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Table of Contents

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Chapter One
Introduction

1.1 Background

In recent years, there have been ongoing reforms in sub-national and central government roles in development planning and management. Of these reforms, decentralization constitutes an important part. It has been increasingly recognized that strengthening of sub-national governments is crucial for the growth of the public and private sectors.

Developing countries have undertaken decentralization as an escape from macroeconomic instability, inefficiency, ineffective governance and poor economic growth (R. Bird, 1998). In industrialized countries, decentralization was adopted to utilize public resources more effectively than before. Besides economic reasons, decentralization has also political basis because it has been implemented in reaction to pressures both from below and above. From above, governments have to adjust to pressures from international institutions like the World Bank and IMF. From below, people and groups organized along ethnic, linguistic and religious lines are demanding for more autonomy and self-governance. In former socialist countries, the motive sought via this reform was to further privatize so as to relive their strained fiscal situations

Thus, it is not surprising to note that decentralization meant different things to different countries. For some, it involves transfer of functions and resources only within the public sector while for others it means sharing of responsibilities and authorities with sub-national governments as well as non-governmental actors and the private sector. Thus, as Bennett (1989) notes, decentralization is a complex process that takes place in different mode and pace in different parts of the world.

An important dimension of such restructuring of intergovernmental relations is fiscal decentralization, which is nowadays being pursued by almost all countries for various reasons. In order to bring allocate efficiency, equitable distribution and macroeconomics stability, governments launched fiscal decentralization and conferred various degrees of revenue and expenditure responsibilities and power to lower tiers of government. As a result, sub-national governments are accounting for significant share of public sector activities even in former socialist countries (Bird, 1995).

Ethiopia has also been part of this globally ongoing readjustment process following the downfall of the socialist regime. Since 1991, major structural reforms have been taking place in the political, economic and administrative landscape of the country. Alongside reorienting its economic policy towards a mixed economy, Ethiopia has been undertaking a unique decentralization program forming sub-national states on the basis of ethnicity and common language. Such formation of ethnic federalism is accompanied by series of legislative acts stipulating the various powers and functions of both levels of government. Both in the 1991 National Charter and in 1995 Federal Constitution, the legal framework has been put in place to facilitate the decentralization of public finance. While it has resulted in a significant transfer of political and administrative power, decentralization does not appear to give lower tiers of government a sufficient degree of fiscal freedom. However, it goes without saying that sub-national governments should also have reliable and adequate resources at their disposal in order that they perform those functional responsibilities decentralized to them more effectively and efficiently.

Only then, many argue, would decentralization results in allocative efficiency, effective service provision, popular participation and initiative, and ultimately better macroeconomic performance. In general, the stated objectives of the decentralization reforms, particularly with respective to sub-national fiscal autonomy, are not forthcoming. Mismatch between sub-national government responsibilities and fiscal power is quite evident. The central tenet of this study is therefore to throw light on the patterns and trends of intergovernmental relationships with specific reference to financial relations between the Ethiopian central government and regional states, which were formed about 10 years ago.

1.2 Statement of the problem

Ethiopia has been a unitary sate for the most part of its history. However, following the overthrow of the military regime in 1991, the country has embarked on several political and economic reforms. After restoring peace and order in 1991, the Ethiopian Peoples Democratic Revolutionary Front (EPRDF) organized a National Peace and Democracy Conference and adopted a National Charter. This formed the basis for the establishment of the Transitional Government of Ethiopia and was followed by the 1995 Federal Constitution. The constitution recognizes nine regional states formed based on common ethnicity and language to be prime actors in development planning and management as well as administration within clearly defined territories. It also assigns vast responsibilities to regional states ranging from enacting and executing regional constitution and other laws to formulating and implementing policies, strategies and plans. It empowers regional states to levy taxes sand duties as well as prepare and administer state budgets. To that end, Article 5 of Proclamation no. 7/1992 divided revenues into three categories; those owned by (a) the Federal Government (b) States, and (C) shared between the two governments. Furthermore, regions receive subsidies from the central government and can borrow from domestic sources. In general, the shrinking role of the central government is apparent from the awesome responsibilities constitutionally assigned to regional governments.

Notwithstanding these constitutional arrangements, practice and studies show that regional states have not taken over those functions. Rather, central government ministries are dictating social and economic development policies and regulations (Cohen, 1995). Eshetu (1994) also remarks, "in the current attempt of fiscal decentralization, high expenditure is accompanied by low fiscal autonomy." For instance, in 1993/94 the revenue decentralization ratio was only 10% while that of expenditure was as high as 42%. More important is, however, financial autonomy which measures the degree to which local revenues finance local expenditures. This was 27 % in the above fiscal year. The latter is especially important because it signifies regional governments' independence from the central government (Eshetu, 1994).

Hence, under such a constrained financial situation, it is not plausible that regional states can discharge the bunch of responsibilities devolved to them. Such a high rate of dependence and fiscal imbalance would also lead to poor tax effort, inefficient resource allocation and poor service delivery. Generally, without optimum level of fiscal autonomy, decentralization is less likely to attain it stated objectives.

Yet, in 1993/94, the program was in its formative stage and much might not be expected at that early stage. However, presuming that fiscal decentralization improves with time, experience and institutional capacity, the present study aims at analyzing the issues over a period of seven years.

1.3 Justification of the study

In Ethiopia, decentralization was essentially designed to serve a political purpose, i.e., to maintain national unity and end decades-old civil war through self-governance and regional autonomy. Normally, there exists a logical relationship between fiscal and political independence, because finance is the means of realizing decision-making autonomy. Because weak fiscal power would gradually translate into weak political power, or vise versa, the study of fiscal dimension of the process is important as it provides an indication whether decentralization has achieved its stated objective or not.

