowing and spending by the *Lander* which puts a premium on fiscal imprudence although it has an advantage of closing the fiscal gap and more importantly that it smoothes the income shocks among the *Lander* significantly through the years.⁹⁰ It is usually underlined that the intergovernmental fiscal transfer of the German system is not welcomed by either richer or poorer Lander.⁹¹ The poorer Lander argues that the equalization system is not enough for them to cover their increasing expenditure responsibilities and the higher per capita expenditure requirements. This is because the system only takes in to account the fiscal capacity of the Lander, not their expenditure needs. The richer Lander, on their part, contends that the system encourages financial mismanagement and penalizes those that are good financial managers. They have also been supported with the view that excessive solidarity is seen to entail absence of accountability, absence of regional growth initiatives, lack of interest to develop own resources, and even moral hazard and waste at the state level. They also argue that the federal government is intentionally favoring this policy to win more power in its favor. This necessitates for a louder call for reforming the German fiscal federalism.

3.2.5 Contemporary Issues on the German Fiscal Federalism

There are different disputes concerning the present functioning of the fiscal system in Germany. As it was considered above, the current equalization system has incorrect incentives for both poorer and richer states to raise more revenue. This as it may, it is also contended that given their disparate territorial areas, population size, and, since re-unification, levels of economic development, it has been argued that territorial reform is necessary if the country is to achieve its goal of equivalence of living conditions, but the earlier attempts to do so are all futile.⁹² Without the special assistance of the federal government, poorer states could not perform the joint tasks as required. It is even argued that unless such territorial reorganization takes place, it is inevitable that the richer states would sue the federal government before the Constitutional Court

⁸⁹ Feld and Hagen, *supra* note 75, P. 144

⁹⁰ *Id.*, P. 144

⁹¹ Ronald L. Watts and Paul Hobson, *Fiscal Federalism in Germany* available at [http://www.fiscal.washington.edu/](#), Last visited on 08/05/2011

⁹² *Ibid*

praying for decreasing their financial obligation to the poorer states. Also, it is recommended that not only the revenue capacity, but also the fiscal need of the Lander should be equalized.

On the other hand, the conflict on equalization, and hence the degree of interregional **solidarity**, as opposed to greater freedom to the act of lower tiers of government, and hence **subsidiarity**, is illustrative for the fundamental issues that are at stake in Germany.⁹³ That is to say, the equalization arrangement that requires richer *Lander* to contribute to the poorer *Lander* to foster solidarity is in direct confrontation with the principle of subsidiarity that principally advocates for power to remain at the lower level of government so long as they are capable of regulating it. This requires a mechanism to strike a balance between introducing rules that grant states more autonomy over taxes and promoting competition among them without undermining the principle of solidarity. However, as it stands now, reforming the financial Constitution (Reform II) and territorial reform (Reform III) are considered the “two hard boxes” which are difficult to intrude and realize in the near future.⁹⁴

One remarkable feature of the German federation is its proximity for adoption to change. Adjustments in the federal balance have been accomplished via Constitutional amendment, intergovernmental relations, and judicial review all of which have proved relatively flexible. However, as far as intergovernmental relationships are concerned, the institutional culture which puts a premium on consensus can mean the indefinite postponement of difficult policy choices, the so called joint decision trap.⁹⁵ In this connection, Jonathan Rodden submits that:

*Attempts to improve the efficiency of the public sector in Germany often fail because of the difficulty of bringing together a reform coalition in a system with so many effective veto players. For these reasons, battles over fiscal federalism will continue to be a key feature of the German political landscape in the years ahead.*⁹⁶

The system is also faced with transparency and accountability concerns.⁹⁷ On accountability, it is submitted that accountability is decreased as the *Lander* pay the bill for some federally mandated

⁹³ Paul Bernd Spahn, *supra* note 87

⁹⁴ Carolyn Moore, Wade Jacoby, and Arthur B. Gunlicks, ‘Introduction: German Federalism in Transition?’, in Carolyn Moore and Wade Jacoby (Eds), *German Federalism in Transition Reforms in a Consensual State*, Routledge, London and New York, 2010, p. 9

⁹⁵ Watts and Hobson, *supra* note 91

⁹⁶ Jonathan Rodden, ‘Soft Budget Constraints and German Federalism’, in Jonathan Rodden, Gunnar Eskeland, and Jennie Litvack (Eds), *Fiscal Decentralization and the Challenge of Hard budget Constraints*, the MIT Press Cambridge, Massachusetts London, England, 2003, p.59

⁹⁷ Watts and Hobson, *supra* note 91

initiatives. Transparency is also alleged to be decreased through the interdependent network of shared taxes, equalization transfers, expenditure responsibilities, and even decision making institutions which renders it practically impossible for voters to identify which government is taxing or spending for particular purposes.

3.3. The Republic of India

3.3.1. On Expenditure and Revenue Assignments in India

The division of responsibilities between the union government and the states in India is provided under schedule seven of the Constitution. It could be generally said that while the Constitution has separate stipulations to the union, state, and concurrent lists with the residual power reserved to the Union government, it opted to follow a separatist approach on division of the taxing responsibilities without providing concurrent jurisdiction of taxing power between the union and the state governments. As such both the central and the state governments collect their own source of revenue.⁹⁸

This in effect means that the right of levying a tax belongs exclusively to which it is assigned in contrast to that of concurrence. In fact, this separatist approach is viable only in the legal sense because there are in practice various areas of concurrency between the two orders of government. As such, we could discern that the Indian system is with a substantial contrast with its German counterpart where concurrent taxes constitute for the most important revenue of both the federal and Lander governments. In India, "the states share in expenditure on administrative services is about 68 percent; on social services, 83 percent; and on economic services, about two-thirds; on providing education, public health, and family welfare, their role is 90%".⁹⁹

Govinda Rao has indicated that the assignment of responsibilities in India is centralized.¹⁰⁰ The first indicator of the centralization of the assignments is that residual power belongs to the union government unlike the case of USA and Ethiopia where residual power, at least, in principle belongs to the states. Further, the union government is authorized to reorganize the territory of the states and could dismiss the state government alleging that it is not functioning according to

⁹⁸ George Anderson, *supra* note 24, P. 38

⁹⁹ M. Govinda Rao, 'Republic of India', in Anwar shah (ed), a Global Dialogue on Federalism Vol IV, *The Practice of Fiscal Federalism: Comparative Perspectives*, Published for Forum of Federations, McGill- Queens University Press, Montreal and Kingston, London, Ithaca, 2007, P. 156

¹⁰⁰ *Id.*, P. 159

the Constitution. It is also the union government that controls major plan strategies and control over major financial institutions. As far as assignment of revenues is concerned, it is the central government that wins most of the broad-based and progressive taxes. The states have also their assigned taxes, the most important on revenue productivity being the sales tax.

3.3.2. On State Borrowing in India

State borrowing is a serious concern in India. It is alleged that over the years, the States of India have sought to finance their increasing needs for expenditures through loans rather than by raising additional tax revenues and/or charging for services delivered.¹⁰¹ This has led to the States running large revenue and fiscal deficits and accumulating unsustainable debt burdens. In India, borrowings are used not only for financing capital expenditures but also recurrent expenditures. It is reported that in 1998-1999 only half of the states' borrowings were used to finance capital expenditures so that the remaining share was consumed for recurrent expenditures.¹⁰² Unlike the case of Germany, where the Lander could borrow from external sources, the Indian states could only borrow from domestic sources. Even this borrowing is with important condition that if the states are indebted to the central government, which is the case for all states for assistance is given for the states as a loan by the central government as part of the central plan, securing the consent of the central government is necessary.¹⁰³

It is contended that the center has not fully exercised hierarchical control over state borrowing and market borrowings of the states do not reflect creditworthiness, which contribute to the lack of fiscal discipline among the states.¹⁰⁴ On the other hand, it is the expectation of being bailed out by the centre that underlies the tendency on the part of a state to incur expenditure beyond its available revenues and resort to improvident borrowing. In fact, it is argued that the existence of hierarchical federal structure in India where the central government has much dominance over the states and the legal restrictions on the borrowing abilities of the states is capable to create a

¹⁰¹ Eunice Heredia Ortiz and Mark Rider, *India's Intergovernmental Transfer System and the Fiscal Condition of the States*, 2006 available at [http://www.ias.ac.in/publications/india/india.html](#), last visited on 16/04/2011.

¹⁰² Govinda Rao, *supra* note 99, P. 169

¹⁰³ *Id.*, P. 160

¹⁰⁴ Ortiz and Rider, *supra* note 101

hard budget constraint.¹⁰⁵ The federal arrangement has also succeeded in imposing a relatively high hard budget constraint.

However, the fact that the lines of authority and accountability have become blurred across levels of government which results in softening of budget constraints or in state level expectations that their budget constraint might soften.¹⁰⁶ Further, the existence of the vertical imbalance and lack of sufficient incentives for better performance by the states creates a moral hazard problem and expectations for fiscal adjustments from the center.¹⁰⁷ William McCarten has concluded his article on the Indian state challenges of fiscal discipline saying:

Political fragmentation, coalition governments at the center, and governments of short duration at the state level have made coordinating politics between the center and the states difficult and reduced the center's effective will to curtail populist policies by the states. This has led to difficulties, but hierarchical controls, even if enforced in a cautious or halfhearted manner, have prevented unfettered state access to credit.... Although debt obligations for most states are manageable with reasonable programs, efforts to date at fiscal correction have not been equal to the challenge.¹⁰⁸

3.3.3. On Fiscal Imbalance in India

As it is the case in other countries, there are also both vertical and horizontal fiscal imbalances in India. It is argued that the presence of horizontal imbalances made it necessary to constitutionally create vertical imbalance. As far as the vertical fiscal imbalances are concerned, Govinda Rao provides that: "The state governments in 2002-03 collected only 41% of total current revenues, but their share in total current expenditure was 57 percent. From the revenue sources assigned to them, they could finance only 54% of their current expenditures. In other words, the states depend on central transfers to finance about 46% of their current expenditures".¹⁰⁹

It could be pointed out that centralization of power of levy of taxes and duties is higher than the centralization of collection thereof, which in turn is higher than the centralization of

¹⁰⁵ William J. McCarten, 'The Challenge of Fiscal Discipline in the Indian States', in Jonathan Rodden, Gunnar S. Eskeland, and Jennie Litvack (Eds). *Fiscal Decentralization and the challenges of Hard Budget Constraints*, the MIT Press, Cambridge, Massachusetts London, England, 2003, P.249

¹⁰⁶ Ibid

¹⁰⁷ Id., P. 282

¹⁰⁸ Id., P. 283

¹⁰⁹ Govinda Rao, supra note 99, P. 162

appropriation, which in turn is higher than the centralization of expenditure.¹¹⁰ With all its shortcomings, however, it is generally argued that both the Finance and the Planning Commissions are increasingly favoring states in order to make them execute tasks due to them by making available more and more resources.¹¹¹

There are also horizontal fiscal imbalances in addition to the vertical fiscal imbalances. Let alone the expected variation between the 11 mountainous states (designated as special- category states) and the general category states, it is submitted that great variation also exists among the general or special category states. There is a marked variation in size, revenue raising capacity, expenditure needs, fiscal efforts, economic characteristics and other variables. Generally, it is said that though there is considerable devolution of resources to the states, the transfer system is less progressive in its allocation among the states.¹¹²

3.3.4. On Intergovernmental Fiscal Transfers

As a way of bridging the fiscal gap, the Indian Constitution provides for revenue sharing from the central taxes and grants. As per article 280 of the Constitution, it is the Finance Commission that is authorized to recommend the proceeds of the revenue sharing and the grants to the states. There is also the Planning Commission which gives plan assistance by way of grants. While the Finance Commission orders unconditional grants, the transfers of the Planning Commission (which is mainly concerned with development projects) are substantially conditional.¹¹³ Thirdly, various central ministries also give specific purpose transfers for various central schemes with or without matching requirements. In India, the central government is authorized to provide grants to state governments for any purpose, whether that purpose is under federal government jurisdiction or not.¹¹⁴ Accordingly, the central government could also spend on areas on which it has no legislative authority.

It is the Planning Commission that plays a great role in supplementing funds for the state plans and also in providing funds for several schemes, sponsored by the union government ministries.

¹¹⁰ P. K. Chaubey (ed), 'Evolution of Union- State Fiscal Relations in India: Two Steps Forward and One Step Backward', in *Fiscal Federalism in India*, Deep and Deep Publications Pvt. Ltd., New Delhi, 2004, P. 31

¹¹¹ Id., P. 41

¹¹² A. C. K. Nambiar, 'Federal State Finance Relations in India: the Post Liberalization Period', in P. K. Chaubey (ed), *Fiscal Federalism in India*, Deep and Deep Publications Pvt. Ltd., New Delhi, 2004, P. 54

¹¹³ Ronald Watts, *supra* note 25, P. 113

¹¹⁴ Id., P. 101

which are carried out by the state level administrations.¹¹⁵ The last form of transfer is criticized for its conditionality (which will affect local autonomy) and for its being discretionary. However, it takes important share of the planning assistance for it accounts for 40% of the total plan assistance and 14% of total current transfers.¹¹⁶

A. Finance Commission Transfers

The first transfer of the commission is revenue sharing. This is a mechanism where the states are entitled to claim a certain portion of the proceeds from all the central taxes. It is only in 2000 that the Constitution, through its 80th amendment, entitles the states to claim revenue sharing from all central taxes but before that it provides only for personal income tax and union excise duties. One reason for amending the Constitution in this regard is because the federal government began to pay more emphasis on revenue sources which are not subject to revenue sharing and a disincentive on effectively handling those taxes which are subjects to the revenue sharing.¹¹⁷

Revenue sharing is a dominant form of transfer to the states within the Finance Commission transfers. In the year 2005, the twelfth financial commission has recommended the distribution of 30.5 percent of the net proceeds of central taxes to be distributed among the states.¹¹⁸ In the year 2010, the recommendation of the thirteenth Finance Commission to devolve 32% of the net proceeds of the central taxes was accepted by the central government expected to last until the year 2015.¹¹⁹ After assessing and determining the amount that should be devolved to the states, the Finance Commission first devolves the shared revenue from the central taxes to the states. It is only after apportioning the shared revenues among the states that the commission would go on to devolve grants- in- aid if there are post devolution budgetary gaps. The apportioning is made through grant formulas.

The percentage share of the grants-in-aid by the Finance Commission is much less than the same of the revenue transfers through tax sharing. It is also experienced that the proportion of tax

¹¹⁵ P. K. Chaubey (ed), 'Federalism in India: an Introduction', in *Fiscal Federalism in India*, . Deep and Deep Publications Pvt. Ltd., 2004, P. 7

¹¹⁶ Govinda Rao, supra note 99, P. 167

¹¹⁷ Boadway and Shah, supra note 31, P. 302

¹¹⁸ Govinda Rao, supra note 99, P. 165

¹¹⁹ Government of India Ministry of Finance Department of Economic Affairs, Explanatory Memorandum as to the Action Taken on the Recommendations Made by the Thirteenth Finance Commission in its Report Submitted to the President on December 30, 2009

shares to total financial resources recommended by the Finance Commission has been increasing while that of grants- in- aid has been constantly declining.¹²⁰ It is submitted that with tax devolution accounting for nearly 90 percent of the revenue transfers ordained by the Finance Commission, the grants-in-aid have lost their teeth as an equalizing and disciplining instrument.¹²¹ On the other hand, the special category states obtain more than 80% of the transfer of the Finance Commission in the form of grants.¹²²

The Finance Commission adopts transfer formulas that are meant to play an equalization function. While the Finance Commission transfers tend to have an equalization effects taking account of differences among states in population, per capita income (to determine the taxable capacity of the states), area, economic and rural infrastructure needs, and tax efforts; Planning Commission transfers for specific purpose projects tend to defy equalization effects.¹²³

It is submitted that the Finance Commission's transfers are much more equalizing than the Planning Commission's because the criterion of per capita income disparities is much more equalizing than the population criterion. The Finance Commission's formula weights income disparities much more heavily than the Planning Commission's formula (62.5 versus 25 per cent, respectively); and the Planning Commission weights population more heavily than the Finance Commission (60 versus 10 per cent, respectively).¹²⁴ The element of backwardness is also included in the tax devolution to serve as an equalization factor although it is criticized as being not specifically targeted to fiscally disadvantaged states.

However, it could be said that the formula of the Finance Commission is pursuing more than an equalization objective because tax effort and fiscal discipline are also in the formula.¹²⁵ Equalization has been further blunted by the fact that the parliamentary resolution requires the commissions to use the 1971 population figures in the transfer formula whenever it is used for

¹²⁰ Sailabala Debi, 'Educational Finance in India: the Role of Finance Commission', in P. K. Chaubey (ed), *Fiscal Federalism in India*, Deep and Deep Publications Pvt. Ltd., New Delhi, 2004, P. 202

¹²¹ Amaresh Bagchi, *Fifty Years of Fiscal Federalism in India: An Appraisal*, available at [http://www.amareshbagchi.com](#), last visited on 18/05/2011

¹²² P. K. Chaubey (ed), 'Evolution of Union- State Fiscal Relations in India', in *Fiscal Federalism in India*, supra note 110, P. 37

¹²³ Ronald Watts, supra note 25, P. 110

¹²⁴ Ortiz and Rider, supra note 101

¹²⁵ Ibid

interstate distribution to provide an incentive for population control.¹²⁶ The criticisms against this stipulation are whether it is proper to incorporate population planning policies in the transfer system and if it is proper there remains a problem for those states with increased population not because of more fertility rates but because of increase in the migration rates in to the states and effective measures in reducing mortality rates.¹²⁷

This as it may, the gap filling methodology of the Finance Commission is criticized for two grounds.¹²⁸ First, it is criticized that the methodology does not take in to account the fiscal disabilities or expenditure needs of the low income states that resulted the existing interstate difference in expenditures to perpetuate. Second, the gap filling methodology creates perverse incentives in that it leads to negative incentives to tax effort and expenditure economy. In effect, states showing large deficits in their budget get rewarded while those that manage their finances better suffer. It is because of such problems that it is argued that the transfer system lacks both equity and incentive although there are different attempts being undertaken to rectify that.

B. Plan Commission Transfers

Unlike the Finance Commission, the plan commission is not established by the Constitution of India and it is argued that this commission is one of the many instances that reflect the central dominance in the country and that greatly undermines and overlaps the jurisdiction of the constitutionally mandated organ- the Finance Commission. It is pointed out that around 30% of the revenue flows from the union budget to the states are dispensed for state plans through the Planning Commission.¹²⁹ These transfers are made through devising a formula that may be modified by the National Development Council, which is chaired by the Prime Minister and is composed of higher officials from both the central and state governments and members of the Finance Commission. Some argue that since both the state and the union officials are represented

¹²⁶ Govinda Rao, supra note 99, P. 166

¹²⁷ Govinda Rao, Changing Contours in Fiscal Federalism in India, available at [http://www.legalserviceindia.com/articles/fed.htm](#), last visited on 18/05/2011.

¹²⁸ Govinda Rao, supra note 99, P. 166

¹²⁹ Sharawan K. Singh, 'Federal Transfers in India: an Introduction', in P. K. Chaubey (ed), *Fiscal Federalism in India*, Deep and Deep Publications Pvt. Ltd., 2004, P. 12

in the Council that approves the rules based on which the Planning Commission makes the award for plan assistance for the states, it has the merit of transparency.¹³⁰

The transfer is divided in two parts.¹³¹ First, 30 percent of the fund is reserved for the special category states. The 70 percent fund of the commission is reserved for the general category states which are apportioned between the states based on a formula the variables and the weights of which is 60% to population, 25% to per capita GSDP, 7.5% to fiscal management, and the remaining 7.5% percent to special problems. The fiscal transfers in India have witnessed various problems.¹³² First, the multiple institutions with overlapping jurisdictions have blurred the objective of the transfer. Second, accommodating different purposes has complicated the transfer formula. Third, the system is not well designed to achieve equalization and to ensure minimum service levels in the states. Finally, it does also have a disincentive effect on fiscal management in the states.

3.3.5. On Challenges of the Indian Fiscal Federalism

It is contended that the Indian fiscal federalism has faced different challenges attributed to problems related to both policies and institutions and changing political and economic environment.¹³³ The first challenge is deterioration in state finances that result in under providing for the maintenance of infrastructure and social development. The fiscal health of the states is being increasingly deteriorated. Second, there has been a significant increase in the fiscal inequalities of the states. This increased inequality is due to the fact that states with a stronger manufacturing base and with better market access have benefited through the economic liberalization undertaken in the country in 1990s. The Economic liberalization has also created interstate sales tax on exports from one state to another the consequence of which is to divide the economy in to several tariff zones.

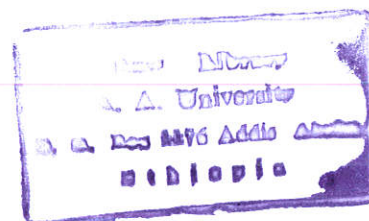
Globalization is also another challenge to the Indian fiscal federalism. It has influence on the states for they are principally liable for the provision of competitive services and physical infrastructures that may also call a policy towards encouraging the participation of the private

¹³⁰ Ibid

¹³¹ Govinda Rao, supra note 99, P. 167

¹³² Govinda Rao, supra note 127

¹³³ Govinda Rao, supra note 99, P. 170



investor. The opening of the Indian economy has also resulted in loss of revenue from customs which remains an important challenge to replace it by other sources of revenue.

The most important challenge on the Indian fiscal federalism is argued to come from the changing political environment. The flourishing of many political parties up on the demise of the Congress Party with competitive relationship between the center and the states and among the states has caused conflicts whose resolution become a vital challenge for there are no effective mechanism for conflict resolution. Moreover, they also lack to reach a consensus on major policy issues of the nation, and with little probability of being re-elected; they prefer to pursue for short term policies through which to win election than resorting to soliciting for medium and long term policies. Finally, these all challenges have called for reforming the Indian fiscal federalism.

3.4. Federal Republic of Nigeria

3.4.1. On Expenditure and Revenue Assignments

In the Nigerian federation, the 1999 Constitution (Section four) provides the **exclusive federal** powers and the **concurrent** powers where both the state and the federal government have powers **with federal dominance** and the **residuary** power which is reserved to the states. As such, one could note that the Nigerian states do not have exclusive enumerated powers save for the residuary powers. On assignment of expenditure responsibilities, it is expected that those functions whose benefits are national are given to the federal government and those whose benefits are local but has a tendency of creating spillover effects are grouped under the concurrent list. On revenue raising powers, the legislative power of important revenues such as import duties, mining rents and royalties, petroleum profit tax, corporate income tax, excise duties and value added tax, and personal income tax come under the jurisdiction of the federal government while the states are required to do the collection and the administration business.¹³⁴

3.4.2. On Fiscal Imbalances in Nigeria

Nigeria is one of those countries where we can witness a great variation between the surplus unit (the federal government) and the deficit unit (the state governments). It is reported that in the

¹³⁴ Ronald Watts, *supra* note 25, P. 213

year 2000- 2004, the federal government has 98% of the total revenue generated in the Nigerian federation before the intergovernmental fiscal transfers.¹³⁵

There are different factors declared responsible for the centralization trends of the revenue raising powers in Nigeria. Emmanuel Ojo has discussed that there is no fiscal federalism in Nigeria, rather fiscal centralism. He cited that “discontinuation of export duties and sales tax on agricultural produce, standardization of personal income tax rates throughout the country, thereby ensuring that the state governments become powerless to change the rates; introduction of uniform fuel prices throughout the country thereby removing the power of state governments to levy petroleum sales taxes; the takeover by the federal military government of all off-shore oil royalties and rent and with it the erosion of the principle of derivation principle in fiscal allocation from about 50 percent to less than 10 percent before rising to the current level of 13 percent of the distributable pool” are the instances signifying the incapacitating trends of states from their revenue raising power in the Nigerian federation.¹³⁶

Attempts were made in the past to go away with such imbalances.¹³⁷ The first attempt was to assign more allocation roles to the federation which was not successful because it is the role that could efficiently be performed by lower level governments. The other option was reassigning more taxing powers to the lower level governments which was again not successful because of the low enforcement capacity of the lower level governments. The only remaining option in the Nigerian case then becomes to devise a formula for revenue sharing. It is manifested that intergovernmental fiscal transfer accounts for 89% of the total state revenues in Nigeria.¹³⁸

3.4.3. On Borrowings In Nigeria

Among the exclusive lists conferred to the federal government, the Constitution empowers it to borrow money from domestic and external sources for the purpose of either the federal or the state governments. Despite such stipulation, it does not seem that the federal government has effectively pursued regulation mechanisms to control borrowings of the states.¹³⁹ The state governments in Nigeria could get a loan from external sources so long as it is approved and

¹³⁵Id., P. 102

¹³⁶ Emmanuel Ojo, The Politics of Revenue Allocation and Resource Control in Nigeria: Implications for Federal Stability”, *Federal Governance*, vol. 7 no. 1, 2010, pp. 15-38

¹³⁷ Akpan Ekpo, supra note 32, P. 215

¹³⁸ Ronald Watts, supra note 25, P. 105

¹³⁹ Akpan Ekpo, supra note 32, P. 210

guaranteed by the federal government and it is contended that the debt accumulation of the 36 states is frightening.¹⁴⁰ There are critics that blame the federal government for it does not devise effective means of supervision on those states unable to pay their debts.

3.4.4. On Intergovernmental Fiscal Transfers In Nigeria

It is usually contended that in Nigeria, the allocation of expenditure responsibilities and tax jurisdiction has raised fewer contentions compared to the issue of intergovernmental revenue redistribution. There is a broadly held view that “the vital problem of federal finance in Nigeria is not so much that of allocating taxing powers, as of allocating the revenues produced by federal taxes between the various governments of the federation.”¹⁴¹ There are two main categories of revenue bases where the three tiers of government jointly pool their revenue for future intergovernmental redistribution. They include the Federation Account Revenues and Value Added Tax Revenues; each of these pool accounts is shared with a distinct sharing arrangement.¹⁴² Vertical revenue transfer in Nigeria comes in a variety of ways such as tax sharing, unconditional grants, block grants, conditional grants and matching grants.¹⁴³

As per section 162 of the Constitution, Nigeria established the Revenue Mobilization Allocation and Finance Commission which is entrusted to review and recommend revenue sharing rules in the federation every five years and to solicit to ensure modifications with changing realities. As such, although virtually all revenues are levied and collected by the federal government, the Constitution provides for a “Federation Account” in to which most of the revenues are paid with allocations from this account being made to federal, state, and local governments (which the Constitution recognize as the third tier of government). In this sense, the federal government administers and collects most of the lucrative taxes, but it does so, on behalf of the entire federation since the proceeds from the taxes are to be shared among the various tiers.¹⁴⁴

¹⁴⁰ J. Isawa Elaigwu, *the Politics of Federalism in Nigeria. An Introduction*, Adonis and Abbey Publishing Ltd, London, England, 2007, P. 255

¹⁴¹ Nkwachukwu Orji, *Power-sharing: The Element of Continuity in Nigerian Politics*, A dissertation submitted in partial fulfillment of the requirements for the degree of Doctor of Philosophy, Central European University Department of Political Science, Budapest, Hungary, 2008, P. 121

¹⁴² *Id.*, P. 122

¹⁴³ *Id.*, P. 123

¹⁴⁴ *Id.*, P. 119

The recommendation of the commission needs approval by both houses of the parliament. The Commission is representative in that it consists of a chair person and one member from each of the states and the federal capital. However, it is sometimes the case that the recommendations of the Commission are subject to the modification of the federal government in its favor. Among the contentious issues prevalent in the Nigerian federation concerning the Federation Account, we could mention the special fund which is deducted from the Federation Account.¹⁴⁵ Although the Supreme Court of Nigeria was successful in voiding the deduction of the special fund from the Federation Account¹⁴⁶, the decision was not effective because the President of the Federation, through his constitutional power of presidential order, simply increased the share of the federal government from the Federation Account from 48.5% to 56% that impliedly includes the special funds. It is reported that in redistributing the special fund, the federal government appropriated more than 82.4 of the special funds which resulted the federal government's actual share in the Federation Account to 54.7 percent.¹⁴⁷

Assigning substantial share of the Federation Account to the federal government may be justified because the federal government is also assigned with more expenditure responsibilities than the lower level governments. The Nigerian federal government covers almost 60% of the total expenditure of the government of the federation.¹⁴⁸ However, it is boldly argued that the federal government should reduce its involvement in most of its production and allocation roles by creating conducive environment for the participation of the private sector so that its share from the Federation Account is also reduced to allow more share to the lower level governments.¹⁴⁹

The federal government has different areas to spend in different states and it may be sometimes the case that a state may get itself at a great advantage because of the federal spending in the state than its share through the revenue sharing. But the Nigerian system is challenged as it tends

¹⁴⁵ Akpan Ekpo, *supra* note 32, P. 216. 7.5% of the accruals of the Federation Account is reserved for the special fund consisting of variables, Federal Capital Territory (1%), stabilization (0.5%), Derivation (1%), Development of mineral producing areas (3%), and General ecology (2%). It is argued that the federal government should alone be responsible for the development of the capital territory as the state governments are alone responsible for their own state capital territories. Further, it is contended that it is the responsibility of the central government to ameliorate ecological disasters with the state government concerned. And owing to the high revenue share of the oil producing areas in the distribution formula, there is no need to reserve special fund for developing the region.

¹⁴⁶ Nkwachukwu Orji, *supra* note 244, P. 125. Among other things, the Supreme Court ruled that all first line deductions from the Federation Account (except the thirteen percent derivation) are unconstitutional.

¹⁴⁷ *Id.*, P. 225

¹⁴⁸ George Anderson, *supra* note 24, P. 23

¹⁴⁹ Akpan Ekpo, *supra* note 32, P. 218

to give preferential treatment for some states and argued for the minimization of the surplus funds from the hands of the federal government without compromising the role to be played by the federal government to maintain the unity of the sub national units and to give the country a sense of national direction.¹⁵⁰

Among the factors taken in to account in the fiscal transfers to the states, it is **population** (25.6%) that plays one of the dominant roles in the Nigerian federation. In Nigeria, population has been used as an index of need.¹⁵¹ Essentially, however, the principle of need emphasizes the need to meet expenditure demands of sub national units in order to carry out desirable services. One challenge on population is the tendency of some states to manipulate the census report to win much revenue than they would have lawfully obtained.¹⁵² The other factor taken is **internal revenue effort** (8.31). Although this factor is meant to encourage states to look inward and try to maximize their internal revenue generating potentials, it has serious obstacles in reducing it in to practice. The main criticism of this factor is that it fails to recognize that revenue effort is a result of a combination of two factors- taxable capacity and tax effort. Akpan Ekpo submits:

*...a state with high taxable capacity but with lower tax rates and inefficient tax administration may still have higher internal revenue or a higher ratio of internal revenue to recurrent expenditure relative to another state with lower taxable capacity but high tax effort. There is, therefore, an urgent need to devise a better index of tax effort. And until such index is devised, the weight currently given to internal revenue effort in horizontal revenue allocation should be very minimal.*¹⁵³

Land mass (terrain) (10.7% in aggregate) was another factor considered in the horizontal revenue allocation but whose weight is argued to be reduced due to their problem of not been thrown open to national debate as it is the case with most variables.¹⁵⁴ In Nigeria great emphasis is given for **equality of states (equity)** for the variable is given more than 45% of the transfer from the Federation Account. Compatible with the logic of federalism that considers each state equal and independent, this principle argues that sub national entities should receive equal shares of federally derived revenues irrespective of population and contribution to the account of the

¹⁵⁰ Ibid

¹⁵¹ Isawa Elaigwu, supra note 140, P. 206

¹⁵² Akpan Ekpo, supra note 32, P. 215

¹⁵³ Id., P. 220

¹⁵⁴ Ibid

federation.¹⁵⁵ This means that each state receives an equal share of this portion of the Federation Account regardless of the state's population or contribution to the Federation Account. There are various justifications given for incorporating this criterion and conferring it with principal weight in the Nigerian federation. Nkwachukwu Orji discussed that:

*First, it is argued that the principle recognizes the reality that each state government has a minimum responsibility, which is to sustain a basic set of public functions and institutions irrespective of its geographical size, population or fiscal capacity. Secondly, the principle of equality of states represents the fiscal aspect of the overarching practice of symmetrical federalism in Nigeria. This practice manifests in the commitment of the elite to create states of relatively equal population, as well as equal constitutional, legal, and fiscal powers. Thirdly, the principle of equality of states compensates states that could not benefit from other criteria due to their small geographical size, population or financial capacity.*¹⁵⁶

As a sole criterion of distribution, however, an argument has been made that the logic of political equality of sub national units, which ignores population, is likely to create inequality of development in the country.¹⁵⁷ This has meant that because of large differences in the size of the states, per capita revenues have in fact varied.¹⁵⁸ It is also argued that according the variable of equality of states substantial weight in Nigeria could create an endless demand of different groups for statehood for they would get great transfer in the name of equality afterwards.¹⁵⁹ It is also challenged that equity would be better guaranteed by distributing resources in per capita terms since the citizens through their states are the ultimate recipients of the federal funds.

Probably the most controversial of the variables in the revenue allocation formula is **derivation principle** or revenue control.¹⁶⁰ It is challenged because it makes rich states richer and poor states poorer and generates intergroup tension in a federation that strives for the unity of the component units. Opponents of the derivation principle claim that it would encourage the development of the rich regions while the regions endowed with less resource would lag behind in socio-economic development. However, proponents of derivation principle see it as efficient because it enables each region to receive revenues that are proportionate to their contributions, thereby promoting national/regional economic development by encouraging all the regions to

¹⁵⁵ Isawa Eliagwu, supra note 140, P. 206

¹⁵⁶ Nkwachukwu Orji, supra note 141, P. 136

¹⁵⁷ Isawa Eliagwu, supra note 140, P. 207

¹⁵⁸ Ronald Watts, supra note 25, P. 111

¹⁵⁹ Nkwachukwu Orji, supra note 141, P. 136

¹⁶⁰ Akpan Ekpo, supra note 32, P. 221

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¹⁵⁷ Isawa Eliagwu, supra note 140, P. 207

¹⁵⁸ Ronald Watts, supra note 25, P. 111

¹⁵⁹ Nkwachukwu Orji, supra note 141, P. 136

¹⁶⁰ Akpan Ekpo, supra note 32, P. 221

identify and exploit revenue sources within their localities.¹⁶¹ The principle is even defended from equity grounds which alleges that a state with a bulk of resources should benefit more than what others receive. It is also defended because the principle encourages using one's resources effectively without a substantial expectation of transfer from others and to discourage a claim for statehood or recognition as a local government expecting transfers from others.

The Constitution also provides that at least 13% of the revenues from natural resources should be devolved based on the principle of derivation to give more capita revenue to natural resources producing states. The fact that this weight is being reduced through the years from 50% to one percent and now 13 % is still claimed as unjust and unfair to answer for the expenditure needs of the region. The region is greatly exposed to high environmental degradation and pollution which is indicative of the extra ordinary expenditure needs of the region. Further, the manner in which the federal government manages the resources together with the poor management and corrupt practices of the officials of the region has exposed the peoples of the region to severe hardships.¹⁶² To alleviate such problems of the region and in a manner that is considered as a welcome move, the federal government has established the Niger Delta Development Commission (NDDC) with various revenue sources in 2000 although some have still challenged its institutional competence in effectively undertaking its mandate.¹⁶³

In addition to the Federation Account, the other source of revenue subject to fiscal transfer in Nigeria is the Value Added Tax which was introduced in 1994 replacing the states' sales tax.¹⁶⁴ Since 1999, it is distributed at the ratio of 15%, 50%, and 35% to the federal, state, and local governments respectively. The horizontal formula for allocating revenues from VAT is based on the following criteria: derivation, equality of states, and population; while the revenues are shared as follows: fifty percent based on derivation, forty percent based on equality, and ten percent based on population.¹⁶⁵ Some states where the bulk of VAT revenues are derived have expressed dissatisfaction with the VAT horizontal allocation formula calling for the application

¹⁶¹ Nkwachukwu Orji, *supra* note 141, P. 134

¹⁶² Ronald Watts, *supra* note 25, P. 51

¹⁶³ Nkwachukwu Orji, *supra* note 141, P. 156

¹⁶⁴ *Id.*, P. 125

¹⁶⁵ *Id.*, P. 126

of hundred percent derivation principle in the distribution of VAT revenues in order to maximize their revenue from the source.¹⁶⁶

3.4.5. On Challenges of Fiscal Transfers in Nigeria

Various problems are witnessed on fiscal transfers in Nigeria.¹⁶⁷ One problem is that the federal government is engaged in activities of diverting some proceeds of the federal revenue from including it in the Federation Account. Such proceeds from the illegal diversion are used in activities which are not the responsibility of the state and local governments. The proceeds are also being used for the development activities of some states in the south in a manner that signify preferential treatment. It is in order to avert this problem and to provide for the proper custodial of the Federation Account that it is recommended to establish Accountant General of the Federation to make it responsible for the maintenance and operation of the Federation Account.

On the other hand, it is difficult to devise a horizontal revenue sharing formula that would be acceptable to all parties concerned. It is reported that since 1946, the government has devised about twenty horizontal revenue sharing formulas but none of them have enjoyed complete acceptance.¹⁶⁸ In a manner that considers the Nigerian federalism as a fragile experiment together with the problems of power sharing, it is said that “the heated debate on resource control and some unpleasant pronouncements on the matter by some delegates highlight the fundamental problems in Nigeria’s fiscal federalism”.¹⁶⁹

3.5. Comparative Lessons to be Drawn

What lessons could Ethiopia learn from the comparative perspectives studied in the previous sections? The legal, institutional and political arrangements of the federal countries studied in this chapter could serve us a necessary reference point from which we could justify the incorporation or relinquishment of a certain idea in the Ethiopian intergovernmental fiscal transfers system. I hasten to add here that the challenge that each country faces on its fiscal transfer system may differ with the same that Ethiopia faces. The same is true on means of

¹⁶⁶ Ibid

¹⁶⁷ Apkan Ekpo, *supra* note 32, P. 230

¹⁶⁸ Nkwachukwu Orji, *supra* note 141, P. 132

¹⁶⁹ Apkan Ekpo, *supra* note 32, P. 231

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¹⁶⁸ Nkwachukwu Orji, *supra* note 141, P. 132

¹⁶⁹ Apkan Ekpo, *supra* note 32, P. 231

handling the problems which differ based on the capacity and readiness of the country for a desired change even when the problems are similar.