After all, finance is a make or break factor in development as well as any decision-making. In this regard, an investigation of intergovernmental fiscal relations can greatly contribute towards our understanding of the existing reality in Ethiopian where political and administrative decentralization are meant to accommodate potentially explosive ethnic differences by bringing governance to the people. However, if such measures are not accompanied by measures that also raise regions' fiscal power the problem remains unmitigated from its root. Thus, the study is justifiable as it brings to light the existing intergovernmental financial relationships, focusing largely on their potentials and constraints. Moreover, the paper may provide an essential platform for policy makers when undertaking fiscal reforms to improve the existing fiscal arrangements between the two tiers of government. Finally, it would be a cornerstone for further analysis and discussion in the area.

1.4 Limitations and scope

It is generally acknowledged that the failure or effectiveness of a decentralization program is better assessed in terms of its impacts at the lowest possible level (*woreda* administrations in this case). Nonetheless, owing to time and financial constraints, this study focuses only on regional governments taking them as proxies for local governments for evaluating the degree of fiscal autonomy of sub-national governments. Due to the same bottleneck, generating primary data particularly in the regional states' decision-making power and resource utilization is impossible and that, admittedly, may reduce the validity and generalization of findings.

With respect to scope, the paper focuses on fiscal dimension of decentralization and does not dwell much on political and administrative aspects of the process. The period covered in the study is from 1993/94 to 2000. The year 1993/94 is a landmark because it is the first fiscal year regional governments are empowered to prepare their respective budget plans whereas year 2000 was selected for data availability reason.

1.5 Objectives and Research question

Objectives

The study will have the following set of objectives. These are:

1. To analyze patterns in sub-national revenue generation and expenditure from 1993/94-2000
2. To examine structure of the subnational governments' fiscal base.
3. To bring to light the evolution of intergovernmental fiscal transfer system in Ethiopia
4. To investigate issues and trends in subnational borrowing
5. To depict the subnational governments' fiscal position over a period of 7 years

6. To discuss the various repercussions of the present fiscal arrangements on the regional government, and based on the findings,

7. Suggest pragmatic policy recommendations that assist in policymaking and implementation

Research question

The analysis and discussion in this study spins around the following key research questions.

1. To what extent are subnational governments independent of central government influence in controlling public revenue and expenditure?
2. What is the trend of central-regional government fiscal relationships over the period 1993/94-2000?
3. Is there parity between responsibilities devolved to regional governments and the resources they control?

1.6 Methodology

A. Method of analysis and data:

The paper involves a balanced mix of description, presentation and quantitative analysis of figurative data obtained from Ministry of Economic Development and Cooperation (MEDaC), Ministry of Finance and any other relevant literature.

B. Level of analysis: The discussion and analysis of decentralization in this study is focused on the relationships between the federal and region governments

C. Indicators

Fiscal decentralization is a true measure of local autonomy because it indicates the extent to which sub-national governments are free to exercise independent decision-making in responding to the needs of their constituents. Hence, the following set of indicators will be employed to objectively assess regional autonomy. These are;

a) **Revenue decentralization ratio**: Share of sub-national government revenue in consolidated government revenue

b) **Expenditure decentralization ratio:** Share of local government expenditure in total government expenditure

c) **Modified Expenditure ratio: b-Debt Serve plus Defense**

d) **Coefficient of Vertical imbalance:** The share of total regional revenues and expenditures in the aggregate revenue and expenditure.

d) **Financial Autonomy Ratio:** Share of local government revenue in total local government expenditure

Chapter Two

Literature Review and Theoretical Framework

The past two decades saw a radical change in development thinking. The neolibral attack on dependency school and developmental states is in turn being challenged. The free market economy has not lived up to the expectations of neolibrals. Now the pendulum is swinging back and strengthening the public sector is top on the agenda of development discourse. The World Bank has recognized that the expected economic growth and human development are becoming questionable. Instead, political pluralism, good governance, public sector reform are gaining universal acceptance (de Jang, *et al*, 1999). Decentralization has then assumed an increasingly central position. Some countries opted for decentralization in response to mounting pressures from civil groups, local authorities and international institutions. Others undertook it to seek legitimacy of the state. In development debate, decentralization became a highly popular rhetoric. It is therefore as Bennett (1991) says, "… a topic which arouse interest and occasional excitement among academics but seemingly little concern among the public and practicing politicians."

What is Decentralization? Is there a universally agreed up on definition? Different authors held slightly different views about the concept. Generally, however decentralization may be defined as dispersing or distributing of power and authority form the center (Bennett, 1991). This definition however, lamp-sums all the institutional restructuring and various dimensions involved in the process. From institutional point of view, the question is to whom should power and authorities be transferred?" In response to this, some identify local governments and civil societies and NGOs while others include market. The conventional definition that decentralization means sheer transfer of political, administrative and fiscal power to lower level of government is therefore limited in scope. One should also distinguish among the various dimensions of decentralization.

2.1 Different viewpoints

The concept of decentralization, despite its considerable popularity and currency, has been a slippery one, meaning different things to different people (Bennet, 1990). Several authors offer different conceptualization and classification of decentralization. In what follows I will review the various schools under four categories.

The bases of this categorization is Randenelli's(1989) four fold classification of decentralization reforms. According to Rondinelli, any decentralization attempt can take one or more of the following four major forms: political decentralization, administrative decentralization; fiscal decentralization and market decentralization. The choice of such a typology is personal and therefore may not be considered conclusive or the best of other classifications.

Some authors make a distinction among various forms of decentralization only within the public sector and assign different functions to different levels in the government system. Others consider such a reform inefficient and ineffective when it comes to provision and production of public goods (Prud'homme, 1995). Still others advocate a form of decentralization whereby the state transfers certain responsibility to the private sector and civil societies (Helmsing, 2000). In adopting Rondinell's broader definition and classification of decentralization, I believed that the various schools in conceptualization and taxonomy of decentralization are accommodated and reflected upon.