The solutions countries discovered to tackle the problems on their transfer system may only be unique and local to fit their circumstances. However, soliciting the foreign perspectives on fiscal transfers is beneficial to test the Ethiopian case against it and rule on whether Ethiopia has valid grounds or excuses to incorporate or not of a certain principle or idea. Accordingly, we could discern some principles that are being applied in the countries reviewed above. This section is then to reflect some of such lessons that may be domesticated (or be strengthened if there are any) or avoided here in Ethiopia.

The first federal country whose fiscal transfer system was reviewed in this chapter is Germany. With the principal aim of ensuring balanced regional development and maintaining equal living standard of the people irrespective of their place of residence in the federation, the German fiscal transfer system has given special emphasis on the equalization transfer where the richer *Lander* directly contribute to the poorer *Lander* an amount which is comparable to two fold of the assistance that all industrialized countries render for developing nations. There are also instances of revenue sharing either on per capita or derivation basis, reserving one quarter of the VAT revenue to the poorer states and direct transfer by the federal government for poorer *Lander*. Although such transfer systems are not devoid of criticisms both from the poorer and richer states, the German system is telling of the fact that we should worry much about equity considerations in the grant formula. Stating otherwise, efficiency should not be the only, if not the principal, objective of the transfer system.

The German system is also admirable in accommodating the interest of states by directly representing them in the second chamber of the Federal Houses, the *Bundesrat*, where it has a law making power. This enabled the *Lander* to attack any legislation that has a potential to jeopardize their interest. The existence of cooperative federalism that expects the *Lander* to administer the bulk of federal laws and the dominant role of the federal government with regard to the concurrent powers creates a strong federal government in Germany at the expense of undermining the autonomy of the *Lander*.

Like most federal countries, the lower level governments in Germany are also unable to fully finance their responsibilities in spite of the fact that it is the federal government that covers almost half of the government spending. This is because the federal government collects almost two thirds of the revenues of the federation and the states do not have the autonomy to fix the tax base and rate. In addition to the fiscal transfer, the German *Lander* also use borrowing as another option of financing their expenditure and the absence of strong regulatory role of the federal government on state borrowing accompanied by the prevalence of perverse incentive on generating own revenues has in practice created a soft budget constraint in Germany.

On the other hand, the existence of perverse incentive, the need for reorganization of the territories of the Lander, striking a balance between subsidiarity and solidarity, the prevalence of important veto players capable of blocking any reform agenda especially concerning the transfer system and accountability and transparency problems are the challenges faced by the fiscal transfer system in the contemporary Germany.

It was India whose transfer system was reviewed in the second place in this chapter. We can also discern some glaring features of the Indian transfer system. India has a Finance Commission that studies and recommends a grant formula to determine the proceeds of the states from all the federal taxes and the gap filling non- plan transfers that the federal government devolves afterwards every five years. The grant formula has attempted to incorporate both equity and efficiency considerations although it is criticized as it does not take account of expenditure needs of poorer states and create perverse incentives.

However, the functioning of the extra Constitutional organ-plan commission, for devolving plan transfers and the centrally sponsored schemes to the states has greatly jeopardized the working of the Finance Commission. Unlike the German system where the joint taxes constitute the major form of revenues of both the federal and state governments, the Indian system in principle follows a separatist approach where there is no concurrency in taxing powers. Although the inevitable fiscal imbalance also concerns India, the states could collect 41% of the total revenues in the country which enables them to finance 54% of their current expenditures.

Borrowing in India is extensively pursued by the states that even half of the borrowing goes to covering the recurrent expenditures even if they could only borrow from internal sources with

the approval of the central government. The expectation of being bailed out by the federal government is a mere indicator of soft budget constraint in India. The deterioration of the fiscal health of the states through the years, the increasing fiscal inequalities between the states, the economic liberalization in India followed by undermining the taxable capacity of the government and creating different tariff zones, and changing political environments that created multi party coalitions to come to power and the subsequent problems of reconciling the various interests are some of the challenges of the Indian fiscal transfer system these days.

Nigeria was the last federal country whose fiscal transfer system was reviewed in this chapter. In a manner that reflects a great vertical fiscal imbalance in Nigeria, the federal government collects 98% of the revenues in the federation which leaves the states to be substantially dependent on the federal transfers to execute their responsibilities. Of course, 60% of the expenditure responsibility of the federation lies on the federal government. The debt accumulation of the states is also declared frightening together with the low regulatory role of the federal government on state borrowing. Most of the revenues collected by the federal government (other than revenues from the VAT) in Nigeria would go to the Federation Account where the state and local governments could also claim entitlement from it. In Nigeria, the revenue sharing formulas are recommended every five years by the National Revenue Mobilization Allocation and Fiscal Commission and approved by the national assembly.

Among the contentious issues raised in the Nigerian fiscal transfer system, one is that the federal government is blamed for retaining some revenues from subjecting it in to the Federation Account alleging special funds for some activities declared illegal by the Supreme Court. Further, some variables of the transfer formula such as granting dominant weight to equality of states variable (irrespective of population size) and 13% reserve for the oil producing areas, internal revenue effort are very controversial up on which there is no consensus to retain or change the status quo. Especially the oil producing states are loudly demanding a higher percentage consideration of the derivation principle as opposed to those who want to maintain the status quo.

In general, it could be said that there are various lessons learned from the comparative reviews. For instance, we should not be surprised by the existence of fiscal imbalance in Ethiopia since all the three federal countries discussed above have similar problem. As it would be discussed in chapter five (section 5.3), however, the fiscal imbalance in Ethiopia is huge than Germany and

India but better than Nigeria. It is because of such huge fiscal imbalances in Ethiopia that we would tend to come up with different options of rectifying it in chapter five. Further, even if the comparative reviews called for the necessity of erecting regulatory mechanisms for protecting soft budget constraints (a phenomenon in all the three countries), the situation we have in Ethiopia is totally different. As it would be discussed in chapter five (section 5.8), inexistence of detailed rules on how states could borrow from internal sources and the low fiscal capacity of the states prevented them from making borrowing as a viable option. The experiences are telling that we should create conducive environment for state borrowing without undermining the role to be played by the federal government to avoid disincentives (soft budget constraints).

On the other hand, the countries have devised their own means on reducing the fiscal imbalances. For instance, Germany has made important taxes (income and corporation taxes where the Lander and the federal government have equal share) to be subjected to concurrent jurisdiction so that it is the main revenue source of the *Lander*. About half percent of the revenues of the VAT is also devolved to the state. In India and Nigeria, all the federal taxes are subjected to revenue sharing that help states to have a better share. In India up to 32% of the federal tax revenues would be devolved to the states through this mechanism. Although federal dominance is predominantly the rule of the game in these countries, the experience of Germany is important in that we should involve the states in areas affecting their interests calling same practice to be developed in Ethiopia than neglecting them (see section 4.3.3)

The necessity of establishing a fiscal commission or organ capable of devising a transfer system (formula) that foster result based accountability, enhance competition, promote regional equity, avoid transfer dependencies, and be open for periodic reviews was also emphasized in the countries reviewed and calls for incorporating same in Ethiopia as it would be discussed in chapter five (section 5.7). There are also different challenges facing each of the countries to justify that challenges to the fiscal transfer is an everywhere phenomenon. There are also actions being taken by the countries. It is in this general idea that chapter five of the paper discussed the challenges of the fiscal transfer system in Ethiopia and the possible options of reducing the huge fiscal imbalances prevalent in Ethiopia.

CHAPTER FOUR- EXPENDITURE AND REVENUE ASSIGNMENTS UNDER THE FDRE CONSTITUTION

4.1 Introduction and Brief Summary

The foregoing chapters were principally concerned with tracing the general jurisprudence on fiscal federalism in general and intergovernmental fiscal transfers in particular. This and the subsequent chapters are here to directly deal with the Ethiopian scenario on the issues that have already been familiarized. This chapter is totally devoted on discussing the expenditure and revenue assignments as it is stipulated in the Ethiopian Constitution. An endeavor is also made as to whether the Ethiopian revenue assignment is in line with the principles of revenue assignments that were discussed in chapter two.

On expenditure assignments, it would be made clear that the Constitution assigned each tier of government with its own expenditure responsibilities. The states are duty bound to cover expenditure responsibilities on areas other than those expressly given for the federal government for residual power is, in principle, reserved for the states. In a manner that places Ethiopia as a dual federalism country, the section on expenditure assignments claims that each order of government is expected to cover the expenditures necessary for its responsibilities by executing the laws it has enacted. In fact, there are instances where the Constitution requires some federal laws to be implemented by the states and where the practice reveals the bulk of federal legislations being executed by the states and where the federal government incurs expenditures on areas it does not have a legislative power.

On revenue assignments, the particular section has lot to say on each form of classifications of taxing power in Ethiopia: exclusive, concurrent and undesignated. Especially the exclusive federal and state tax powers seem to be based on the category of the tax payers, on who owns the object of the tax, and the national/local concern and administrative efficiency considerations. The section also discusses on what notion concurrency is stipulated in article 98 of the Constitution and discusses the controversies on what is meant by 'jointly levy and collect' including the attempted amendment of the constitution.

A discussion would also be made on the peculiar approach the Constitution follows regarding taxes not expressly assigned to either order of government or concurrently to both. Instead of being residual to the states, the jurisdiction of such undesignated taxes is subjected to the

decision of the joint session of the Federal Houses. The discussion tries to respond the objective served by subjecting the jurisdiction to the joint session of the two Houses, the factors to be taken in to account by the Federal Houses on ruling on the jurisdiction, the undesignated taxes whose jurisdictions are determined so far, and some controversies revolving around undesignated taxes including the VAT. In its last section the chapter assesses whether the Ethiopian revenue assignment is in conformity with the general principles of revenue assignments that we have discussed in chapter 2. Despite some inconveniences that the constitution created to favor the federal government in some cases and problems with regard to split organs responsible for income tax, it concludes that the tax assignments are generally in conformity with the principles.

4.2 Expenditure Assignments

The Constitution of the FDRE has divided legislative, executive, and judicial powers between the federal and state governments.¹⁷⁰ After both the federal and state governments are assigned their own legislative, executive, and judicial responsibilities (article 50 (2) of the FDRE Constitution), each is required to bear the financial expenditures necessary to carry out all the responsibilities and functions assigned to it by law (article 94 (1) of the Constitution). This in principle tells us that the Ethiopian Constitution follows the dual federalism model that expects each tier of government to execute the laws it has enacted and to bear the expenditure responsibilities arising there from. However, there are instances whereby the federal government may enact some legislation and leave the administration to the state governments when it is provided in the Constitution (e.g. article 52 (2) (d) expects the states to administer lands pursuant to the federal laws) or when the federal government exercises its power to delegate the states for some functions (article 50 (9)). In other cases, it is alleged that the Constitution lacks clarity on the administration of the federal laws by the states. In this connection, Solomon Nigussie (PhD) submits:

*The administration of federal laws by the states is not clear although in practice the executive powers of the state extend beyond the scope of their legislative power. On the other hand, the expenditure responsibility of the federal government may not be limited to its legislative powers due to a de facto asymmetry substantially related to capacity problem in most of the regions.*¹⁷¹

¹⁷⁰ For more on the expenditure assignments for the federal government, see Solomon Nigussie, *supra* note 22, PP. 68 et seq.

¹⁷¹ Solomon Nigussie, *supra* note 55, P. 93

4.3. Revenue Assignments

The Ethiopian Constitution has also provided tax assignments as function should be followed by finance. In fact, the Constitution has also provided other non-tax sources such as borrowing and subsidies that have a potential of enhancing the shares of the regional states. Exclusive federal taxes, exclusive state taxes, concurrent taxes, and undesignated power of taxation are the four forms of classification that the Constitution opts to assign tax powers between the state and federal governments. Such classifications of (especially) exclusive powers of taxation are in conformity with article 50 (8) of the Constitution that expects one tier of government to respect (not to encroach) the power of the other and article 94 (1) of the same that requires each order of government to cover the expenditures necessary for its functions.

4.3.1 Exclusive Federal taxes

Article 96 of the Constitution stipulates those areas on which only the federal government has the legislative and executive power to levy and collect them. In fact, the captions of article 96 "federal power of taxation" and article 97 "state power of taxation" are misleading in that the content of the provision has incorporated other matters than taxation such as determining and collecting charges and fees on the licenses issued and services rendered by each tier of government that naturally involves a *quid pro quo* whose absence in tax is one of its distinguishing features.

It could generally be said that the Constitution opted to rule on the jurisdiction of federal and state powers based on the category of tax payers, the owners of the undertaking, and the national/local concern and administrative convenience of taxing the thing subject to taxation. As far as the category of tax payers is concerned, article 96 provides that it is the federal government that has power to tax income tax on employees of the federal government and international organizations. Regarding ownership of the thing subject to taxation, on the other hand, it is the federal government that has exclusive power to tax income, profit, sales, and excise taxes on enterprises owned by the federal government and on income of houses and properties owned by the federal government. It is also the federal government that has exclusive power over those taxes which are of national concern and could not efficiently be undertaken by sub national governments. Such include custom duties and taxes and charges on import and exports, on income of air, rail, and sea transport services, and taxes on monopolies.

4.3.2. Exclusive State Taxes

In like manner with federal taxes, Article 97 of the Constitution provides areas up on which the state governments have exclusive power to levy (legislation) and collect (administration) them and the classification is based on the category of tax payers, ownership, and state/local nature and administrative efficiency on the collection of the object of the tax. Accordingly, state governments have exclusive power 'to levy and collect income taxes on employees of the state and private enterprises'. In line with the contention that ownership determines jurisdiction, the provision stipulates that it is the state government that collect rent on houses and other properties they own, and levy and collect profit, sales, excise, and personal income taxes on income of enterprises owned by the state government.

States are also given exclusive power on some tax sources presumably based on the state/local concern of the taxes and the administrative efficiency achieved if the taxes are bestowed with the states. These include taxes on the incomes of private farmers and farmers incorporated in cooperative associations, profit and sales tax on proprietors, fees on land usufructuary rights, on income from transport services rendered on waters within their territory, and on income derived from private houses and other properties within the state. States have also the power to levy and collect taxes on income derived from mining operations, and royalties and land rentals on such operations and royalty for use of forest resources.

4.3.3. Concurrent Power of Taxation

Ordinarily speaking, concurrency implies shared power that both the state and federal governments have power over a certain matter independently with usual federal supremacy in case of conflict. This signifies that the laws enacted by one order of government do not need the involvement of the other order to become enforceable. It is in this manner that the FDRE Constitution envisages for concurrent jurisdiction of courts under article 80 where both orders of government have judicial powers on their respective fields conferred up on them by law.

Coming to concurrent power of taxation under the FDRE Constitution, however, the notion of concurrency differs. Concurrency here is an instance where two authorities acts conjointly. Article 98 of the Constitution provides that both the federal and state governments shall jointly levy and collect taxes under the concurrent jurisdictions. These taxes subject to concurrent jurisdiction of both the states and federal government are profit, sales, excise, and personal

income taxes on enterprises they jointly established; taxes on profits of companies and on dividends due to shareholders; and on incomes from large scale mining and all petroleum and gas operations, and on royalties from such operations.

This stipulation invites the question of what is meant by jointly levying and collecting the tax or how the two tiers of government go about jointly levying and collecting the tax. It is easy to discern that it is difficult, if not impossible, for both orders of government to jointly meet to legislate a law on concurrent taxes and thereafter meet when a need arise to change the rate of the tax. Neither there exist a legal procedure in this favor. The same is true if one order of government is given the power to approve the laws enacted by the other order. From the point of view of collection (administration), on the other hand, it should be given for one entity for administrative efficiency reasons. The proclamation enacted before the coming in to force of the Constitution has important stipulations on the manner of dealing with concurrent taxes which was surprisingly ignored by the provisions of the Constitution. Article 8 (1) of Proclamation No. 33/1992 (A Proclamation to Define the Sharing of Revenue between the Central Government and the National/Regional Self- Governments) empowers the federal government to levy and collect before sharing the proceeds with the state governments.

It was to go out of these messes that an amendment to article 98 of the Constitution was proposed. Even the joint session of the House of Federation (HOF) and House of Peoples' Representatives approved the proposal whereby the federal government levies and collects the concurrent taxes.¹⁷² However, it is not made clear whether the amendment has passed all the requirements required under article 104 and 105 of the Constitution such as approval by six of the nine State Councils by majority vote and subjecting it to the general public and stake holders. Further the provision of the amendment is not proclaimed in the official Federal *Negarit Gazeta* that is required for certain legislation be effective and enforceable in Ethiopia.¹⁷³ As such, legally speaking, the practice of the federal government that levies and collects concurrent taxes and shares the proceeds to the states is not constitutionally recognized for the proposed amendment of the Constitution is not binding as it did not pass all the requirements provided by the law.

¹⁷² See the minutes of the joint session of the House of Peoples' Representatives and the House of Federation, Miazia 2, 1989 E.C.

¹⁷³ Article 2(2) of Proclamation No. 3/1995, Federal Negarit Gazeta Establishment Proclamation

The other issue raised concerning concurrent taxation powers is how to go about deciding on the vertical transfer between the federal and state governments (general pool) and horizontal transfer among the states. Article 62 (7) of the Constitution empowers the HOF to decide on such issues of apportioning the revenue. However, the Constitution is not clear whether the principle employed for the horizontal transfer is derivative or equity based.¹⁷⁴

4.3.4 Undesignated Power of Taxation

The fourth form of taxing power in Ethiopia is undesignated power of taxation. In spite of the general stipulation under article 52 (1) of the FDRE Constitution that confers residuary power to the states, the rule differs as far as residuary power of taxation is concerned. Instead of reserving it to the states, article 99 of the Constitution enunciates that those taxing powers not exclusively given for either order of government or concurrently given to them should be decided by two third majority of the joint session of the House of Peoples' Representatives (HPR) and the HOF. It seems to be believed in the constitutional negotiation stage that assigning one order of government to levy and collect undesignated taxes in advance is not wise because the forgotten matter may either have national or local concern. As such undesignated power differs from residual powers because residual powers are left for one order of government in advance.

It is to be noted that the joint session of the Federal Houses only rules on the jurisdiction of a tax not found either in the exclusive or concurrent list. As such, it does not have a law making power. The legislative power over such taxes belongs to the organ that is decided by the joint session, i.e., the federal or state government or concurrently both. There are different taxes that could safely be grouped under this category. Owing to the various sources of taxes that fall under this classification, it could even be said that the group has substantial sources of revenue potential.

On deciding the jurisdiction over the taxes, the Federal Houses are required to take the federal arrangement into account.¹⁷⁵ Accordingly, it may be imperative to observe the tax jurisdiction classifications in the Constitution. The role of the predecessor of the Constitution on allocating taxing powers and fiscal transfer, Proclamation No 33/92, that stipulated the objective achieved through distribution of powers should not also be underestimated for it is regarded as the 'voice

¹⁷⁴ I would have more to say on concurrent taxes in the next chapter in connection with revenue sharing and empowering the states

¹⁷⁵ Article 95 of the Constitution

behind the silences and ambiguities of the Constitution'¹⁷⁶. Article 4 of the proclamation stipulates that ownership of source of revenue, the national or regional character of the sources of the revenue, convenience of levying and collection of the tax, and other factors which are the basis of integrated and balanced economy should be taken in to account to rule on the jurisdiction of a certain tax.

Until recently, the undesignated tax bases which have been decided by the joint session of the Federal Houses are excise tax on both private enterprises and individuals, state stamp duties, income tax on royalty derived from patent right, income tax on interests of bank deposit and VAT.¹⁷⁷ While excise tax on individuals is decided to be the exclusive source of regional governments, excise tax on private enterprises constitutes the joint source of revenue.¹⁷⁸ On the other hand, jurisdiction over state stamp duties and income tax on royalty from patent rights derived by individuals is given to the states.¹⁷⁹ Income tax on royalty of patent right by enterprises was decided to be the joint sources of revenues of both tiers of government.¹⁸⁰ The other undesignated tax whose jurisdiction was decided by the joint session of the Federal Houses was the power of levying and collecting income tax on revenues derived from bank deposit and it was exclusively given for the federal government.¹⁸¹

We may also consider some other taxes such as gift, inheritance, and death tax as those subjects whose jurisdictions are awaiting decision by the joint session of the Federal Houses. It is however contended that there are some undesignated tax sources which are being levied and collected by the federal government without the joint session of the Federal Houses conferred the federal government of such powers.¹⁸² Among the taxes that are considered undesignated, we could cite the contentious case of VAT which the joint session of the Federal Houses decided to

¹⁷⁶ Taddese Lencho, *Income Tax Assignment under the Ethiopian Constitution: Issues to Worry About*, Mizan Law Review, Vol. 4, No. 1, March, 2010, P. 42

¹⁷⁷ Girma Hundessa and Zewdu Kebede (Dr), *Ethiopian Experience on Systems of Revenue Sharing and Grants made by the House of Federation to the States (Amharic)*, (unpublished), Meskerem, 1998, P. 40

¹⁷⁸ *Id.*, P. 39

¹⁷⁹ The joint session of the HOF and the HPR, Meskerem 26, 1996, P. 4

¹⁸⁰ *Ibid*

¹⁸¹ Joint session of the House of Federations and the House of Peoples' Representatives, Meskerem 25, 1997, P. 2

¹⁸² We would discuss this issue in detail in the next chapter

4.4. An Appraisal of the Tax Assignments of the FDRE Constitution

In chapter two, I have discussed some of the principles employed in assigning revenue responsibilities between the federal and state governments. An attempt to evaluate the revenue assignments of the FDRE Constitution in light of those principles is worthy to judge whether the division has centralizing or decentralizing trends and to indicate any recommendations thereto. Assigning the federal government to have the legislative and executive powers over taxes on custom duties, imports and exports and on incomes from air, rail, and sea transports is important because such taxes are in need of effective administration through centralization. This is because such taxes require better expertise of collection, best ability to monitor, and their reach is not limited to a single state that puts the federal government in the proper side to regulate them.

On the other hand, since the federal government does not possess power over all income tax sources, it is not possible for it to pursue redistributive (equity) and stabilization functions through income taxes. There are also some authors that argue that the normative theories of fiscal federalism favor the federal government in assigning income taxes which is not the case in the Ethiopian Constitution.¹⁸⁷ This assertion is true seen in light of the role of the federal government to play a redistributive and stabilization role through taxation. As all income taxes are not levied and collected by a single entity, it may also be argued that it create split tax base which may lead to a complex and distortionary tax structure and tax competition which is very difficult to administer. This is because it has a potential to expose different persons with same income to incur different taxes based on the rate set by the orders of government. This led us to argue that revenues from all income taxes should be given for the federal government.

However, as we have already considered in chapter two, the principles of revenue assignments may sometimes go in conflict with each other. A serious challenge on assigning all income taxes to the federal government could come from the other principles of revenue assignment. We have said that to ensure accountability of regional states and ensuring regional autonomy, state should be given enough revenue sources to fit their expenditure needs with a revenue means and

¹⁸⁷ Taddese Lencho, *supra* note 176, P. 41. After reminding that the federal government cannot, through the income taxes, reach farmers, cooperatives, businesses organized as sole proprietorships, employees of state governments, and employees of private enterprises, Tadesse doubts whether the federal government be effective in its stabilizing and redistributive role (P. 50). Incidentally, he also argues that the present arrangement is an obstacle to reform the income tax of Ethiopia. This is because any reform agenda on the income tax needs the consent of the regional states or at worst needs the arduous task of amending the Constitution especially when one contemplates the demise of the present 'party discipline' that is dictating the tones of federal-state relations.

be a federal power.¹⁸³ This expectedly compromises the exclusive power of the states to levy and collect sales tax on individual traders carrying out a business activity in their territory.¹⁸⁴

There are arguments raised whether VAT is really undesignated power because the principal purpose of the government in introducing it was to replace the sales tax used to be taxed by both orders of government which requires amendment to the Constitution. There are some scholars that argued that VAT is not undesignated power of taxation which can be manifested through the federal government's later decision to share a certain percentage of the proceeds from the VAT to the states on derivative basis.¹⁸⁵ Of course, the fact that the federal government opts to share the proceeds of the federal taxes with the states could not by itself manifest that VAT is not undesignated power to be given for the federal government. This is because there are some federal countries such as India and Nigeria that conferred the states a legitimate right to claim a share from the proceeds of the federal taxes.

What distinguishes Ethiopia from those countries in that respect is that it is only from the proceeds of the VAT that the federal government decided to share the proceeds with the states that may cast a doubt whether VAT was undesignated from the very outset. That is to say, it may be said that the sharing of VAT proceeds with the states is an admission on the part of the federal government that VAT was not undesignated power. One should, however, note that the decision of the federal government for revenue sharing only emanates from the resolution of the two houses. This is because the minute of the joint session of the two houses clearly indicate that even if the mandate of enacting legislation over VAT is given for the federal government, regional governments are entitled to share the proceeds albeit the exact amount of the regional share is not specified.¹⁸⁶

¹⁸³ See the minutes of the joint session of the House of Peoples' Representatives and the House of Federation, *Miazia* 3, 1994, P. 1-6

¹⁸⁴ The practice, however, reveals that states are allowed to claim exclusive proceeds from VAT collected from individual traders as it would be manifested in the following chapter.

¹⁸⁵ Tadesse Lencho, Book review, Solomon Nigussie, *Fiscal Federalism in the Ethiopian Ethnic Based Federal System* (Revised Edition), 2008, *Journal of Ethiopian Laws*, Volume 23 no. 1, 2009, P. 191. There are also some members of the joint session of the houses that expressed their concern that this arrangement needs a constitutional amendment. See the minutes of the joint session, *supra* note 183

¹⁸⁶ See minutes of the joint session of the HOF and HPR, *Miazia* 3, 1994. As it would be discussed in detail in the next chapter, the regional states are even delegated by the federal government to collect VAT from individual traders there by allowed to take the proceeds exclusively.

reducing federal transfers to the states. Competition between the states is also favored for it is believed that it is a source of better policies. All such principles advocate for the state to be assigned with more revenue sources. Seen in light of such latter principles and owing to the fact that stabilization and redistribution are not the immediate concerns in Ethiopia¹⁸⁸, I believe that the argument to confer all income taxes to the federal government is overwhelmed by its counterpart of maintaining the status quo which is vital to ensure the autonomy and accountability of the states. It is even argued to oust the federal government from some of its income tax powers such as incomes from employees of the federal government so that we could enhance the revenue capacity of the states.¹⁸⁹

On the other hand, we have discussed that economic efficiency criterion requires that the power of those subjects of tax which have a tendency to have mobile character and effect in more than one state should be given for the federal government. *Acontrario* reading of this assertion entitles state governments to have taxation power to those subjects which have mobile characters. This latter stipulation could be a basis for conferring states power to exclusively tax companies (especially private limited companies) (and partnerships) and their share holders so long as such undertakings do not have other establishments in other states instead of making such powers under the concurrent jurisdiction of both the federal and state governments.

Proclamation No. 33/1992 had also important provisions on means of tax power categorization worthy of considering at this juncture. While stipulating the objectives of division of revenue between the two orders of government, Article 3 of the proclamation pays due emphasis for the revenue categorization to enable both orders especially the sub national entities to cover their expenditure responsibilities, narrowing the economic gap in the development of the regions and pursuing activities for the common interest of all. These principles have seemed to influence the tax categorization provided in the Constitution for most classifications are in favor of the principles. Despite the issue of its constitutionality, the practice of the federal government of collecting and levying the concurrent taxes and sharing the proceeds with the states is backed by

¹⁸⁸ This is true for two reasons. First, it is alleged that interpersonal distribution of income and wealth is not an important policy in Ethiopia because of the level of the country's economic development. second, there are no divergent tax policies between the federal and state governments because of the existing 'Party discipline', Tadesse Lencho, supra note 176, P. 50

¹⁸⁹ Solomon Nigussie, supra note 22, P. 130

article 9 of the proclamation although the latter has also indicated the possibility of delegating the regional states for this purpose.

In spite of some of the inconveniences that the Constitution created that has a tendency to shifting the balance towards the federal government and some problems witnessed on assigning income taxes to the two orders of government, this writer believes that the tax assignments as stipulated in the FDRE Constitution are, in general, in conformity with the principles of revenue assignments. After all, we are already familiar in chapter two that decentralizing revenue power is not as compelling as decentralizing expenditure responsibilities on the face of the fact that there is a reasonable suspicion that provincial jurisdiction is susceptible for producing inefficiency and causing inequities among people in different jurisdictions.

CHAPTER FIVE-INTERGOVERNMENTAL FISCAL TRANSFERS IN ETHIOPIA: CHALLENGES AND SOME OPTIONS

5.1 Introduction

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. In fact, it is usually alleged that Ethiopia had undergone some features of federalism and fiscal transfers for most time in the nation's history albeit the fiscal transfer is not top-down.¹⁹⁰

The main theme of this chapter is discussing the two forms of intergovernmental fiscal transfers: revenue sharing and grants (mainly unconditional grants of the 2007 and 2009) together with their challenges. Before directly dealing with the fiscal transfer, some sections are there to level the ground to signify whether there are legal frameworks for it and whether it is an issue to worry about through discussing the prevalent fiscal imbalances. A slight attempt is also made on ascertaining whether we have an effective institution for intergovernmental fiscal transfers.

Once I have ascertained that there is huge fiscal imbalance in Ethiopia and the difficulty of channeling this problem through the current mechanisms of fiscal transfers, I have especial section devoted to indicating different options of minimizing the fiscal dependence of the states on the federal government. One thing that the section seeks to remind, however, is that the huge dependence of the states may also be the result of inefficiency of the states in pursuing their exclusive tax sources and we should first exhaust this option before going to the others. It should also be emphasized from the very outset that each of the issues raised in each section of this chapter are in one way or another the challenges to the fiscal transfers in Ethiopia. This is because they have a tendency to exert their own impact on the final amount of the share that is dispersed to the regions from the federal government (be it revenue sharing or grant).

¹⁹⁰ Befekadu Degefe, 'The Legal Framework for Fiscal Decentralization in Ethiopia during the Transition Period', in Eshetu Chole (ed), *Fiscal Decentralization in Ethiopia*, AAU Press, 1994, P. 60

5.2 The Legal Framework on Intergovernmental Fiscal Transfers

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. For being composed of members who are representatives of each Nation, Nationality, and People (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. 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.

On the other hand, the Constitution has also provided the possibility when the federal government could give direct assistance (and loans) to the states. 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. We could say that this is a situation when the federal government could award conditional grants for the execution of matters within the states' jurisdiction.¹⁹¹ A condition is, however, attached on the exercise of such power. That is, such assistance and loan should not be a hindrance to the proportionate development of the states. Once the federal government ascertains that the assistance and loan would not be a hindrance to the proportionate development of the states and provides the assistance, it is entitled to audit and inspect the subsidies it has conferred to the states.

Furthermore, the economic objectives of the government have implications on fiscal transfers to require the federal government to provide timely assistance to the victims in emergency cases and to the Nations, Nationalities, and Peoples least advantaged in economic development.¹⁹² The Constitution has also committed to stipulate other provisions to the effect of enhancing equity or solidarity principle. For instance, article 41 (3) of the Constitution confers every citizen the right

¹⁹¹ Solomon Nigussie, *supra* note 22, P. 210

¹⁹² Article 89 (3) (4) of the FDRE Constitution

to equal access to publicly funded social services. The policies of the government should also aim to provide all Ethiopians access to public health and education, clean water, housing, food, and social security (article 90 (1)). Article 89 (2) of the same also expects the government to promote equitable distribution of wealth among the citizens.

Article 35 of proclamation No. 251/2001 (Consolidation of the House of Federation Proclamation) has also reaffirmed the fact that revenue sharing and subsidies are decided by the HOF and the latter would follow up whether they are implemented in accordance with its recommendations. The provision has also required the HOF to facilitate the undertakings of studies to promote proportionate development of the states (there by to rectify any defects) and to enable states be independent from federal grants. In fact, such important power of the HOF is only regulated in a single provision of its consolidation proclamation and it is imperative to have a law that possess elaborate procedures on how to accomplish such vital functions of the house.

5.3. Fiscal Imbalances in Ethiopia.

We are now well aware that the issue to worry about is not the existence of fiscal imbalance for it is a phenomenon of every country. The countries whose experiences were reviewed in chapter three are all faced with fiscal imbalances. This is because, as it was considered in the previous chapters, the existence of (especially vertical fiscal imbalance) is inevitable owing to the need to centralize some revenue sources by the federal government for achieving objectives other than augmenting its fiscal capacities. Among other things, it is only when the federal government is in a position to control some revenue sources that it could accomplish the tasks of setting minimum standards across the federation, promoting free trade all over the country, control sources that have national importance, enhancing its redistribution and stabilization role, control resources unevenly distributed across the federation to play equity role, and the like. That is why we have alleged that decentralizing revenue powers is not compelling as the need to decentralize expenditure responsibilities.

If the existence of imbalance is an everywhere phenomenon, then we should rather concern on the extent to which it is huge. Ethiopia could not in any way be an exception to the general rule that there is both vertical and horizontal fiscal imbalance between the federal and state governments on one hand and among the states on the other. It is even witnessed that the imbalance is huge in Ethiopia. We could substantiate such contention with different facts. As far

as vertical fiscal imbalance is concerned, in the 1993/94 fiscal year, regions were only able to cover 26% of their expenditure so that the rest three quarter is covered by grants from the central government. During that period, the regions' own revenues were projected to finance no more than 47% of their recurrent expenditure, and 26% of their total expenditure.¹⁹³ In the same period, regions were only able to claim 37% of the total expenditure of the government indicating that the bulk of the expenditure is allocated to the central government.¹⁹⁴ On the revenue side, the share of the regions accounts for less than 10% of the total revenue.¹⁹⁵

In the 2000/2001 fiscal year the share of all the state governments (including Addis Ababa City Administration) to the total revenue of the nation is little more than 18% the remaining 82% being the share of the federal government to the total revenue.¹⁹⁶ As far as the states' total revenue to their recurrent expenditures is concerned, it accounted to 55% in the same fiscal year so that the remaining percentage of the recurrent expenditure and the whole capital expenditure is covered through federal transfers.¹⁹⁷ In the 2006/2007 budgetary year, the share of the states (excluding Addis Ababa) to the total revenue is even reduced to 9.7% so that the lion's share (90.3%) of the revenue is collected by the federal government.¹⁹⁸ In the same fiscal year, the federal government has managed to transfer 28% of its revenue to the states as (unconditional) grants retaining the remaining for its capital (45.2%) and recurrent (26.8%) expenditures.¹⁹⁹

It is easy to witness that the share of the federal government's expenditure exceeds its states counterpart because major expenditures like defense, internal and external debt repayments, and special purpose grants are its responsibilities.²⁰⁰ As it will be manifested in the following table, regional states (excluding Addis Ababa) cover only 19% of their expenditure in the same fiscal year so that they are dependent on the federal transfers for the remaining 81% of their

¹⁹³ Befekadu Degefe, supra note 190, P. 72

¹⁹⁴ Girma Seyoum, 'Fiscal Decentralization and Macroeconomic Management in Ethiopia', in Eshetu Chole (ed), *Fiscal Decentralization in Ethiopia*, AAU Press, 1994, P.129

¹⁹⁵ If foreign assistance and loan are excluded, their shares of domestic revenues rise to slightly more than 20% which is still low. Eshetu Chole, 'Issues of Vertical Imbalance in Ethiopia's Emerging System of Fiscal Decentralization', in Eshetu Chole (ed), *Fiscal Decentralization in Ethiopia*, AAU Press, 1994, P. 184

¹⁹⁶ Computed from "the Federal Government of Ethiopia Countrywide Budgetary Revenue and Expenditure", (MOFED Archive, unpublished). Note here that the share of the states to the total revenue would be reduced to almost 11% if we exclude Addis Ababa from the computation.

¹⁹⁷ Ibid

¹⁹⁸ HOF, the New Federal Budget Grant Distribution Formula, 2007, P. 3

¹⁹⁹ Ibid

²⁰⁰ Ibid

expenditure needs. An attempt to explain the reasons for this huge vertical fiscal imbalance would indicate that the most fertile revenue sources such as charges on imports and exports are given for the federal government. We should also remember from the previous chapter's discussion that it is the federal government that levies and collects taxes under the concurrent jurisdiction of both orders of government. The states' revenue is, on the other hand, insufficient to cover their expenditure needs. In fact, as it would be made clear in subsequent sections, insufficient taxes of the states are not only the result of limited tax bases of the states but also the inefficient tax administrations of the states and inability and unwillingness of the states to discharge their responsibilities. The low level development of the regional states also plays a role in demanding high expenditure needs in the region that in itself deepens the vertical fiscal gap.

One peculiarity of the Ethiopian case on vertical fiscal imbalance is that the federal government is not in a position to generate revenue in excess of its expenditure requirements. That is to say, unlike the conventional notion of vertical fiscal imbalance that puts the federal government in the surplus side, the surplus of the Ethiopian federal government is only true if one compares the revenue it collects with the same of the regional states. The federal government does not cover its expenditures from its own revenues- tax and non-tax. In the 2001/02 fiscal year, for instance, the federal government was able to cover only 63% of its expenditure from tax and non- tax revenues so that it is dependent on domestic loan and capital receipts as well as foreign loan and aid for the remaining amount of its expenditure²⁰¹.

As far as the horizontal fiscal imbalance is concerned, we could also witness substantial variations among the states on the percentage that they cover their expenditure from their own revenue sources. Accordingly, while Tigray regional State covers 28% of its expenditures from its own revenue sources, Somali region only covers 6.1% of its expenditures from its own revenue sources. We could note here that the share of the state's own revenue to its expenditure requirements is not only dependent on the amount of revenue collected in that region but also on the amount of the expenditure it requires. The expenditure requirement may, *inter alia*, be based on population size and average size of the states. As such, even if Oromia region collects the largest amount of revenue (624.3 million birr, compared to 195 million birr of the Tigray region),

²⁰¹ MOFED, "the Federal Government of Ethiopia Countrywide Budgetary Revenue and Expenditure for the 2001/02 fiscal year (MOFED Archives, unpublished)

its share to the total expenditure of the region (2958.3 million birr) is only 21%. Similarly, even if Gambela Regional state collects the lowest amount of own revenue (12.4 million birr compared to 31 million birr of the Somali regional state), its share to its total expenditure of the region (156.2 million birr) is 7.9%. We could deduce then that the horizontal fiscal imbalances arise particularly because of the different per capita capacities of the regional governments to raise revenues.