2. 1.1 Political Decentralization

This from of decentralization deals with transfer of power from the state to the public and their organizations. It aims "to give citizens and their elected representatives more power in public decision-making political pluralism and representative governance." (Rondinielli, 1989). In addition to participatory policy-making, political decentralization has an advantage of promoting democratization through fair election of representatives from local jurisdiction, allowing citizens to know their representatives and officials. It gives the constituents a chance to know whether their desires and needs are fairly represented in the policy. Presence of favorable political atmosphere for development of pluralistic parties, constitutional reforms, strong legislative, formation of local political units and effective interest groups are key prerequisites for political decentralization (Rondinelli &others 1989)

Inman and Rublinfeld (1997), who categorize decentralization into fiscal, political and administrative components, judge political decentralization in terms of the degree to which political institutions map the diverse need and wants of the citizens onto policy decisions.

Wolman (1990) distinguishes among three forms of decentralization: political, administrative and economic decentralization. Wolman views political decentralization as being intimately related to administrative decentralization though the former refers to "the concentration or dispersal of political decision making, that is, the scope of discretion with respect to decision regarding policy issues". Policy issues here refer to policy regarding the volume of revenue to be raised and allocated.

Wolman (1990) identifies numerous politically desirable governance values two of which are responsiveness and accountability. Since decentralized structure brings governance closer to the people, there will be a convergence between policy decisions and public preferences. Moreover, it makes decision-makers to be held directly accountable to the local electorate through local election. Advocates of political decentralization add that political participation, education and good leadership can be sought if a government decentralizes its structure and decision-making powers to lower levels of government and to the public. Decentralized structure can also create a political environment of check and balance assuring countervailing centers of power and influence in a plural society (Wolman1990).

2. 1. 2. Administrative Decentralization

Administrative Decentralization is concerned with redistribution of responsibilities, financial resources and authority for provision of public goods among different levels of government (Rondinelli, 1989). Many of the decentralization literature seem to deal with such forms of decentralization. It is a shift of planning, financing and management responsibilities from the center to lower levels of government, quasi- autonomous public agencies or corporate regional or functional authorities. Such decentralization may take one of the following three forms: **deconcentration**, a **delegation** and **devolution**.

2.1.3 Deconcentration.

This is said to be the weakest form of decentralization. It is often undertaken by authoritarian states when restructuring their public sector. Deconcentration is the shifting of workload from the central government ministries or headquarters to line field offices, but without transferring discretionary power alongside those responsibilities. This may vary from sheer shifting of workload from officials in the capital to those working in lower tiers of the government, creating strong field or local administration under the supervision of the central government (Rondnelli,1989). Decentralization can be achieved either through field administration, where a better degree of freedom for planning, making routine decisions and adjustment of central government directives are transferred to subordinate staff outside the central government, or local administration, where local administrations are carried out via agents of the central government agencies.

As such deconcentration, though it does not involve power decentralization, enables citizens to better understand what the government does and therefore can enhance participation and adoption of innovative ideas. Others however argue that deconcentration is not decentralization at all. Flesler (1989) contends that although it improves efficiency and convenience of delivering public goods, as long as there is not much transfer of discretionary power there is no room for decentralized units for maneuver.

2.1.4 Delegation:

Delegation is a more extensive form of decentralization whereby the center transfer decision-making responsibilities and administration of public functions to quasi-autonomous institutions not entirely under the control of the government, but ultimately accountable to the central government. The location of such semi-independent organization can be outside the regular government structure. They also prove to be capable of handling their responsibility effectively and efficiently both in terms of capacity and technical know-how without central government supervision. Delegation thus entails shifting of broad planning and management authorities and functions to organizations like public corporations, regional and district planning authorities, single or multiple functional authorities and special project execution unit (Rondinelli, 1983 &1998).

Litvack, *et al* (19970) noted that such decentralization can be characterized as participial-agent relationship where the Principe, that is, central government wishes to get its activities done through the agent(local government or parastatal organizations). This has a distinct advantage because it allows for expedient decision-making which is free from bureaucratic red tapes and constricting procurement and labor regulations. Such organization can hire highly motivated and able personnel because they attract them using their special authority and independence. Efficiency is hoped to be sought through this mechanism. Foe example, they can be organized to undertake commercial projects in areas in which government has an important interest or where the private sector is relatively weak (Litack et al (1997); Rondenelli, (1983). Therefore, public corporations and special authorities can be quite broader in scope and more efficient in terms of resource allocation and service delivery.

2. 1. 5. Devolution

Devolution is a more extensive form of decentralization whereby authority to plan, manage and finance public functions is transferred to semi-autonomous organization or local governments. Here power is shifted from the central government to municipalities that elect their own council, raise their own revenue and make independent investment decisions (Litvack, et al 1997). According to Radinelli (1983& 1998) devolution is characterized by substantial degree of autonomy and independence of local government whereby they have clearly defined geographical boundary, clearly considered as a distinct level of government with a little or no central government influence. Second local governments must have a corporate status and the authority to obtain resources in order that they effectively undertake their functions. Thirdly, local governments must be considered as institutions providing public service over which the citizen can have some influence. Finally, devolution implies that there exists a mutually beneficial reciprocal relationship between the central and local governments.

Nevertheless, it is hard to find a devolutionary decentralization because in reality, local governments are given responsibilities over which the central government retains significant level of authority and supervision. All too often, using their resources and regulatory powers, central government make local governments act consistent to the national policies and priorities. This eventually reduces local governments to carry out what the center does not like to be involved in. Hence, theoretically, it sounds quite valid, but in practice, devolutionary or democratic decentralization rarely exists since as long as central government influences and control is can not be done away with.