Table 5.1 Regional Governments Expenditure Finance from Own Revenue (2006/07 F/Y)

(In Million Birr)

Region	Total Exp.	Own Revenue	% Share of (2)
	1	2	3
Tigray	695.7	194.9	28.0
Afar	332.0	38.0	11.4
Amhara	1899.7	380.3	20.0
Oromia	2958.3	624.3	21.1
Somale	506.2	31.0	6.1
B.S Gumuz	229.0	22.1	9.7
SNNPR	1624.4	262.8	16.2
Gambela	156.2	12.4	7.9
Harar	119.0	20.5	17.2
Dire Dawa	153.9	34.3	22.3
Total/Average	8676.4	1620.6	18.7

Source: HOF, the New Federal Budget Grant Formula, 2007, P. 4

Once we have ascertained that there are both vertical and horizontal fiscal imbalances in Ethiopia, the next sections are there to solicit on means of bridging such fiscal imbalances which include fiscal transfers from the federal to state governments.

5.4 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. 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. We have already discussed in chapter three that all federal

taxes are subjected to revenue sharing both in India and Nigeria.²⁰² That is to say, unlike the case of India and Nigeria, where revenue sharing involves a situation when the federal government divides the proceeds from its own tax revenues to the states, 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. We could also remember the discussion on the previous chapter that the practice of the federal government of levying and collecting such taxes is not constitutionally recognized. In effect, the states are also the owners of such taxes and it is a misnomer to consider such transfers of the federal government to serve the same purpose of revenue sharing in other jurisdictions.

Although the practice until 2003/2004 fiscal year was for the federal government to devolve the whole revenue sharing, grant, foreign aid and loan in a single pool to the states, the federal government has since then introduced a new scheme of revenue sharing from the concurrent taxes decided by the HOF. As it would be manifested in the following table (Table 5.2), the HOF has apportioned the shares of each order of government from each source of the concurrent taxes. It is easy to discern that the share of the federal government is especially huge in case of indirect taxes—presumably because of the cost required for its collection and the dominant federal jurisdiction of some taxes such as the VAT.²⁰³ On direct taxes, we could see that the share of each order of government is equal. As there are no enterprises that both the federal and state governments jointly established, there are no revenues collected from such concurrent source.

²⁰² See generally my discussions of chapter three regarding intergovernmental fiscal transfers in India and Nigeria

²⁰³ For a detailed analysis of the jurisdiction on the VAT, see the discussions on undesignated taxes in the previous chapter

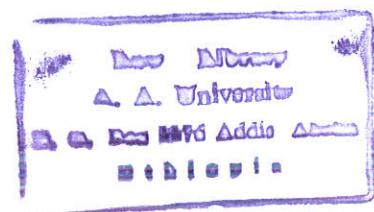


Table 5.2: Types and Percentage Share of the Federal and State Governments of Concurrent Taxes as Decided by the HOF.

Source of Joint Revenue			The Respective Shares (in %)	
			Federal	State
1	Revenues from Enterprises they Jointly Established		-	-
2	Revenue from Companies			
	2.1	Profit Taxes	50	50
	2.2	Service, VAT, and Excise Taxes	70	30
	2.3	Tax on Dividends	50	50
3	Revenues from Large Scale Mining and All Petroleum and Gas Operations			
	3.1	Tax on Profits	50	50
	3.2	Royalties	60	40

Source: As reported by the Ministry of Revenue, December 2003

Although the Constitution is silent on this point, the practice of the Ethiopian Revenue and Customs Authority reveals that the respective shares of the regional states is distributed on a derivative basis.²⁰⁴ This arrangement is beneficial in that the states could exert a sense of belongingness so that actively cooperate with the federal 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 taxes. The revenue sharing scheme on derivative basis has also its own problems. For one thing, 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.²⁰⁵

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. 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. For another thing, the derivative principle is a potential source of conflict on some tax

²⁰⁴ Interview with Ato Teka Abreha, Tax Account Consolidation Coordinator at the Ethiopian Revenue and Customs Authority, made on 29/07/2011

²⁰⁵ Solomon Nigussie, *supra* note 22, P. 215

sources such as revenues from natural resources which are unevenly distributed all over the country. This is especially true when revenues from such sources are huge in the future. One possible argument in this regard is that since ownerships of natural resources are constitutionally conferred to the states and the peoples of Ethiopia in general²⁰⁶ the present arrangement of the revenue sharing scheme to give at least 50% to a single region is to be challenged.²⁰⁷

We could also argue that since there are negative externalities created on the particular region in whose land such natural resources are extracted such as environmental degradation,²⁰⁸ it is wise to maintain the *status quo* of conferring the particular state at least 50% of the proceeds of taxes from such sources so that it could compensate its losses. There are also scholars that argue to favor a state whose residents show 'secondary allegiance to the federation', and although natural resources belongs to the government and the people as a whole, the sense of entitlement of the place where the resource exist is different.²⁰⁹ In fact, we may also argue that some portion of the federal government's share of 50- 60% from such sources would be used to confer grants to the states for it play equity role as it is implied under article 89 (1) of the Constitution. This line of argument would lead us to conclude that the share of the federal government could be used for it to play a redistribution role when it devolves grants to all states.²¹⁰

5.5. Unconditional Grants and the Grant Formula

The other form of intergovernmental fiscal transfer recognized in Ethiopia is grant, either conditional or unconditional.²¹¹ We have earlier on considered that it is the federal grant together with the revenue sharing that covers more than 80% of the expenditure of regional states. This section is only committed to discussing unconditional grants and the grant formula as it is applicable in the Ethiopian legal system. After the federal government has determined and reserved the amount necessary to cover its expenditure responsibilities, it would leave the

²⁰⁶ Article 40 (3) of the FDRE constitution

²⁰⁷ Solomon Nigussie, *supra* note 22, P. 214

²⁰⁸ We may remember the harsh environmental and social problems witnessed in the Niger delta regions of southern Nigeria in our discussion in chapter three.

²⁰⁹ Bekele H/Sellassie, *The Constitutional Law of Taxation and its Implication for Federal- State Relations*, a Thesis, University of Wisconsin Law School, 1999, P. 104. However, he did not conceal that preferential treatment of one region is likely to cause tension in a federation and admits that handling the issue is not an easy affair particularly in a country where the 'centrifugal forces of ethno- regional politics are at work'.

²¹⁰ I will have a separate section dealing with the challenges with regard to revenue sharing and some options to tackle them.

²¹¹ See the extensive discussions on the two forms of transfers in chapter two (section 2.5.2.2.)

remaining amount to be distributed to the regional states based on the applicable grant formula adopted by the HOF. Pursuing this line of understanding would imply that it is the full discretion of the federal government to unilaterally decide the general pool to be dispersed to the states. But there could also be made contrary argument to broaden the role of the HOF in that regard.²¹²

We may remember our discussion in chapter two (section 2.5.2.3) that up to date and reliable data is the principal problem in devising effective grant formula. There are also other factors that need to be considered in the grant formula. In this regard, it is contended that the 'use of reliable and up to date data on the regional development level, the impact of extra budgetary flows, and the importance of proportional federal spending in the regions require further refined grant formulas'.²¹³ Regional population asymmetries have also their problems in the grant formula for it was population that was the main bone of contention in the grant formula.

The federal government of Ethiopia officially declares²¹⁴ that there are at least six key challenges in the Ethiopian fiscal system. It admits that lack of adequate expenditure for undertaking capital projects at the local level, federal government dominance of intergovernmental expenditure and revenue management, lack of reliable and up-to-date data for the grant formula, weak regional revenue base and lack of incentives to raise revenues for local government, inadequate borrowing authorities by regional states, and inequality of regional states and growing demand for financial resources by relatively less-developed regional states and nationalities are challenging. Below I am going to discuss the 2007 and 2009 Grant formulas. Although the 2007 grant formula was only effective for two years²¹⁵, it has envisaged important novel ideas that make its discussion paramount at least for academic purposes.

²¹² We would have separate discussion on this issue in a subsequent sub-section in this chapter.

²¹³ Solomon Nigussie, *supra* note 22, P. 221

²¹⁴ Notes on Fiscal Federalism, Service Delivery and Capacity Building: The Case of Ethiopia, internet source, *supra* note 3

²¹⁵ Through the different interviews I have conducted, I came to realize that the 2007 formula was effective for two years and there was no gap feeling role played by the MOFED in this regard. For instance, Interview with Dr. Zewdu Kebede, Grant Distribution and Joint Revenue Sharing Formula Preparation Case Manager at the House of Federation, and Yacob Bekele (expert) made on 20/07/2011

The 2007 Grant Formula

Before the introduction of the 2007 grant formula that 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. In the year 2007, the HOF has come up with a new grant formula which is alleged to address the shortcomings of the previous formulas and to enable regional governments to provide public services based on their relative expenditure need assessments and revenue raising capacities²¹⁶, albeit on selective basis of some sectors owing to limitations of data on all sectors. It is said that the previous formulas were based mainly on the subjective weights given to variables that indicate size of population, differences in level of development, revenue collection effort and sectoral performance. Three problems are witnessed on the previous grant formulas.²¹⁷

First, the variables adopted and the respective weights assigned to it were subjective that could not measure the actual expenditure need of the states. Second, the formula gave much weight to capital expenditures without due regard to recurrent expenditures. Third, it is alleged that the previous formula failed to consider the potential revenue raising capacities of the regions though it was not also possible to tackle this problem in this formula. As a result, it was not possible to identify the difference between the actual revenue collection and the potential revenue raising capacity of the regions.

²¹⁶ The 2007 grant formula, supra note, P. 6. This formula has three principles. Principle one provides that "every Ethiopian living in any part of the country is entitled, by and large, to similar range and level of public services". Principle two holds that "the annual budget distributed to regions is independent of their tax effort or expenditure level, i.e. it is effort neutral. This principle advocates that as a result of higher tax collection (higher revenue on average than other regions), the region will not get incentive or its budget transfer will not be affected. Similarly, if a region manages to save more, it will not get direct additional transfer as an incentive or its share of the transfer will not be reduced. Incentives to the regions to execute various development activities out of their own initiatives are, in principle, only given by the federal government through specific purpose grants. Indirectly, however, the grant formula will accommodate the recurrent expenditure needs of the additional investments i.e. schools and health care services constructed by savings. Neither would additional transfers made if a region spends more compared to others. But the study later assumed that effort is equal for all regions for it was difficult to assess it and **conclude that taxable capacity equals actual tax collected** (P. 17). The third principle submits that "regions that are forced to spend more than the standard regional expenditures are entitled to budgetary support to finance the gap. This principle is in light of article 89 (4) of the Constitution that require the government to provide special assistance to the Nations, Nationalities, and Peoples least advantaged in economic and social development. (P. 7-9)

²¹⁷ Id., P.6

4 There are three variables included in the new formula: population, differences in the relative revenue raising capacity, and differences in relative expenditure needs.²¹⁸ As far as population is concerned, the proper way is believed to start with equal per capita distribution of grants. Then, an assessment is made to what significant respects the expenditure needs or revenue capacities of the regions are such to warrant variations (negative or positive) from the average; and determining how those differences might best be measured, translating them to per capita terms and adjusting the equal per capita amount accordingly.²¹⁹

Instead of attaching subjective percentage to the variables, the 2007 grant formula aimed to measure the expenditure needs and revenue capacities of the regions to compensate, through federal grant, those regions that signify more expenditure needs than the average need of the regions and/or less revenue capacities than the average capacity of all regions. The assessment of the revenue capacity and expenditure needs have been made by comparing each region's situation with an average of all regions combined. The formula begins from apportioning the federal grant based on the population size of the regions (on per capita basis) and modifying it in due course taking the **relative capacities and needs** of the regions in an effort-neutral manner. To tackle the problem of up to date data to make the assessment more realistic, the formula used the average data of 2001/02- 2005/06 fiscal years.

However, owing to the data related problems on examining all factors necessary to signify the revenue raising capacities and the expenditure needs of the regions, only some factors are selected. On the revenue raising capacities six taxes which account for more than 90% of regional revenues are selected that include personal income tax, business profit tax, agricultural income tax, rural land use fee, tax on chat, and the VAT. On the expenditure needs assessment, on the other hand, six major functional areas that again accounted for more than 90% of the regional expenditures are selected. These functional areas are Agriculture, Rural Water Supply, Rural Roads, Education, Health, and Administration and General Services. And for each revenue or expenditure factors that are mentioned above, it results in "plus" for some states and "minus" for others.²²⁰

²¹⁸ Id., P. 11

²¹⁹ Id., P. 12

²²⁰ Id., P. 14. The plus or minus result differs based on whether the variable is revenue capacity or expenditure needs. If it is revenue capacity, a 'plus' means that the region has lower than average capacity to raise taxes and should be compensated for this, and a 'minus' means that the region has a higher than average capacity to raise taxes and that,

The formulas are developed based on a detailed quantitative assessment of relative expenditure need and revenue raising potentials based on the factors selected to manifest same. After analyzing the manner of calculations of each of the factors for the need and capacity assessments, the study arrives at a finding summarized in the following table. It assumes that the grant reserved for the states is 6043.34 million and calculates the shares of each region based on the average per capita transfer and any modifications due to differences in revenue capacity and expenditure needs of the states. It made it clear that the share of the percentage share of the states would not be affected if the size of the pool is changed.

Table 5.3: Summary of the Differences in Revenue Capacity and Expenditure Needs Assessment

Region	Average Population	Ave. per capita transfer	Difference in per capita revenue capacity	Difference in per capita expenditure needs	Sum of 2, 3, and 4	(5) multiplied by (1)	Percentage share
	1	2	3	4	5	6	7
Tigray	4.10	88.95	-5.04	10.25	94.16	385.59	6.38
Afar	1.33	88.95	3.33	21.95	114.23	151.57	2.51
Amhara	18.06	88.95	4.26	-4.57	88.63	1600.84	26.49
Oromia	24.97	88.95	-3.92	-3.44	81.59	2037.62	33.72
Somale	4.09	88.95	6.14	3.58	98.67	403.68	6.68
B/Gumuz	0.59	88.95	-4.42	60.54	145.07	86.03	1.42
SNNPR	14.01	88.95	3.06	-2.67	89.34	1252.10	20.72
Gambela	0.23	88.95	-22.59	172.8	239.15	55.87	0.92
Hareri	0.18	88.95	-56.91	133.38	165.41	30.40	0.50
DireDawa	0.37	88.95	-34.02	52.43	107.36	39.64	0.66
Total/Ave	67.94	88.95	0.00	0.00	88.95	6043.34	100.00

Source: the HOF, the New Budget Grant Distribution Formula, 2007, P.64

As it could be inferred from the table, if this formula is totally used, only Oromia and Amhara Regions would get a reduced share of grant compared to what would otherwise transferred to them solely on average per capita basis. We could, however, say that the formula pays especial emphasis to population size. This is because the formula starts from apportioning the grant on per capita basis and it is only from that amount that it makes the necessary modifications taking accounts of revenue capacities and expenditure needs. On the other hand, the number of population is

other things being equal, it should receive a less than average share of the grants on this account. If it is expenditure needs, on the other hand, a 'plus' indicates that the region has a higher than average expenditure needs and therefore should be compensated while a 'minus' indicates the reverse.

frequently used in the assessment process even to determine the needs and capacities of the regions based on the factors given above. Even the reduced shares that the two regions incurred are not that much significant which is indicative of the fact that the formula confers especial emphasis to population size. For example, from the 2221 million birr that Oromia regional state could have obtained if population size dominates 100% of the formula, its share only decreased only by 184 million birr as a result of the factors of revenue capacity and expenditure needs that relatively favored other regions. Stating otherwise, the ratio of the percentage share of the budget transfer to the region (33.72) to the percentage share of its population (36.76) is 0.917.

If we compare these figures with the grant proposed to be allocated to the regions in 2003/04, from the average 85.3 per capita share that each region would have got had population been the sole variable, the region only gets 75.68 per capita shares.²²¹ If we convert this figure in birr terms, from the 2081 million birr that it should have got, the region only gets 1846 million birr, a reduced amount of more than 235 million birr. It should also to be noted that the weight attached to population size even reach its highest peak, i.e. 65%, in the 2003/04 fiscal year.²²² The possible inflation of the birr from the 2003/04 to the year 2007 should not also be underestimated.

Accordingly, the 2007 grant formula pays much emphasis to population size even with a substantial higher degree than the previous grant formula that by itself conferred paramount weight to population size greater than its predecessors. These figures reveal that the 2007 formula could not be welcomed by less populous regions that need to see high percentage shares to the revenue capacity and expenditure needs variables than consideration of the population size to a much greater emphasis.²²³ As far as narrowing the per capita share between the regional states is concerned, the 2007 formula is much better than its predecessors partly attributed to the emphasis it accords to population size. As an illustration, we could observe the grants of Gambela and Oromia Regions in the years 2003/04 and as it is stipulated in the 2007 grant formula. In crude terms, it could be observed that while Gambela region receives 130.58 million birr grants in the year 2003/04, it only receives 55.87 million birr in the 2007 formula. But while Oromia region

²²¹ Calculated from a table, Solomon Nigussie, *supra* note 22, P. 228

²²² Solomon Nigussie, *supra* note 55, P. 112.

²²³ That is why the formula incorporated transitory provisions (implementation modalities) whereby it was proposed for the states to get only 25% in 2007, 50% in 2008, and 75% in 2009 and 100% in 2010/11 fiscal years based on the 2007 formula. see the 2007 grant formula, *supra* note, P. 66

receives 1846.61 million birr in the 2003/04 formula, its share is increased to 2037.62 million birr in the 2007 formula.

To be more specific, in the 2003/04 fiscal year, the ratio of the percentage share of budget transfer to the Gambela region (2.18) to its percentage share of the population (0.34) is 6.41 so that it derives more than six fold of its population size.²²⁴ When we come to the Oromia region, in the same fiscal year, the ratio of the percentage share of the budget transfer of the region (30.93) to its percentage share of the population (34.86) was 0.887 which indicates that the region does not get transfer commensurate to its population size. On the 2007 formula, however, as it could be observed in the above table, the ratio of the percentage share of the grant of Gambela region (0.92) to its percentage share of the population (0.34) is reduced to 2.706.²²⁵ The ratio of the percentage share of the grant of the Oromia region (33.72) to its percentage share of the population has increased to 0.917. These facts reveal that the 2007 formula is somehow effective in narrowing the per capita share of regional states. However, it is not difficult to deduce that it gives immense emphasis to population size at the expense of undermining the interest of less-populous states.

The 2009 Grant Formula

In May 2009, the HOF endorsed a new grant formula. Without prejudice to some peculiarities, the structure and methods of this formula are more or less similar with its 2007 counterpart. In a manner enhancing participation of all stakeholders and transparency, the preparation of the formula is said to have passed three stages: review of the literatures of fiscal federalism, field visits during which discussions were made with the different regional authorities and professionals and those data that could not be found in the federal government or the Central Statistics Agency were collected, and reviewing the comparative experience of other countries to draw some lesson to Ethiopia.²²⁶ It is alleged that the expert team that prepared the formula had had different discussions with different stakeholders at the regional and federal level through which it collected necessary inputs and make the stakeholders to have some sense of ownership of the formula.

²²⁴ Calculated from a table, Solomon Nigussie, *supra* note 22, P. 228

²²⁵ The document justified why the transfer shares of the less populous regions are higher than their population shares even in such (wide) variations. It submits that cost differences from economies of scale especially in the less populous regions, cost differences arising from dispersion/distance in some regions including Gambela, higher expenditure needs of rural roads for some regions including Gambela, and lower than average capacity to raise revenue. HOF, *The New Federal Budget Grant Distribution Formula, 2007*, P. 66

²²⁶ *The Federal Democratic Republic of Ethiopia House of Federation The Federal Budget Grant Distribution Formula to Regional States, May 2009*, P. 7

Although some countries may devise the grant formula based on either expenditure needs or revenue capacity, Ethiopia is like those nations that adopt both variables in to account and in that case the 2009 formula is similar to its 2007 counterpart. This is because of the heterogeneous composition of the regional states and their development needs that preclude from deducing effective formula based on a single indicator.²²⁷

This formula has also taken revenue capacities and expenditure needs in to account so that it seeks to balance differences regarding capacities and needs. Among the peculiarities of this formula, special percentage share is reserved to the less developed states. Accordingly, Afar, Somale, Benishangul Gumuz and Gambela, which are defined as emerging regions by the Ethiopian government because they are far behind the rest regions in development, are allowed a specific budget grant which is one percent of the general pool that is additional to their share.²²⁸ The respective share of each region is also allocated based on a formula devised for this purpose.

The 2009 formula has also other peculiarities. For one thing it attempted to take the revenue potential of the states than actual revenues collected in the region in a far better way than its 2007 counterpart so that it pursues its principle of effort neutral approach effectively. This would potentially force regional states to make substantial effort so that the potential gap between revenue potential and actual revenue would be closed. For another thing, the expenditure needs assessment pays due emphasis on the number of beneficiaries (e.g. number of students, number of sick people) than on a per capita basis.²²⁹

Like all the previous formulas, the 2009 formula also concern regional states than the building blocks of the federation: Nations, Nationalities, and Peoples of Ethiopia. There are, however, some

²²⁷ Dr. Petra Zimmermann-Steinhart, *The Federal Budget Grant Distribution Formula and the Solidarity Principle of the Ethiopian Federal Democratic Republic*, available at <http://www.diplo.de/ForeignRelations/press/07072011>, last visited on 07/07/2011.

²²⁸ The 2009 Grant Formula, P. 51 It is contended that while the needs and capacities assessment help to reaffirm the equality requirements of the constitution, the third scenario of special share to the emerging regions would enhance the solidarity principle where relatively better developed regions are making indirect horizontal transfer to the emerging regions. Incidentally, it is worthy of reminding that such emerging regions are also awarded technical support (capacity building support) in the areas of Civil Service Reform, Agriculture, Water, Education and Health and the Ministry of Federal Affairs is principally responsible for the coordination of such programs. Each concerned ministry is then responsible to cover the cost arising there from (Interview with Ato Adgo Maru, Plan and Finance Director General at the Ministry of Federal Affairs, made on 27/07/2011).

²²⁹ Interview with Dr. Zewdu Kebede and Yacob Bekele, *supra* note 215

peculiarities in the 2009 formula. This is because it attempted to accommodate the especial expenditure requirements of multi ethnic states. For instance, those multi ethnic regions that have established council of nationalities and special administrative structures (Amhara, SNNPR, and Gambela) are awarded some share for their extra expenditure requirement.²³⁰ Similarly the formula has also taken account of the number of first languages used in each state in primary education and the expenditure share of the region would also increase accordingly.²³¹

The revenue capacity of the regions is assessed by taking major tax sources that are reported to cover more than 80% of the revenues of the regions. Pursuing its principle of effort neutral approach, the formula only used the regions' revenue potential not the revenues they have actually collected. The taxes used for this purpose are six which are personal income taxes, business profit tax, VAT, Agricultural income tax, Rural Land Use Tax; and Turn over Tax (TOT). The formula has also incorporated non tax revenue, i.e. sales of medical visits and drug appointment whose proceeds are alleged to be consistently increasing across regions. The 2009 grant formula is better than its predecessor in that it tries to take the revenue potential of the regions than the actual revenues they collected. It is mentioned that except for personal income tax²³², the formula attempted to take the revenue potential of the region than actual collections. For instance, the potential revenue from agricultural income tax as well as Rural Land Use Tax is arrived by applying the lowest tax rate on the number of holders by land size. The same is true for potential revenue of the states from business profit tax and TOT which is calculated by taking the number of wholesale, retail, service, and micro enterprises in the region.

The expenditure needs is also calculated based on indicators that accounts more than 90% of regional expenditures. These indicators together with the respective weights attached to them are expenditures required for general administration (Organ of the state, Public order & security and Justice)(29%); Primary and secondary education (including TVET) (32%); Public health (9%);

²³⁰ The 2009 Grant Formula, P. 28. Benishangul Regional State is left out in the list presumably because, presently, there is no such establishment of council of nationalities or especial administrative structure despite its multiethnic composition.

²³¹ The 2009 grant Formula, P. 36

²³² It is said that because of the difficulty of measuring the revenue potential of regions from personal income taxes and owing to the fact that government employees form the major source of personal income tax, the use of actual revenue will approximate the potential (The 2009 Grant Formula, supra note, P. 13). In fact, it is unfortunate to hear that it is difficult to measure the revenue potential of regions from personal income taxes and that traders are less important than government employees as a source of income tax.

Agriculture and Natural Resource (14%); Clean water supply (5%); Rural road construction and maintenance (5%); Micro and small scale enterprise development to reduce poverty and unemployment (3%); and Work and urban development (3%). It is provided that expenditure need for administration and general services includes special fund for ethnic diversities, cross-border conflict, hardship allowances, ventilation/air-conditioning and refrigeration. On the other hand, the formula has also committed to take in to account the unit cost differences across the members of the federation for price variations can affect the unit cost of providing all kinds of services.²³³

It is to be noted that Addis Ababa City Administration is not the beneficiary of the federal grant to the states unlike Dire Dawa that gets 1.01% share of the grant. The reason for the exclusion is because the city has huge revenue potential, there is no need to include it in the grant. The percentage grant share of regions approved by the house to 2009/10-2011/12 is shown by the following table.

Table 5.4: Grant percentage shares of regions to 2009/10-2011/12

Regions	Percentage Share of the Grant
Tigray	7.04
Afar	3.34
Amhara	23.33
Oromia	32.53
Somale	8.43
Benishangul/Gumuz	1.96
SNNP	19.90
Gambela	1.57
Harari	0.89
Dire Dawa	1.01
Total	100

Source: The 2009 Grant Formula, P. 55

Even if the draft of the formula proposed for it to be enforceable for five years fearing that the states could not predict their budget and will not undertake projects that require a longer time span if the formula has to be changed every year, the House approved it to work only for three years. On the other hand, in a manner to tackle the lack of unreliable and up to date data, the formula is devised by taking data reports issued by the Central Statistics Agency. Like its predecessor, the

²³³ The 2009 grant formula, P. 45

2009 grant formula has also emphasized for it to be effort neutral so that it would not be affected by the policies of the regional governments and should not affect the conducts of the regional governments. This helps to avoid the disincentive problems.

As it is expected, there are challenges for the effective preparation of the grant formula. The main problem is data related problem.²³⁴ Data is not obtained as it is required in the variables stipulated in the grant formula and data obtained from regional and federal bodies contradict each other. The other challenge to the grant formula is its attempt to address all needs of the states in the formula. We have discussed in chapter two (section 2.5.2.3) that variable to a grant formula should be available and comparable across units of governments. There are also specific region problems that have jeopardized the share of some regions. For instance, due to the alleged problem created due to the population census report of the Amhara region, it is believed that the region has lost 3% share from the grant formula.²³⁵ This means that due to the under estimation of the population of the region, the region is alleged to have got 3% less than the share that it would have got had the population been counted properly.

5.6. Conditional Grants

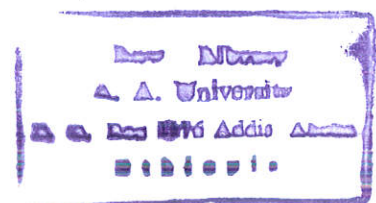
The other means of grants that are used to bridge the fiscal gap and serve other purposes such as targeting a certain groups of the society is conditional grants.²³⁶ It is only for the intended purpose of the transfer that the grant could be spent.²³⁷ Such transfers are especially important to secure national minimum standards because it is the federal government that principally dictates the manner of spending of such transfers. As it was already discussed in section two of this chapter there are assistances that the federal government is required by the constitution to give for the states for emergency, rehabilitation, and development purposes. The federal government is also mandated to accord special assistance to the regions least advantaged in economic development. It could be said that such provisions are the basis for the federal government to give conditional grants for the mandates which are the responsibilities of state governments.

²³⁴ Interview with Dr. Zewdu Kebede and Yacob Bekele, supra note 215

²³⁵ Interview with Ato Girma Tesfaye, Development Planning Process Owner at the Finance and Economic Development Bureau of the Amhara National Regional State, made on 04/08/2011

²³⁶ As I have delimited the scope of the paper in chapter one, the paper would not be extended to dealing with the practical aspects of conditional grants in Ethiopia for it needs extensive study of its own and is beyond the scope of this paper.

²³⁷ See in general my discussions on conditional grants in chapter two (section 2.5.2.2).



The Constitution is not clear as to the role of the HOF on conditional grants given by the federal government. However, since such grants are conditional on the performance of a specific task, it is proper to leave them to be the functions of the federal government to equitably undertake them with the consultation of the state executives. Currently, the house does not involve itself in controlling the distribution of the conditional grants across the federation.

We have already reflected on that conditional grants could be a tool for accompanying the grant formula as to fill the gap that are beyond its reach. Accordingly, it is not necessarily important to exhaust all objectives of the fiscal transfer system in the grant formula for doing so would have its own inconveniences. In fact, as different objectives of fiscal transfers (grants) are contradictory each other, it needs to limit the objectives to be served through a single system leaving others left to be served by other transfers such as conditional grants. For instance, unconditional grants are disadvantageous in that they encourage beneficiaries to spend their share in any manner they deemed fit. In those areas where the beneficiaries are fiscally imprudent and corrupt, such unconditional grants would lead to inefficiency in provision of comparable public services to the people concerned. To alleviate such problems, it is wise to devise conditional grants so that each activity of the beneficiaries are under the immediate follow up of the federal government through the conditions that the latter has attached.

It is also not possible to satisfy the extremely special expenditure needs or low revenue capacities of some regional states through unconditional grants because there is a huge gap among the needs and capacities of the states. The best way to tackle this problem then would become to balance the special needs of such regions through conditional grants. In the Ethiopian case, the emerging regions' special needs due to historical marginalization could only be rectified through such grants. Conditional grants are also important for the federal government pursue a goal of minimum provision of some beneficial projects across the federation. This is because the state governments would not otherwise be willing (save for other factors such as party discipline that greatly monitors federal-state relations in the present Ethiopia) to provide uniform projects by the grants they have received owing to their autonomy to spend their share in their own priorities which is not necessarily the project required by the federal government.

5.7. Institutional Frameworks for Intergovernmental Fiscal Transfers in Ethiopia

Countries may adopt among different institutions that undertake the functions of revenue sharing and grants as a principal body in a manner it adopts itself with the daily changing environments of the federal and state conditions.²³⁸ In Ethiopia, it is the HOF that determines the shares of the federal and the state governments from the proceeds of the concurrent taxes levied and collected by the federal government and that determines the formula for apportioning the federal subsidy to be distributed for the regional states.²³⁹ In the process of discharging its functions, however, the house has encountered various problems. It is only commencing from the year 2002/03 that it began to produce a formula to rule on the apportionment of the general pool among the states using its own experts and before that it was acting to approve the formula based on the recommendations of the now Ministry of Finance and Economic Development (MOFED).

At this juncture one needs to query as to whether the HOF could be effective in handling such political and technical issue of determining the fiscal transfer relationship between the federal and state governments. The fact that it is a political organ, its members being representatives of each Nation, Nationality, and People, makes it a proper organ to determine such contentious political issue of determining revenue sharing and grants among the states. The query is rather strong in relation to its effectiveness towards accomplishing the demands arising from the technicalities involved in the transfers on the face of the fact that it only meets twice a year. Such technicalities include soliciting up to date and reliable data from different authorities, devising mechanisms to study the revenue capacity, expenditure needs, and special realities of each regional state, endeavoring the proper factors that could safely indicate the needs or capacities of regions, ruling on the proper way of assessing the factors thus selected, appreciating the impacts of conditional

²³⁸ On the different institutions on revenue transfer across federations, see my discussion on 2.5.4 above.

²³⁹ This would group Ethiopia to those countries that conferred the power to rule on revenue transfers to their second chambers. What is peculiar about the HOF, however, is the fact that it has no law making power and the members are represented in majoritarian manner because ethnic groups would have additional one member with each one million people they have. In addition to the numerical considerations (where those regions that have high population size would have many representatives in the house), this majoritarian tendency is also reflected in those states such as the SNNPS that have many ethnic groups so that it has at least one representative in the house for each ethnic group in the region. Such majoritarian tensions from different angles subjects the decisions of the house to be challenged to be accepted by all the stakeholders unless, at least, it is assisted by a technical commission. On the other hand, the fact that the region have members which are representatives of the Nations, Nationalities, and Peoples, not their states, is also another point of departure of the HOF from second chambers of some other federations although one could also observe that they could be appointed by state councils, and that some (especially those who have higher population size) ethnic groups have their own states in which cases ethnic representatives are also assumed to represent their own state's interests.

grants in each region, assessing the impacts of the previous formulas on the activities of the regions, and so on.

Although it needs a study of its own, the contentions claimed by the less populous regions against the 2003 and 2007 formulas devised by the house indicate that the grant formula is somehow defective in accommodating the interests of all groups. This fear could at least be mitigated if a permanent and effective body was institutionalized to study (needs and capacities of the regions and any changing circumstances to make necessary adjustments) and present recommendations for the house as to the proper grant or revenue sharing formulas so that the house could be in a persuasive position to deliberate and approve the proposal of the body.

It is understandable that the non-existence of permanent and institutionalized commission for revenue transfer is not felt in the present Ethiopia because there are some important factors that smoothes such a contentious issue behind the stage. Since it is EPRDF and its allies that dominated federal and regional government organs, its party discipline has greatly contributed for reaching amicable settlements among the regions. However, there is a need to separate governmental and party channels to resolve the issue in formal manner and permanently.²⁴⁰ One can imagine what the challenges for the house would be if opposition parties are represented in the house.²⁴¹ If that is the case, it would be extremely challenging for the house as there is no more party discipline behind the stage. It is at that time that the idea of having a commission that assists the house would specially be important since the commission is assumed to come up with persuasive recommendations amenable to all parties.

This discussion should not give a wrong impression that the house is totally devoid of some bodies to assist albeit in ad hoc and non institutionalized manner. In fact, the house assigns a committee to prepare a draft grant formula. For instance, the draft of the 2007 grant formula was prepared by a technical committee which the house decided to be composed of experts from regions and the HOF. As such, there are expert committees that are assisting the house in the preparation of the grant formulas. On the other hand, among the four case teams currently in the Research, Decision, and

²⁴⁰ For more about the need to separate the present blurred line between governmental and party channels in Ethiopia, see Assefa Fiseha, *Intergovernmental Relationships*, Journal of Ethiopian Laws, Vol. No., 2009

²⁴¹ This is possible when regional parliaments are controlled by majority members of opposition parties because members of the house could be appointed by the state councils from their own members. (Article 61 (3) of the Constitution)

Implementation Surveillance Process of the secretariat of the HOF, one is the Grant Distribution and Joint Revenue Sharing Formula Case Team.

The main function of the team is to prepare the grant formula with the advice of (external) consultants and adjusting the respective share of the states yearly within the formula approved by the house as new data on expenditure needs and revenue capacity is found that calls for adjusting the share. However, it only has four members (including the manager) and we can imagine their effectiveness especially when the general pool dispersed to the states increases, and when the activities and awareness of the states expands in the future to make it very difficult for them to overcome the associated challenges. So far, the case team has never recommended for adjustment of the respective share of the regions in its three years life span and did not perform any agenda for amending the formula devised by the HOF on the concurrent revenues.²⁴² Among other things, this has something to do with the capacity problems of the case team. It is at this juncture that we need either independent or all inclusive fiscal commissions.

5.8. The Need for Empowering States

A. Introduction

In our previous discussions, we have just acquainted ourselves with the huge vertical and horizontal fiscal imbalance prevalent in Ethiopia. Taking the vertical imbalance, for instance, the states could not cover at least their recurrent expenditures but for the revenue transfer from the federal government. The proceeds of the states from their own exclusive²⁴³ revenue sources could not cover more than 55% of their recurrent expenditures let alone to have a share in their own capital expenditures. This fact should make us conscious as to what are the relevant factors responsible for such huge imbalance and to solicit any possible recommendations to increase the capacity of the states so that we could at least minimize the problems related to such imbalances.

²⁴² Interview with Dr. Zewdu Kebede and Yacob Bekele, *supra* note 215

²⁴³ In fact, the states also have a constitutionally entrenched entitlement to have a share in the proceeds of the concurrent taxes as determined by the HOF thereby decreasing the extent of vertical fiscal imbalance that was just reported without regard to the legitimate share of the states from such particular source. This is because revenue sharing of such kinds should be regarded as own revenue of the states owing, *inter alia*, to the fact that there are no strings attached on the states on the manner of spending of such sources and most importantly, states are also one stakeholders of concurrent taxes as per article 98 of the Constitution.

I have already considered in my previous discussions that the vertical fiscal gap is very huge in Ethiopia beyond the tolerance that we should make given the inevitability of imbalance across federations. On the other hand, there is a concern that fiscal transfers are not effective ways of handling such (especially huge) vertical fiscal imbalances and we should only claim them as a last resort.²⁴⁴ Among the problems associated with unconditional grants, we could say that the amount fixed is dependent on the will of the federal government which the states have no option than accepting whatever amount is transferred to them.

This lowers their expectations and hinders them from having long term and advance strategic plans from the federal transfers. It would also discourage them from pursuing their own revenue sources effectively and the transfer would be a disincentive for them. It also reduces their accountability towards their electorates since they are not undertaking substantial percent of their responsibilities from their own revenue sources. The deficiencies of the revenue transfer should be an alarming call for us to find other solutions to enhance the capacity of states and thereby reducing their dependence on the federal transfers. Article 35 of Proclamation No. 251/2001 has also an important stipulation for the HOF play a role in minimizing or avoiding the dependence of the states on the federal subsidies. It reads:

*The House shall undertake a series of studies on the impact of subsidies and division of revenues on States to achieve balanced development among States and eventually enable them be independent from subsidies. It shall therefore **take or cause any corrective measure** be taken to rectify defects.*

As it could be inferred from the provision, the measures on achieving the proportionate development of states and relieving them from being dependent on federal grants could either be performed by the house itself or the house may direct others (may be legislators or concerned organs for constitutional amendment) to achieve same. The provision is implying that there need to be works to be done to empower the capacity of the states especially when states could administer it without unduly jeopardizing efficient tax administration. Different options could be raised for this purpose and this section is exclusively devoted on reflecting on such possibilities of empowering states together with a discussion on whether it is possible and associated risks of buying the idea.