Apart from local authorities, it is also possible to include the growing participation of non-state actors in the provision of public services. Thus, if real devolution is to take place, local governments should also integrate formal and informal structures of local governance (Olowu, 2001).

2.1.6 Economic or market Decentralization

This from of decentralization refers to a situation where functions that are previously carried out by the government are decentralized to market, semi- market and non-governmental organizations (Olowu, 2000). Rondinelli (1998) argues that privatization and deregulation are the most complete form of decentralization. The shift of responsibilities from the public to the private sector always take place alongside economic liberalization and private sector or market development policies.

Advocates of this school of thought are Bennet(1990) and Helemsing(1996, 2000) who conceptualize decentralization not only as a local government affair but as a process whereby state- market-society relationship is enhanced for better public goods and service delivery. This perspective is a significant shift in thinking in decentralization, which has traditionally been confined, to the public sector. According to this new decentralization thinking, the role of government is different form the traditional one. Instead of being a sole provider of public goods, the government plays the role of enabler so that other actors namely community and their organization as well as regulated market are empowered to contribute their share in the public goods provision. Each of these actors perform their functions according to their capacity and at different levels (Helmsing, 2000). Here, public goods are provided through public-private partnership between government and the private sector. Rondinelli(1998) characterizes both privatization and deregulation as components of economic decentralization. Privatization may mean provision of goods and services through free market, public- private partnership, out-contacting or allowing enterprises to perform functions that are traditionally performed by the state. It may also include delivering services by the private sector by way of the "divestiture" of state controlled enterprises. In the contrary, deregulation means reducing the legal barriers to the development of private sector in service provision. It allows competition among private suppliers to provide services and goods, which were previously delivered by the government (Rondinelli, 1998, Olowu, 2001).

In general, there is a growing consensus in the decentralization debate that decentralization should enable transfer of responsibilities to the market and non-government sectors. Deregulation and privatization have therefore been important options in the provision of basic services.

2.1.7 Fiscal Decentralization

Available literature in the area of fiscal decentralization reflect what Bennet (1990) calls intergovernmental decentralization i.e. decentralization of governance between levels of the government. In any case, financial responsibility is an essential subset of decentralization as local governments and private or semi-private organizations need to have adequate fiscal and revenue authorities in order to carry out their functions properly.

The central tenet of the intergovernmental school in the decentralization debate is which levels of government should take care of which public functions to ensure efficient allocation of public resources, macroeconomic stability and high level of employment as well as an equitable distribution of income and wealth (Oates, 1993). This school draws on the standard work of Musgrave's public sector responsibilities and delineates set of public functions to be performed by different layers of government. This framework of the welfare economy justifies state intervention (as opposed to free market) on the ground of macroeconomic stabilization, fair and just distribution of wealth and efficient allocation of resource when the market mechanism fails.

The Tiebout-Musgrave Layer Cake model of fiscal decentralization begins by advocating the existence of various levels of government, each level having its own legal position and set of responsibilities and resources (Helmsing, 1997). Here the local government is conceived as an entity that operates almost independently from the other level of government. The model then proceeds to allocate set of public responsibilities to those levels of the government. Accordingly, the model assigns the stabilization and distribution role of the government to the centre while local or subnational governments should take care of the allocation role of the public sector. The latter function is justified on the basis that decentralized units are in a better position in revealing public preferences and tastes (Javier Hauscar, 1996).

Charles, Tiebout argues that local government provision of public goods is more efficient than the central government because in such a system a consumer can choose among local governments a community whose fiscal package best suits his/her preferences.

Through such a mechanism, one can obtain a pseudo- market solution to the problem of efficient allocation of resources. If a given local government fails to produce local public goods that don't satisfy the demands and interest of its residences, individuals **vote with their feet**, allocating themselves between local governments depending on their preferences. More specifically, Tiebout argues that individuals select where to live by carefully balancing the mix of public goods they receive with the tax they pay. Rather than waiting for annual elections, people then move to other community that provides public goods suiting their interest and tastes. However, it is assumed that inter-jurisdictional mobility is cost-less and possible. One more contribution of Tiebout's model is that based on same argument, local government can't redistribute income because, with costless mobility such policies lead to social polarization. Redistribution polices can attract immigration of poor people and out-migration of the rich (Berglas, 1982 in Oates 1993). Consequently, Tiebout assigns the distribution role to the central government instead of leaving it to the decentralized units in a system of multilevel government.

In general, however two broad models of intergovernmental fiscal relationship can be distinguished. These are, according to Bird, and Vaillancourt (1998) **Fiscal Federalism** and **Federal Finance** Below, I will highlight some characteristics of these two models with a purpose of setting a theoretical framework for the present study.

2. 1.7 1 Fiscal Federalism and Federal Finance

Much of the literature on fiscal decentralization including the world Bank's publications is dominated by the traditional fiscal federalism orientation of the public finance approach which is highly driven by Musgrave's equity, suitability and efficiency principles (Musgrave, 1989). The Conventional Fiscal Federalism approach sets a normative framework where the central government exercise significant degree of influence in structuring the institutional rules governing the intergovernmental fiscal relations to make sure that local governments act as agents of the central government. It also presumes that the central government behaves as a 'benevolent interpreter' of the needs and preferences the citizen (Bird and Valliancourt, 1998).

An important authority in Fiscal Federalism is W. Oates (1993) who provides useful guidelines on the assignment of the central government roles. Britain and France are representative of such a pattern (Bennett, 1990). Here, a top-down framework for assessing fiscal decentralization seems to be appropriate. In this model, funds or transfers to the subnational governments are basically meant to promote subnational autonomy, but are subject to the guidelines and requirements of the central government (Bird and Vaillancourt 1998).