²⁴⁴ For more about the defects of fiscal transfers, see my discussions in chapter two (section 2.5.3).

B. Bridging the Gap between Potential Revenue and Actual Revenue Proceeds of States

The primary issue that crosses our mind to empower states is whether the states are effective in actually collecting the revenue sources assigned to them because it may be the case that the revenues of the states are deteriorated not because they have not been assigned fair revenue sources but because they have not established an effective mechanism to collect its revenues. That is to say, it may be contended that it is because of capacity problems that there is huge vertical imbalance not because states are not assigned enough revenue raising powers. As such hard work should rather be done on means of capacity building of the states' man power towards efficient revenue collection of its own.

In the 2010/11 fiscal year, for instance more than 1.2 billion birr was collected from direct taxes, more than 0.5 billion birr from indirect taxes, and about 0.4 billion birr from non-tax revenues in the Oromian Regional State which in aggregates become more than 2.016 billion birr.²⁴⁵ In the same fiscal year, more than 1.06 billion birr was collected from direct taxes, about 197 million birr from indirect taxes, and about 260 million birr from non-tax revenues from the Amhara Regional State which totally collected about 1.52 billion birr.²⁴⁶ When we compare such figures with the respective share of the regions from the federal grants in the 2011/12 fiscal year, while Oromia Region is allocated to get more than 10 billion birr, the Amhara Region is in like manner reserved to get more than 7 billion birr from the federal grants.²⁴⁷ Accordingly, roughly speaking, it could be said that the regions get five fold of their actually collected revenues from the federal subsidies. Without prejudice to their expenditure requirements, these two regions are also the two top regions that collect the highest revenues owing to their revenue potential and we can assume the revenues collected in other regions are even less.

For so many reasons states do not collect as they could. The inefficient policies of tax collection of states, the low attitude of the people towards taxation, the relatively low level of development of regional man power and their inadequacy in number, problems associated with rigor enforcement practices in the states are only illustrations for this gap.²⁴⁸ Further as the states do not have cash register machines like the federal government, concealing of revenues, not

²⁴⁵ Data obtained from Oromia Regional State Revenue Bureau

²⁴⁶ Data obtained from Amhara Regional State Revenue Bureau

²⁴⁷ The 2004 federal budget Proclamation (subsidies to the regions)

²⁴⁸ Interview with W/ro Berhane Shiferaw, legal expert at the Revenue Bureau of Oromian Regional State, made on 27/07/2011

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handling accounts effectively for category “A” and “B” tax payers, and tax evasion practices are bottle necks for effective tax collections in the regions.²⁴⁹ The fact that regional revenue bureaus do not have their own prosecutors to effectively undertake the tax enforcement is also there to take some share in the problems of effective tax collection.²⁵⁰ Currently, prosecutors of the revenue Bureau of Oromia are undertaking their activities by delegation. Investigators for this purpose are also assigned from the police commission of Oromia as a way of cooperation. A modification to this effect is effective only in making the commission duty bound to consider the investigation required for the Revenue Bureau as their ordinary function.

Here, it is worthy of discussing the current practice of the ERCA of administering both the federal taxes and taxes of the Addis Ababa City Administration. The ERCA is currently (as of February, 2011) collecting tax sources assigned to the city administration and thereafter transfers the proceeds to the administration after retaining the costs for administration.²⁵¹ It is said that the City Administration has delegated the ERCA and public prosecutors of the ERCA are instituting actions of the suits of the administration²⁵². There are different reasons given for such centralization.²⁵³

First, it is to treat similar tax payers similarly. That is to say, the amount paid by the tax payer was dependent on whether he is registered as a federal or the administration’s tax payer and, because of low enforcement capacities of the administration’s tax officials, he was subjected to less tax if he is registered as the administration’s tax payer. This in effect created tax migration from federal to states and city administrations. Second, the taxes of the city administration were not effectively collected and there are some sign of improvements in the amount of the taxes collected since the introduction of such federal administration. It is also argued that as the city has wide development projects, delegating the federal government to collect its taxes would help the city to concentrate on such development projects.²⁵⁴

²⁴⁹ Ibid

²⁵⁰ Ibid

²⁵¹ Interview with Ato Eshetu W/Semayat, Public Prosecutors Directorate Director (chief public prosecutor) at the ERCA, made on 28/07/2011

²⁵² Ibid

²⁵³ Ibid

²⁵⁴ Interview with W/ro Alganesh Arefe, Income Tax Law Enforcement Process Coordinator at the Bole Sub City, made on 29/07/2011

However it is problematic to measure the exact gap between the revenue capacity and actual revenues of the state. It is even contended that 'it is simply impossible in almost every case to make useful estimates of the potential tax base'²⁵⁵ (of regional states).²⁵⁶ It is because of such difficulties in measuring the potential tax base of regions that the 2007 grant formula equalizes potential tax base with actual revenues collected by assuming there is equal revenue effort in all regions. Despite such difficulties of measuring the potential tax base, the HOF should strive to reduce capacity problems of the states as per the mandate given to it in its consolidation proclamation. It should study what factors hinders effective collection of taxes in regional states and take measures to rectify same. If states are successful in effectively collecting revenues as they could, it would be a vital step as it is like the notion of exhaustion of local remedies. It is only proper to pursue other means of empowering states when the huge vertical fiscal imbalance still persists after the states are capacitated to collect revenues comparable to their potentials.

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If we ascertained that the vertical fiscal imbalance could not be bridged only by assisting them to pursue their revenue sources in their fullest capacity, the next attempt is to check whether we should derive something helpful on our issue from the provisions of the Constitution.

I. Evaluation of the Exclusive Tax Powers of the States and the Federal Government

A point at issue here is whether there is a need to reconsider the exclusive tax powers of the two orders of government in a way winning more tax jurisdictions for the states. We could imagine different scenarios to this effect. We have already contended that charges on imports and exports are the exclusive tax domains of the federal government. There are however some arguments to share the regional states that originate the exportable item from the proceeds of such charges. They argue that rather than centralizing all export duties in favor of the federal government, it would have been better if a mechanism is adopted to share the proceeds with the regions where the exportable items are originated to avoid possible future conflict.²⁵⁷

²⁵⁵ Potential tax base is what the tax base would be in aggregate for a region if all persons and organizations legally liable to pay tax were identified and the base applicable to them was accurately measured (there was no tax avoidance or evasion)

²⁵⁶ HOF, the New Federal Budget Grant Distribution Formula, 2007, P. 16

²⁵⁷ Solomon Nigussie, supra note 22, P. 131

No doubt that this contention could be against the interest of those regions that have no major exportable items as it has a potential to reduce the share to be dispersed to them by way of unconditional grants when the federal government tends to share its revenue from export charges with the states that are the home lands of the exportable items. This proposal also undermines the redistribution role to be played by the federal government especially in such cases where the resources are not evenly distributed all over the country. But it is imperative to accommodate the interest of those states that have primary attachment to the items being exported and who should somehow especially reap the fruits of such items in preference to others. It should be noted that the regional state government concerned creates conducive environment for the exporters. A reconciling approach is to accept the proposal, but undertaking due considerations on the percentage share of the concerned states from the items in a way it does not unduly ignore the interest of both parties.

It is also argued that income tax from employees of public enterprises and international organizations should be assigned to the states for the proceeds from such tax is used for the purpose of providing local public goods and infrastructure.²⁵⁸ This proposal could also empower them to provide efficient local services when the tax follows the employees' residence, not the employer. The other option in this regard is entitling the states to share the revenues accrued from the federal taxes as it is practiced in India and Nigeria. As it is remembered from the discussions in chapter three, revenue sharing from the federal taxes are important sources of revenues for the states in India and Nigeria and are worthy of domesticating them in Ethiopia.²⁵⁹

II. Comments on Undesignated Power of Taxation

It is to be remembered from our discussion in chapter four that the jurisdiction of tax sources not exclusively enjoyed or concurrently levied and collected by both orders of government awaits the decision of the joint session of the two houses. A closer look at the practice of ruling on such tax sources however signifies some unfavorable treatments of the states. As such, some of the decisions made on undesignated taxes favor the federal tier. For instance, there are arguments

²⁵⁸ *Id.*, P. 285

²⁵⁹ For more on revenue sharing in India and Nigeria, see my discussions in chapter three (section 3.3 and 3.4).

that allege that VAT was not undesignated and the introduction of the VAT replacing sales tax should have only been possible through constitutional amendment²⁶⁰.

In fact, an attempt to solicit the practice of the Ethiopian Revenue and Customs Authority (ERCA) manifests that regional states are, since the previous year, delegated to administer VAT and take the proceeds exclusively from unincorporated undertakings (private traders) that are VAT registered and the files are also transferred to the regions.²⁶¹ Each region is delegated to administer VAT from unincorporated undertakings so long as it has introduced the Standard Integrated Government Tax Administration System (SIGTAS), a system that handles all taxes in a single software system. The fact that states are allowed to take all the proceeds of the VAT from unincorporated undertakings could help them to augment their fiscal capacities albeit to a certain extent.²⁶² There are also some undesignated taxes that are levied and collected by the federal government without the joint session of the two houses assigns the tax jurisdiction to same. Such taxes include tax on income derived by entertainer, musician, or sports person, immovable property and apprentices thereto, income from livestock, royalties derived from copy rights of artistic, literary or scientific works, and capital gains tax from transfer of buildings held for business, factory, office and shares of companies.²⁶³ These factors should also be noted of to arrive at more tax jurisdictions in favor of the state governments.

III. Evaluating the Concurrent Tax Jurisdictions

It is to be recalled that it is the federal government that levies and collects the concurrent taxes and it shares the proceeds with the states as per the formula devised by the HOF. The share of the states is 30% for indirect taxes and 50% for direct taxes.²⁶⁴ As one of the mandates of the HOF is to strive to find solutions for relieving the states from being dependent on federal transfers

²⁶⁰ See generally the discussions of chapter four (section 4.3.4) on how the federal houses decide VAT to be the jurisdiction of the federal government with the duty to apportion proceeds to the states.

²⁶¹ Interview with W/ro Abaynesh Abate, Inland Tax Administration Program Development Team Coordinator at the ERCA, made on 30/07/2011

²⁶² W/ro Abaynesh has also informed me that the states used to get 90% of the VAT proceeds from unincorporated undertakings even when the states are not delegated to collect it. However, one respondent challenged such practice of the ERCA. He said that as VAT is complex, serve as information base for other taxes as well, and an undertaking whose annual turnover is over 500000 is presumed to function all over the country, it is unwise to reserve some of its proceeds for the exclusive dominance of a specific region. (Interview with Ato Mekonnen Ayele, Civil Cases surveillance Team Coordinator (Vice Chief Prosecutor) at the ERCA made on 30/07/2011).

²⁶³ See article 6 (c), 6 (f), 31 (1), and 37 (1) (b) the Income Tax Proclamation, Proclamation No. 286/2002

²⁶⁴ A detailed discussion on concurrent taxes has been made in chapter four (section 4.3.3) and in the section of this chapter dealing with revenue sharing to which readers are referred.

(unconditional grants), it is expected to take the fiscal need of the states in deciding the respective shares of the two orders of government. In this connection, we could remember our discussion in chapter three (section 3.2.4) where the Lander in Germany get equal share of the proceeds of the concurrent taxes (income and corporation taxes). The HOF has not yet revised the revenue sharing formula that was adopted in 2003 and, in conformity with the above assertion; it should reconsider the formula taking cognizant of the current fiscal problems of the states.

One issue that could be raised here is whether it is proper to deny the states any say in the levying and administration of such taxes. The practice of the federal government of collecting the concurrent taxes without a constitutional mandate may be important especially seen in light of adopting a unified application of the taxes to avoid adverse tax competitions, to reduce duplication of efforts in different jurisdictions and for treating similar tax payers equally.²⁶⁵ However, it is also argued to incorporate other options such as allowing the regions to levy their own additional taxes on the concurrent taxes to drive best benefit out of it.²⁶⁶ For instance, if the transaction of a given company is below 500, 000 birr, the states could collect Turn over Tax (ToT) from such company so that they would exclusively retain the proceeds. However, the practice that we currently have is that even the ToT collected from the companies that are not VAT registered is the concurrent revenue of both the federal and state governments and the states could only get 30% of the tax.²⁶⁷

The other issue worthy of considering is the case of partnerships. There seems to be a discrepancy between the Amharic and the English versions of article 98 (2) of the Constitution. While the English version subjected only companies to be the concurrent jurisdictions (thereby making taxes from partnerships undesignated), the Amharic version, which is prevailing as per article 106 of the Constitution, opted to use the word “ግብይቶች” meaning “Enterprises” that seem to include both companies and partnerships. The practice of the ERCA also reveals that both companies and partnerships are the concurrent tax sources to entitle the federal government to administer them and share the proceeds with the states.²⁶⁸ This means that the taxes collected

²⁶⁵ Solomon Nigussie, *supra* note 22, P. 189

²⁶⁶ Taddese Lencho, *supra* note 185, P. 195

²⁶⁷ Interview with Ato Tesfa Adugna, Tax Account Consolidation team expert, made on 29/07/2011

²⁶⁸ Interview with W/ro Abaynesh Abate, *supra* note 261

from micro and small scale enterprises (partnerships) is the joint revenues of the two orders of governments.

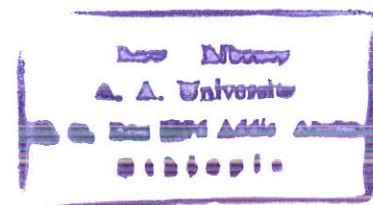
One respondent has informed me that there are some regions that opposed this practice. While some regions argued for the tax collection to be undertaken by the states by delegation (thereby accruing the proceeds arising out of it) because ERCA does not have institutional arrangement to the woreda level like the states, others contended that since such micro and small scale enterprises are conducting with the resources of the states, they should be the exclusive domain of the states. So it is imperative to assign them to the states. On the other hand, the Constitution subjected tax proceeds from any company to be the concurrent jurisdiction of both orders of government. But we should remember the discussions in the previous chapter (section 4.4) that contend that states should be given exclusive jurisdiction on the proceeds of those companies that have no mobile character.

D. Evaluating the Income Tax Laws

It could be argued that both the federal and state income tax laws have stipulations detrimental to the interest of the states. Taking the federal Income tax Proclamation (Proclamation No. 286/2002), it subjects some undesignated taxes to the federal government without the federal houses decide them in its favor as it was already discussed in the previous sub-section. It has also some provisions that have a tendency to encroach the exclusive tax jurisdictions of the states. For instance, it is not proper for the proclamation to regulate Category C tax payers under article 68 (see also article 18 (3) of the Income Tax Regulation, Reg. No. 78/2002) for such tax payers fall under article 97 (4) of the constitution that entitles the states exclusive jurisdiction to tax individual traders so long as the business activities are not incorporated in the form of companies to be joint taxes and for the tax payer be Category A tax payer.

On the other hand, the regional Income tax Proclamations are also in a way limiting the tax jurisdictions of the states. The fact that they took the federal law as a model implies that the states recognized the jurisdictions already taken by the proclamation.²⁶⁹ Such stipulations of both the

²⁶⁹ Taddese Lencho, *supra* note 176, P. 45. He even contends that "the regional income tax laws are not just eerily similar to the federal tax law; the regions have not even bothered to sift out provisions that are clearly inappropriate from the vantage of regional income tax jurisdiction. For example we find the same article (number as well as content) referring to a provision that is clearly not a regional income tax jurisdiction-dividend tax".



federal and state income tax laws inevitably reduce the revenue potential of the states. This is because had the joint session of the federal houses ruled on the undesignated taxes which are taken by the federal law, there might have been a possibility where the states are entitled to tax them. We need the joint session of the two houses to revoke such stipulations of the federal income tax proclamation by ruling on a tax base which is undesignated even when it was already mentioned in the proclamation.

E. Autonomy of States on Fixing the Tax Base and Rate

The extent of the capacity of the states on tax powers could be inferred from examining their autonomy in fixing the base and rate over, at least, those tax sources that are in their exclusive domain. In fact, a harmonized tax system advocates that the tax rates and bases should be identical or at least similar across the federation²⁷⁰ and this helps to avoid unequal treatment of citizens with similar position, for the federal government play equity role (implied under article 90 (1) of the Constitution) especially in situations when states do not have equal natural endowments, not to jeopardize interstate business activities, and to avoid disastrous competition among the states that would, *inter alia*, have a tendency to lower provision of public services due to lower taxes. It is also desirable especially when the states are not capable enough to come up with their own system of administering their taxes. It may also be said that it is the federal government that is entitled to regulate macroeconomic policy of the country and tax is one big instrument for achieving that and the Constitution also aspires to create one economic community. For this purpose, it is argued that we need harmonized fiscal policy one aspect of which is harmonized tax.²⁷¹

However, such uniformity has a risk of subjecting the states to the inevitable dominance by the federal government, does not enhance competition which is helpful to influence states to strive for better policies and to allow them to attract business within their boundary, and precludes the states from imposing taxes in a manner that could augment their revenue capacity comparable to their expenditure responsibilities. An issue may be raised whether the Constitution stipulates a requirement for a harmonized tax system across the federation. The Constitution does not give a clear answer for this query. Article 100 (2) of the Constitution provides that (the federal and state

²⁷⁰ Tax Harmonization, available at <http://www.ethiopianlaw.com/ethiopian-law-articles/121-tax-harmonization.html>, last visited on 12/10/2011

²⁷¹ Interview with Ato Mezgebu Ameha, Macroeconomic and Policy Management Directorate Director of the Ministry of Finance and Economic Development, made on 25/07/2011

governments) should ensure that “the tax does not adversely affect their relationship”. In fact, different tax rates in different states and the federal government has a potential to affect the vertical and horizontal relationships of the tiers of governments though one still question whether the stipulation is especially targeted for harmonization.

However, the meanings of “levy” and “collect” under article 97 of the Constitution do not warrant such interpretation. This is because the states have the legislative and executive power over those tax sources which are in their exclusive jurisdictions. The provision also seems to imply the possibility of existence of different tax rates in different states but seeks to regulate it in a way it does not adversely affect their relationships. Rather than being a requirement, the Constitution seems to imply that harmonized tax system is a guideline to which states and the federal governments are encouraged to arrive at. This could be done through intergovernmental forums and negotiations between the federal and state governments.

However, Proclamation No. 648/2009 (The Federal Government of Ethiopia Financial Administration Proclamation) has opposite stipulation because it provides that “Tax systems at the Federal and Regional levels shall have harmonized and standardized tax bases”. This stipulation is in a way against what is implied under article 100 (2) of the constitution. What is legitimate for the MOFED is to lead the intergovernmental negotiations to reconcile and negotiate so that there would be a tax system which is proximate in all the states. This is to contend that states should be convinced for the tax harmonization and it should not be an imposition. The federal government (MOFED) is required to seek to provide incentives for the states so that they would be consented to such kind of arrangements.

Even if we could say that states could fix their own tax rates at least in revenue sources exclusively reserved to them, this entitlement should not go to the extent of affecting interstate commerce. It is the power of the federal government to regulate interstate commerce so that it could quash some actions of the states that are legitimately affecting interstate commerce.²⁷² On the other hand, it does not seem feasible for the states to impose their own tax rates due to capacity problems. The states presently do not have the necessary expertise to deal with the impact of imposing different tax rates.