Contrary to the Fiscal Federalism model, what is called 'Federal Finance' grants a substantial degree of autonomy for local governments. The objective is not purely economic but political stability and national unity. Even in unitary governments, where geographic or ethnic differences are the rule rather than exception, this model is appropriate in designing intergovernmental fiscal relations. It is characterized by the presence of bargaining and negotiation between the two principals and in principle, there is no central government dominance. The right analytical framework in this case, in the words of Wheare (1969:10 in Bird 1998) is, "one of negotiation among equals". Equals here refer to federal and state governments, which engage in federal-province diplomacy when deciding on major fiscal matters.

The other important difference between the two models is that in the Fiscal Federalism model jurisdictional boundaries, functions or responsibilities and transfer are all subject to revision depending on the central governments wish to promote equity and efficiency. Nonetheless, in the Federal Finance setting, allocation of finance and boundaries are fixed and determined at some earlier times. Hence, under normal circumstances, these issues are not open to negotiation unless required by the constitution.

The model is predominantly adopted by those countries where the federal structure is principally meant to hold the nation together (Bird& Vallancourt, 1998). In contrast, in the Fiscal Federalism the central government can alter local government revenues, expenditure and other fiscal arraignments to pursue its redistribution policy and overcome the problem of information asymmetry. Here the appropriate analytical framework is a principal-agent model.

The two models highlighted above can be applied to assess fiscal decentralization in both developed and developing countries. Bird (1993) contends that the most appropriate normative framework for designing intergovernmental fiscal retaliations is the traditional fiscal federalism approach as set by Oates (1972). He adds that even if in few countries like South Africa, Pakistan and Argentina the theory is Federal Finance, practice shows it is Fiscal Federalism

Intergovernmental relations in developing countries are characterized largely by high degree of central government domination and low-substantial autonomy. Central government imposes several conflicting and at times unreachable rules upon local government, which are consequently over-controlled and fails to be efficient contrary to the central government's expectations. More often than not, the center unilaterally alters substantial government revenue and expenditure responsibilities. Under such a circumstance where the central-regional government relationship is that of principal agent, as already noted, Fiscal Federalism is deemed an appropriate theoretical framework to analyze fiscal decentralization in developing countries.

The case of Ethiopia is no exception. The policies and constitutional fiscal arrangements seem to reflect the Fiscal Federalism model or multilevel finance whereby some responsibilities are delineated to regional governments while other are retained by the center. Some degree of revenue decentralization is also apparent. Transfer-allocation formula is well in place, but subject to revision by the central government. The selection of the Fiscal Federalism model to analyze the intergovernmental fiscal relations in Ethiopia is therefore justifiable and in what follows, an overview of the model will be presented.

2.2 Theoretical Framework of the Study

Fiscal Federalism, in addition to identifying three economic roles of the government calls for a multilevel government structure. It then sets some rules to determine which tier of the government should do what and their sources of revenues. These rules are designed as a system paying due attention to the interface among the political, administration and fiscal institutions (Litvack, et al, 1997, World Bank, 1999, 2000). Assignment of expenditure, revenue, grants and sub-nationals borrowing are therefore the building blocks of the system of intergovernmental finance. This section deals with these components and outlines some principles governing their assignment.

a. Expenditure assignment

In determining expenditure responsibilities between levels of government, the following guidelines are provided by the fiscal federalism model (Shah, and Qureshi, 1994)

1. Public goods and services are efficient catered for if provided by "the jurisdiction having control over the minimum geographical area that internalize benefits and costs of such provision" (Oates, 1972 :25, cited in Shah, 1994). This enhances accountability, fiscal responsibility and efficiency on top of allowing government to be responsive to local needs and preferences.
2. Although local government provision of pubic goods ensures congruence of level and mix of public goods, due to factors related to spatial externalities, economies of scale and administrative and compliance cost some services need to be provided at central level.
3. For equitable provision of public goods, some level of decentralization is necessary because it reduces uneconomic inter-jurisdictional tax and expenditure competition. Moreover, since local governments are not effective in redistribution, the center should assume responsibilities in provision of some basic services. Local governments may however play an important role in implementing redistribution programs for targeting reasons.
4. Provision of Quasi Private Goods: For equity reasons and as the ultimate benefit of some services which are technically private goods accrue to the society, public

provision of those services like health, education, fire protection, social welfare, etc. is justifiable. Yet, the central government role, aside from setting minimum standards, is minimal.

5. Internal common market preservation: Sometimes sub-national units may put barriers to free flow of goods and services unless central regulatory measures are enforced. Hence, regulation of trade, investment and other economic activities must be centralized. But sometimes central government can also engage in policies hindering capital mobility without constitutional guarantee (Boaway, 1991, cited in Shah)
6. Finally, economic stabilization policies should not be assigned to lower government units due to problems of leakage of multiplier effects.

The following table provides a summery of conceptual guideline for expenditure assignment

Table 3.1 Conceptual basis for expenditure assignment.

Expenditure Category	Service responsibility	Provision of Services
Defense	F	F
Foreign Affairs	F	F
International Trade	F	F
Environment	F	S, L
Currency, banking	F	F
Interstate Commerce	F	F
Immigration	F	F
Unemployment insurance	F	F
Airlines/Railways	F	F
Industry and Agriculture	F, S, L	S, L
Education	F, S,L	S, L
Health	F, S, L	S, L
Social Welfare	F,S , L	S, L
Police	S, L	S, L
Highways	F, S,L	S, L
Natural Resources	F, S.L	S, L

Source: Adapted from A. Shah, 1991 "the New Fiscal Federalism in Brazil"

B. Revenue assignment

Once responsibilities are assigned to different levels of government, the next step is to determine how those responsibilities should be financed. Tax assignment therefore specifies which sources of revenue need to be levied and collected by which tier of government. Based on Musgrave's (1983) equity (consistency between revenue and expenditure responsibilities) and efficiency (minimum resource cost), Shah and Qureshi (1994) suggest the following broad principle for tax assignment:

1. Progressive redistribution taxes should be central
2. Taxes suitable for economic stabilization should be central; lower level taxes should be cyclically stable.
3. Taxes bases distributed highly unequally among jurisdictions should be centralized.
4. Taxes on mobile factors of production should be administrated at the central.
5. Residence based taxes such as sales of consumption goods to consumer goods or excise taxes are suitable for substantial governments.
6. Taxes, on completely immobile factors are best suited for local level; and
7. Benefit taxes and user change might be appropriately used at all levels.

Table 3.2Conceptual bases of tax assignment

Type of tax	Determination of		Collection and administration
	Base	Rate	
Custom	F	F	F
Personal income	F	F,S,L	F
Wealth taxes	F	F,S	F
Payroll	F,S	F,S	F
Corporate income	S,L	S,L	F
Excise	S,L	S,L	S,L
Property tax	S	L	L
Resource Tax	F	F	F
VAT	F	F	F
Retail sales	S	S	S
User Charge	F,S,L	F,S,L	F,S,L

Source: Shah and Qureshi (1991: 39)

Notes; F: Federal S: State/Province L: Local Municipal

It is generally apparent form that some taxes are determined, levied and collected by different layers of government. Nevertheless, such a vertical allocation of taxes can result in horizontal as well as vertical imbalances because not every region stands on equal footing in resource endowment to effectively carryout its responsibilities. To reduce such imbalance, tax sharing and intergovernmental transfer are employed by many federations.

C. Tax Sharing

As stated above, the vertical tax assignment principle results in mismatch between decentralized expenditure responsibilities and the resource base of sub-national governments. To fill in such fiscal gaps, governments engage in either tax sharing arrangements or revenue separation. Tax sharing arrangement refers to a situation where some taxes are levied and collected jointly by the two levels of government. Usually, the tax base is determined centrally while subnational governments levy, supplementary surcharges thereon (Musgrave, 1989, Shah, et al 1994). Then collection is carried out centrally which also shares it with the jurisdictions involved.

The other option is where subnational governments receive unconditional access to a certain share of centrally collected taxes. This often involves an agreed upon formula or criteria to redistribute the revenues to local governments (Helmsing, 1997). However, developing such an allocation formula is often complex and poses some conditions on eligibility and the use of such revenues (Shah & Qureshi, 1994).

D. Grants

Because jurisdictions are not equal in their resource endowment or due to pre-existing circumstances, inter jurisdictional fiscal imbalances arise in federally structured governments. Correcting for such a horizontal fiscal imbalance is a basic rationale for central government transfers besides narrowing vertical fiscal gaps, which arise out of in-congruencies between expenditure assignments and own-revenue (Ahmad, 1997)

The fundamental objectives of transfers are to close the vertical fiscal gap and compensate for horizontal fiscal imbalances. The later is important because jurisdiction vary in their capacity to finance their needs out of own revenues due to past circumstances or their may differ in the composition of their population. These can all trigger political instabilities if left unaddressed (Ehsetu, 1996). Bird (1998; 220-221) contends that for political reasons and to salvage national pride even those regions that are economically unviable should receive transfers and kept alive. Finally, as political boundaries may not always coincide with spatial coverage of service areas, inter-jurisdictional externalities may arise, making non-residents benefit without paying any cost. In this case, too transfers are necessary to compensate for efficiency loss caused by spill over.

Transfers may take a form Gap-Filling where they are related to real fiscal deficits of jurisdictions. This form of transfers however discourages local tax efforts. It also provides no incentives for efficient expenditure by lower levels of government.

Conditional transfers, where specific conditions are attached to funds, are very popular but reflect only central government interest and objectives, undermining local priorities. It has also a disadvantage that poorer regions may not be in a position for such grants as sometimes it requires matching funds which such jurisdictions can't provides. While it ensures minimum standards of services, this kind of grants poses some administrative costs on both governments (Ahmad, 1997). The final form of such a central government allocation is Equalizing Transfers, which normally are designed to address horizontal imbalances. It takes the form of Unconditional or General-purpose grant. It also helps to reduce or close a vertical fiscal gap. There are several variants of this type of grant.

In general, there are a number of other ways of classifying transfers and the above is just one of them. It is also worth noting that the basis for designing depends on government policy objectives and should take into account institutional framework, simplicity, incentives, revenue capacity, expenditure needs and the like considerations.

E. Borrowing

A final means to close fiscal imbalances is loan finance. Based on the benefits principle, it is efficient for local governments to finance their capital investment as long as the benefits accrue over a period of time in the future. Thus, it is conceptually sound if such projects are finance from loan funds as it significantly promotes local development. It also provides an incentive for local authorities to mobilize local resources and design better cost recovery mechanisms. Therefore if local governments need to contribute towards their development, borrowing is conceptually an option to increase their spending capacity (Shah & Quereshi, 1994).

Nevertheless, one major issue in sub-national borrowing is whether local authorities are allowed to have access to capacity market at home or abroad. Experience demonstrates that local government borrowing is possible from international agencies and domestic sources just like borrowing from local authorities own funds (Helmsing, 19997). However, as a rule subnational borrowing should be discouraged as it impedes the stabilization role of the central government. Especially in growing economies, domestic borrowing should also be consistent with central government effort to stabilize the economy and hence needs to be assessed from this perspective.