²⁷² Article 51 (12) of the Constitution

F. Comments On the General Pool Dispersed to the States and the Role of the HOF

The revenue capacity of the states is also influenced by the amount of money reserved for the subsidy of the states by the federal government and by the role of the HOF in that regard.²⁷³ This require us to evaluate whether the role of the HOF on unconditional grant under article 62 (7) of the Constitution is only distributing among the states whatever amount is given to it by the federal government or does it also have power to rule on the sufficiency of the general pool that the federal government prepared for the states or whether it is the HOF that decides the amount that the federal government should reserve as a general pool to the states. We remember from our discussions in chapter three that countries such as Germany have resolved such issue by involving their upper house in the law making process so that it could block any agenda which have a tendency to jeopardize the interest of the states. This is not possible in Ethiopia since the HOF does not have a law making power. The problem is also solved in India because it is the Finance Commission that is authorized to recommend the proceeds that should be devolved to the states (see section 3.3.4) and the same is true in Nigeria (section 3.4.4). We do not also have such a commission in Ethiopia.

Article 62 (7) of the constitution is not clear and one way of understanding it is that the role of the HOF on unconditional grants starts to commence only after the federal government ruled on the general pool dispersed to the states. The other way of understanding is to empower the HOF to recommend the possible general pool that the federal government is expected to devolve for the states. Some respondents informed me that when the HPR approves the total budget of the federal government, including grant subsidies to the states, it is assumed that it would take the expenditure responsibilities of the states vis-à-vis the federal expenditures in to account and there is no role to be played by the HOF.²⁷⁴

Others also emphasized that the pool reserved to the states is given special consideration. The process of determining the general pool to the states is like this.²⁷⁵ First, estimation is made as to the anticipated resource of the federal government both from tax and non-tax revenues. Then an assessment is made as to the non-discretionary expenditures of the federal government such as

²⁷³ In a reported record amount of the share of the regional states, the HPR has approved over 117 billion birr budget of the federal government for the year 2011/12 among which more than one-quarter amount (more than 31 billion birr) is reserved for the regional subsidy. (see the budget proclamation of the 2004 fiscal year (E.C))

²⁷⁴ Interview with Dr. Zewdu Kebede and Yacob Bekele, supra note 215

²⁷⁵ Interview with Ato Mezgebu Ameha, supra note 271

salary for federal employees, external and domestic debt repayments, defense, etc. Thirdly, an assessment is made as to the minimum expenditure requirements of the states in light of the expected commitment from the states on a given strategic plan of the government. It is only after satisfying the needs of the states through the pool on the minimum that the federal government allocates expenditure for federal capital and other expenditures from the remaining amount. Ato Mezgebu believes that since the HPR approves the federal budget after considering the given resource of the federal government with the different expenditure needs and after compromising each need to the other, the practice that we have now is safe. He contends that the HOF should not be allowed to recommend on the general pool that should be dispersed to the states because it only entertains the matter solely from the interest of the states and that would tend to jeopardize expenditure requirements of the other sectors of the federal government.

Whether there are procedures in the Constitution on directing and controlling such conduct of the federal government is subject to interpretation although one may cite the general stipulation made under article 95 of the Constitution that requires each order of government to share revenues taking the federal arrangement in to account and broadly interpreting the power of the HOF under article 62 (7) of the Constitution to include ruling on the amount that the federal government should reserve for the states as a grant for it also studies the expenditure needs of the states to devise the grant formula.

G. State Borrowings

In addition to tax revenues that the states can use, borrowings are also the other means of augmenting the capacity of the states to discharge their expenditure responsibilities. This source of revenue is however subjected to different conditions attributed to the problems associated with it. We are going to see how far borrowing could be an effective source of revenue for the regional states in Ethiopia.

Generally, state borrowings are subject to immediate control by the federal government because it has the power to regulate fiscal and monetary policies. Article 51 (7) of the constitution has indicated the possibility of state borrowings from internal sources as per the laws enacted by the federal government. Consistent with such stipulations, Article 65 of Proclamation No. 648/2009 authorized the MOFED to determine the maximum amount that individual regional state could borrow from internal sources and required the latter to submit the necessary information. There

are no other stipulations concerning state borrowings either in this proclamation or Proclamation No. 591/2008 (A Proclamation to Amend the National Bank of Ethiopia Establishment Proclamation). This generality would inevitably enable the federal government to closely follow up and scrutinize the borrowings to be taken by each individual state resulting in fewer loans allowed to states.

The practice shows that there are two ways in which the states could borrow although in both cases the states submit their share from the federal grant as collateral for their repayment of the debt.²⁷⁶ The first case is when the states apply to the MOFED for the latter give them some amount from their share in the next year in advance. The Ministry would then scrutinize the justifiability of the application and whether the disbursement would not have substantial effect on the region's share in the subsequent year before responding for the application. The states would usually get a reduced amount than the amount they have applied. The other case is when the states want to borrow money from banks to undertake some activities such as to buy fertilizers. In that case either the state or the bank would apply to the MOFED to check whether it is willing to reduce the share of the states to repay the loan in case the state is in default of discharging its obligation.

On the other hand, owing to the insignificant revenues that regions derive from their own revenue sources and the current huge fiscal dependence of the states on federal transfers, it does not seem that borrowing is a viable alternative to finance regional governments.²⁷⁷ This is because, in the normal course of things, the financial sources of the debtor and the feasibility of its projects should be examined to approve the loan and it is less likely that the states presently could live up to the expectation of such requirements from their own sources. Accordingly, it needs to empower the fiscal capacity of the regions first before we tend to broaden their borrowing capacity.

H. Possible Risks and Problems Associated with the Means of Empowering States

All the options we have discussed above to empower the states have their own associated risks or problems to hinder their effective realization. Probably the most important risk of all is the proposals' potential of requiring the arduous task of interpreting the constitution for their full

²⁷⁶ Interview with W/ro Elisabeth Mamo, Treasury Directorate Higher Officer at the Ministry of Finance and Economic Development, made on 26/07/2011

²⁷⁷ Solomon Nigussie, supra note 22, P. 255

realization. Here, we could cite that amending the Constitution requires procedures on who initiates it, requirement to subject it for public discussions, consent of 2/3 of the State Councils, and approval of the proposal by 2/3 majority vote of the joint session of the federal houses.²⁷⁸ This indicates that to amend the Constitution, it needs that the proposal should be shared and supported by almost all stakeholders of the state and federal government. This in turn requires a commitment towards empowering the fiscal capacity of the states thereby relieving them from being substantially dependent on federal transfers.

Without prejudice to the role of the federal government to regulate interstate commerce and the results obtained from the establishment of intergovernmental forum that is discussed above to reconcile tax rates in different regions, according states the autonomy to fix their own tax rates would also create a risk of detrimental tax competitions that has a potential to unduly benefit the relatively developed states that could attract more investment through its favorable low tax rates and various exemptions. On the other hand, obtaining such autonomy of the states does not seem feasible presently when the rule of the game is party discipline that could not favor different tax rates in different jurisdictions and requires the states to be loyal to the harmonized tax system.

²⁷⁸ Article 104 and 105 of the Constitution

CHAPTER SIX- CONCLUSION AND RECOMMENDATION

CONCLUSION

After devoting this much on intergovernmental fiscal transfers and its challenges in the Ethiopian context, a time has come to recap the points that are raised in the previous chapters and pointing some areas that need to be concentrated and adjusted in the future. One obvious finding that the study arrives at is not the existence of fiscal imbalance (both vertical and horizontal) but its extent is huge that could not even be rectified through fiscal transfers from the federal to state governments. Although the constitutional tax assignment comes at the forefront to take the lead to justify such huge vertical fiscal gap, the capacity problems of the states are also there to take some share for there are also some important tax sources that are exclusively assigned for the states that if used effectively could boost their revenues. It is easy to discern from our discussions that the tax collection capacity of the states is less efficient than the same of the federal government and there is more gap between potential revenue sources and actual revenues collected in the states than is in the federal government.

On the other hand, we have discussed the two forms of fiscal transfers in Ethiopia: revenue sharing and grants. We have said that, though article 98 of the constitution did not pass all the procedures for constitutional amendment, the prevailing practice in Ethiopia is for the federal government levy and collect the concurrent taxes and share the proceeds to the states as per the formula devised by the HOF. Although the constitution is silent on this point, the practice of the ERCA reveals that the proceeds of the states from the concurrent revenues is determined on derivative basis and with due regard only to the place of incorporation of the undertaking.

On unconditional grants, we have found that although the constitution is again not clear at this point, the practice shows that it is the federal government (as approved by the HPR) that unilaterally decides the share of the regions for regional subsidy. And the role of the HOF starts to commence after the regional share is determined by the federal government and it has no role in recommending the share that should be dispersed to the states. As far as the grant formula devised by the HOF through which it distribute the allocated share of the regions among themselves is concerned, the discussion was particularly interested in elaborating the particular features of the 2007 and 2009 grant formulas.

The principal peculiarities of such formulas is the fact that they attempted to take the revenue capacity and expenditure needs of the states and seeks to fill the gap to the extent that the region's revenue potential does not cover for its expenditure needs in an effort neutral manner. Before 2007, the formulas used to give subjective weights to some variables that only indicate expenditure needs and some level of fiscal performance of the states. Both formulas selected major revenue and expenditures of the states that account to the extent of 90% of regional revenues and expenditures. Among the peculiarities of the 2009 formula, we have mentioned that it tried to take potential revenue and expenditures of the states than its 2007 counterpart that relatively failed to take the potential owing to the data problems. The 2009 formula also concentrated on the number of beneficiaries than on a per capita basis. It has also allocated one percent share of the pool exclusively to the four emerging regions in addition to the share that they would get together with the other regions. It has also tried to take in to account the special expenditure requirements of multi-ethnic states such as costs required for Council of Nationalities and other administrative structures and additional costs for book preparation for those states that have students with more than one first language (mother tongue).

It was found that in addition to the obvious data related problems, it was also emphasized that it is challenging to accommodate the especial expenditure requirements of all the states in the single grant formula because usually the problem prevalent in one region may not be shared by the others. There are also specific region problems that we have discussed such as the under estimation of the Amhara Regional State Population due to which the region claimed to have lost three percent of its share.

We have also reflected the existing institutional frameworks for intergovernmental fiscal transfers in Ethiopia. It was said that the fact that the HOF is a political organ for it is composed of the representative of each Nation, Nationality, and People would make it politically fit to undertake this function. The unsettled issue was whether the bodies undertaking the technicalities of the transfer are effective in adapting themselves to the changing fiscal circumstances of the federal government and the states. Presently, among the four case teams in the Research, Decision, and Implementation Surveillance Process of the secretariat of the HOF, one is the Grant Distribution and Joint Revenue Sharing Formula Case Team that prepares the grant and revenue sharing formula with the assistance of external advisor. The inefficiency of the

case team is manifested through different indicators such as its few human power (four including the case team manager), they have not yet amended the revenue sharing formula despite a need to update it with the changing realities, they have not adjusted the 2009 grant formula as they are required when new data are discovered without affecting the general framework of the formula. It was in that way that the necessity of either independent or all inclusive fiscal commission felt.

On the premises that fiscal imbalances in Ethiopian are very huge beyond the tolerance that we could make owing to the inevitability of imbalances across federations and that we could depend on fiscal transfers as a last resort after all attempts to narrow the fiscal gap are accomplished, the writer found it proper to solicit means of empowering the states thereby reducing the dependence of the states on federal transfers. To that effect, a discussion is made in a better detail as to different alternatives of boosting the fiscal capacity of the states though most of them involve the difficult task of interpreting the constitution. It was found that it is the HOF that should take the lead to help states so that they would be relieved of federal grants though there are no effective steps taken by the house yet. Based on the major points that are raised above, here are some of my recommendations that need to be taken care of in the future.

RECOMMENDATIONS

It is imperative to note that variable to a grant formula should be available and comparable across units of government. It is difficult to accommodate all the expenditure needs of each region in the formula and doing so would complicate the matter and exacerbate the data problem that we have mentioned earlier. This is because we have now many variables in to the grant formula and it is impossible to open all doors with a single key. It would have been better if the especial expenditure needs of the states are channeled through other means than incorporating it in the grant formula. This is to argue that the grant formula should only be based on indicators that are shared by all regions and other specific region based expenditure needs should better be channeled through other means (such as conditional grants).

On the other hand, if the current Grant Distribution and Joint Revenue Sharing Formula Case Team of the HOF is not effective in discharging its functions effectively, we need to solicit other options to rectify the inconveniences. One proposal for the effective allocation of revenue transfer then is to formally establish and institutionalize a commission which is all inclusive of the regional states (equal representatives for each state to reduce the tension of different majority

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tendencies in the house that I have discussed above) and the house of federation in non discriminatory and equitable manner. The fact that it is all inclusive has also the advantage of internalizing politics in the commission owing to the identity of the members and they could deliberate even on political compromises to reach at an amicable decision.

The other option is to establish an independent commission which does not have any partisan relationship/influence. Such commission is especially required in cases when it is difficult to safely accommodate the interests of all regional states in an all inclusive commission. For instance, if few of the regions are controlled by opposition parties, the interest of such regions would not be accommodated because they would be dominated by the interests of the majorities of the ruling party representatives. In such and other similar cases when it is not possible to accommodate the interest of all stake holders, it is wise to establish an independent commission whose decisions would be acceptable for all parties. The word 'independent' should however be emphasized. The members of the commission should **define their role** that they are only there to give recommendations based on the technical findings they have reached through undertaking different studies without there being any tendency to solicit any political compromises. It is in that way that such commission could win the support of all parties to the revenue transfer. Most importantly, it is in that way it can escape the possible influences of the executive and the party discipline in the present Ethiopia.

On empowering the fiscal capacity of the states, it is in that way when there is an organ that is a custodial for enhancing the fiscal capacity of the states that we could cope with the prevalent huge fiscal gap in Ethiopia. One thing that should be emphasized, however, is that the current practice of the HOF of totally ignoring the issue of boosting the capacity of the states should be rectified in the future because it is one of the important mandates of the house as it is provided in its consolidation proclamation.

As far as some options of empowering the fiscal capacity of the states are concerned, we have indicated the ways through which we could bridge the fiscal dependence of the states without prejudice to their associated challenges such as their requirement to amend the Constitution. The first task and alternative we should sought is to study how far the states are capable of pursuing their revenue potential and what exactly is the gap between the revenue potential and actually

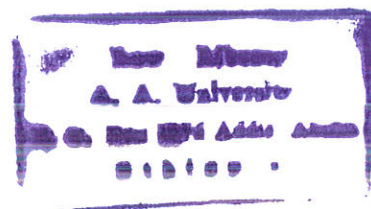
collected revenues of the states and devising different mechanisms to narrow the gap.²⁷⁹ It may be the case that the capacity problems of the states to collect their revenue sources could be principally responsible for the predominant dependence of the states on the federal transfer.

The second proposal to augment the capacity of the states is revisiting the FDRE Constitution. To that end, it was discussed in what ways revisiting the exclusive tax jurisdictions of the federal government would be beneficial and imperative to give more jurisdictions to the states such as returning revenues to the originating jurisdictions (without forgetting the associated risk of ousting the federal government from its redistributive role (of resources that are unevenly distributed) and impacts of the proposal on those states that do not have resources including exportable items), assigning the income tax from employees of public enterprises and international organizations to the regional state where they accrue their local benefits, and entitling the states to have a legitimate share to the federally collected taxes as it is practiced in India and Nigeria.

On undesignated power of taxation, the practice shows that the federal government is usually in the winning position of taking the jurisdiction especially when we consider instances where it has levied and collected it without the joint session of the two houses did not decide on it and this need to be adjusted in the future for the sake of the interest of the states. On the other hand, it is an appreciating practice that the states are allowed to collect and take all the proceeds of the VAT from unincorporated undertakings (individual traders) though the joint session of the federal houses required the federal government only to share the proceeds.

We have also commented on concurrent power of taxation and it should be adjusted that since the formula did not undergo revision since it was introduced once, the house should come up with other refined and well studied formulas that would take in to account the huge fiscal gap to live up to the expectation of its mandates to relieve the states from federal grants. On the other hand, although it may be justified to centralize the federal administration of the concurrent taxes, the states should have been allowed to accrue additional gains such as allowing them to levy and collect ToT from companies and partnerships. A proposal should also be made to assign levying and collecting of taxes from partnerships exclusively to the states.

²⁷⁹ The study team of the 2009 grant formula has roughly concluded that states are unable to collect more than 51% of their revenue potential on the average. See generally the 2009 grant formula, P. 24



If the administration of the concurrent taxes is alleged to have been given for the federal government for administrative convenience and if taxes from such enterprises (partnerships) could better be administered by the regions, there seems to be a valid ground for the states be entitled exclusive jurisdiction over taxes from partnerships. One should not also forget that partnerships, unlike companies, have in principle unlimited liability which places the states than the federal government in a better position to pursue the personal properties of the members of the partnerships (partners) as they are exclusively entitled to levy and collect taxes from private traders. On the other hand, even companies (especially private limited companies) that are not mobile should be reserved for the exclusive jurisdiction of the states.

The third means of soliciting to empower the fiscal capacity of the states that we have considered is the problem that we have witnessed on regional tax laws. For one thing, they should not take for granted the undesignated taxes that are taken by the federal government when they are not decided by the federal houses and also those provisions that tend to jeopardize even the exclusive tax jurisdictions. The fourth means was checking whether the states are entitled to impose their own tax rates at least on revenue sources exclusively reserved to them and we have considered the pros and cons of the practice of the federal government of favoring tax harmonization both in its activity and legislations without the Constitution clearly prescribing for that requirement. With all its limitations, however, it could be generally said that it is also possible to empower the states if they opted to levy the rates of the taxes within their exclusive jurisdictions and it is desirable to capacitate the states with the necessary man power and other resources so that they could deal the complexities involved in it. Strengthening intergovernmental relationships to deal with not seriously jeopardizing federal-state relationships should follow then to influence the states to adopt proximate tax rates as possible.

On the general pool dispersed to the states by the federal government and the role of the house, the practice that we have now is that the house does not have any role. The main reason for this is that the federal government has only taken the expenditure responsibilities of the states in to account while deciding the general pool compromising it with its other expenditures and the house is ill equipped for the task since it could only see the matter solely from the interest of the states. I argue that the constitutional requirement of unconditional grants to the states is meaningful when the federal government is mandated to act without its absolute discretion and

some sort of recommendation from the HOF is desirable. It is also the HOF that is constitutionally fitted to best protect the interest of the states.

State borrowing was the last alternative that we have sought to enhance the fiscal capacity of the states. The absence of detailed provisions on state borrowings either in the Finance Administration Proclamation (Proc. No. 648/2009) or non in Proclamation No. 591/2008 (A Proclamation to Amend the National Bank of Ethiopia Establishment Proclamation) would subject the states to stringent borrowing conditions by the federal government. Further, the fact that the states do not have enough revenue sources through which to secure borrowing makes it improper alternative. The practice also shows that they are only borrowing by discharging their share of the general pool as collateral for their repayment and it does not seem effective way of boosting the fiscal capacity of the states unless they are strong enough in collecting their own revenue sources or be given other sources in their favor.

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