The conclusion in this regards is therefore "subnational governments can be permitted to borrow but a great deal of caution is required." Unchecked subnational borrowing particularly those dependent on transfers may increase current expenditure above their capacity to finance them out of their current revenue." Litvack, et al, 1997. Some however argue that local government borrowing should be restrained as it exacerbates cyclical pressures, thereby adding additional burden on the central government to service debt (Terminassian, 1997, cited in Litvack, et al,)

Chapter Three

The political Economy of Decentralization

Ethiopia is one of largest country in Africa with a total population close to 60 million. Before the present multi-ethnic and geographically diversified state of Ethiopia come in to being, the country experienced series of wars of conquest and expansion, which eventually culminated in the creation of the empire state of Ethiopia towards the end of the 19th century.

3.1 Historical perspective

For the most part of its history, Ethiopia had been a country of absolute monarchy and totalitarian rules, with the emperor at the apex of power. Nevertheless, owing to difficulties in communication and absence of modern administrative apparatus, individual governors had enjoyed relative autonomy. Once they paid their expected tributes to the imperial household, the local administrators were free to exercise relative autonomy with respective to local affairs.

As the nation building process continued during the reign of emperor Minilik, a more centralized mode of government started to deepen its root. Minilik sent his expansionist forces to the southwest and eastern part of the present Ethiopia who eventually turned into administrators of the newly incorporated regions. Politically, this was accompanied by forceful conversion of the people in the conquered areas to Christianity and institutionalization of the new system of cultural and linguistic domination. Consequently, the vanquished become tenants and subjected to all form of supervision by the then ruling Amhara ethnic group. This set a ground for age-old ethnic conflict and at times persistent demand for independence in the country. The power struggle in the Ethiopian politics is therefore characterized as interplay of centripetal forces of consolidating the role of Amahara and the opposite centrifugal forces to end a one-ethnic group domination and thereby establish self-administration.

It was during the reign of emperor Hailesllasie that a modern administrative structure was established. After assuming power, the emperor took series of steps to materialize his centralization drive, which was said to be the highest level of centralized administration. As Asmelash remarks:

> *When Haileseillasie came to power, he centralized power in his person to an extent hitherto not experienced in the country's history. In his 1931 constitution and subsequent administrative regulations as well as the revised constitution of the 1955, he shared away power from regional notables, who were reduced to simple government employees serving at the pleasure of the emperor(Asmelash, 200).*

The 1931 constitution and its 1955 revised version did not change the emperor's absolute privileges, rather they legitimized his reign and absolutist rule. Accordingly, the power and administration were so centralized by the emperor that he involved himself in all petty details of government. This was a point of concern for a number of students of Ethiopian politics before the 1994 revolution (Demissie, 1999). Administratively the country was originally divided into 12 *teklaigizat* (regions) which later increased to 14. The provinces had three administrative layers: *Woreda* (District), *awrajas* (province) and *Teklaigizat*. With the split of Hararge into Bale and Hararghe as well as incorporation of Eriterea the number of *Teklaigizats* reached 14 while *awrajas* were 99. The 14 *Teklaigzats* were composed of 444 *woredas*. The lowest tier of administration, was represented by the landed gentry (*balabats*) who were responsible for keeping law and order as well as levying and collecting tax. They were supported by the various enforcement bodies of the state. However, as the educated civil servant increased both in number and importance, after 1940's the aristocracy witnessed a gradual erosion of power. Centers of power were created in various regional nobility. A conflict was set in motion between the nobility and the church on one side and the bureaucracy (the new product of the western training) on the other. This contradiction between the conservative social groups and the bureaucracy is said to be a distinguishing feature of the emperor's reign in the post World War II Ethiopia (Markakis, 1974, Clapham, 1969; cited in Demissie, 1999).

In general, the imperial rule was characterized by centralization and authoritarian administration, with regional governors being appointed by the center. The 14 *teklay* gizats were administered by governors directly assigned by the emperor. It was a period of steady diminution of the power and autonomy of the previously dominant and powerful social groups. The state extended it repressive machineries in both rural and urban Ethiopia. Delegation of specific responsibilities to regional governors was quite apparent (Meseret, 1996)

The imperial system had however been reluctant to address the problems of unjust land tenure system and nationality question. State oppressive machineries harshly crushed protests and movements of nationality groups. Unable to live under such an exploitative and totalitarian system, challenges against the system gathered momentum. Common among such pressures are the peasant up rise in Bale *teklaigizat*, the *woyane* rebellion of 1943, the Eritrean war of liberation, and the 1975 woyane (the currently ruling group) resistance movement in Tigray.

From 1960's onward, more and more pressures were put on the imperial regime, demanding itself-governance and decentralized administration. As a result, some early attempts at decentralization were made at *awraja* (Sub-province) level by legal order No 43 of 1966. The legal order establishes a system of elected *awraja* administrative council that deals with affairs occurring within their jurisdiction. The proposal however failed for two reasons. First, there was no sound policy framework to implement the reform. Second, the parliament, who perceive the measure as instigating secessionist tendencies and undermining national unity, did not accept the legal order. No significant move towards decentralizing power had been made since then (Tegegne, 1997, de Jang, 1999).

In 1974, the monarchy collapsed without addressing any of the above problems. A combined force of the military, students, farmers and other segments of the society set the 1974 revolution in motion to end decades-old exploitation and political alienation. The power was immediately taken over by a military junta (Dergue). The revolution was meant to give an end to age-old suppression and exploitation. The military rule then took series of radical reforms that transferred land to the landless peasantry and urban housing to the urban poor. These developments marked a major breakthrough. Concomitantly, the government created local administration through *kebeles* and urban dwellers Associations (UDAS). The purpose was for mobilization and implementing the proclamations. Nonetheless, the new government, which adopted a socialist ideology of democratic centralism; did not resolve the persistent nationalist-based movements and demand for self-administration. Rather through top down approaches it restructured the government administrations conferring certain responsibilities to the newly created organs. The *Kebele*s (neighborhood associations) were responsible for handling local matters and implementing of land reforms, whereas the UDAs were given the power to hear localized civil disputes, minor criminal cases, collect house rent and property taxes, maintain nationalized building and small business (Meseret, 1996)

In response to mounting pressure for self-administration and nationality problems, the Derge proclaimed a new constitution in 1987. The new constitution, paid special attention to the nationality problem, proclaiming Ethiopia as a civilian state where all nationalities live in equality. It insures equalities of ethnic groups while at the same time fighting narrow nationalism and chauvinism. The constitution shows the commitment of the government to eliminate enter-ethnic disparities in economic development paying close attention to backward nationalities. Besides, the constitution attempted to address the nationality problem by granting autonomy to some regions based on common ethnic, cultural and economic backgrounds. Accordingly, the country was divided into 5 autonomous regions and 24 administrative regions. The five autonomous regions include Eritrea (now an independent country), Tigray, Assab (Afar area), Dire Dawa and Ogaden (inhibited by Somali ethnic group. Except exercising some degree of power in relation to language and culture, there had not been much difference between administrative and autonomous regions. Therefore, the proclamation didn't achieve its end in decentralizing power from the center to lower levels. Several reasons can be mentioned for the failure of this decentralization attempt. According to Asmelash(2000);

> *Right form the beginning, the impetus for granting autonomy came form the pressure war in Eritrea rather than out of genuine attempt to solve the nationality problem. There was no readiness to apply the "principles" of regional autonomy to all nationalities. The major nationalities of oromo and Amahara did not benefit form the new reform (Asmelash, 2000, 127)*

This is a clear indication that the military regime was not willing to commit itself to genuine decentralization, responding sincerely to the persistent demand for self-administration by ethnic group. The government was reluctant to grant full autonomy because of the latent danger involved in the long-run. Meanwhile, Derg was increasingly aware that it is not possible to crush down all the opposition movements through military means. However, the Tigiray People's Liberation front entered into a military alliance with Eritrean liberation fighters, who are already with established fighting record. Through such a joint armed struggle, the military regime was over throw in 1991. Since then, major political, administration and economic transformation have been taking place in Ethiopia. The downfall of the military rule marked the end of central planning and reorientation of the country's economy towards marked-led economy. The structure of the government was also changed from unitary to federal system composed of regional states.

These changes were set in motion after a national peace and Democracy in July 1991. The conference, involving all the liberation fronts and opposition groups in the country, adopted a charter for the transition period. This interim constitute laid a foundation for political pluralism, right of ethnic groups to self-administration, freedom of organization and expression of ideas; the right to use own language and, the right to establish an independent judicial system. These were enacted through series of proclamations. One of this proclamations is proclamation No 7/1992, which provides for the establishment of national/ regional self-governments. Article 2 of the interim constitution "guarantees" the right of nation, nationalities and peoples to self-determination. Moreover, it grants each nation, nationality and people the right to administer their own affairs within their own defined territories and effectively participate in the central government on the bases of freedom, fair and proper representation. Yet, the extent to which nations and nationalities have taken advantage of the opportunity and established the fought for self rule remains to be seen. The following chapter deals with this matter basing its analysis on empirical evidences.

Chapter Four

Analysis and discussion

Decentralization in Ethiopia is basically designed to serve a political purpose. As such it appears quite evident that regional states are enjoying great latitude of political autonomy. Nonetheless, delineating functions or administrative responsibilities alone is not a guarantee for a decentralization measure to be successful. It is therefore axiomatic that decentralization should also result in a considerable degree of fiscal and administrative independence over and above political autonomy.

In this section, an investigation of an intergovernmental fiscal relations is made to judge if decentralization in Ethiopia has resulted in subnational autonomy in terms of decision-making power related to resource control. The analysis is made under four sub-sections and in the following sequence: Revenue, expenditure, intergovernmental transfers (subsidies) and subnational borrowing.

4.1 Revenue Decentralization

One of the fist and critical steps towards a genuine decentralization is to clearly articulate the fiscal relations between the levels of government. This involves allocating sources of revenues that enable both central and subnational governments to effectively carry out their respective responsibilities. In this regard, it appears that essential elements of fiscal decentralization have been enacted through a number of legislative and constitutional provisions. One of such laws is Proclamation No. 33/1992 (TGE, 1992/b) which provides for tax base and revenue sharing between the central and regional states. This was meant to enable regions to successfully accomplish their new responsibilities, enhance local initiatives, reduce inter regional disparities and promote activities whose significance cut across regions. Accordingly, revenue bases are allocated between the Federal and regional governments based on the following considerations: regional or national nature of the revenue source, ownership, capacity to levy and collect, population, level of development, equity and balanced growth issues.

The following table summarizes revenue allocation as provided by the above proclamation and articles 95, 96 and 97 of the 1995 Federal Constitution.

Table 4.1 Revenue assignment between levels of government

Federal government (article 96)	**Regional government (article 96)**
1. Custom duties, taxes and charges on imports and exports 2. Income tax from federal government, international organization employees 3. Income tax, sales tax and excise tax on federally owned enterprises. 4. Taxes on proceeds on national lotteries and other games of chances 5. Taxes on income of air, rail and sea transport services 6. Taxes on rented income of houses and properties owned by the federal government 7. Federal government issued license fees and charges 8. Taxes on monopolies 9. Federal stamp duties	1. Income tax from state and private enterprise employees 2. Fees for land use rights 3. Income tax on private farmers and cooperatives 4. Profits and sales taxes on individual traders 5. Taxes on income from inland water transportation 6. Income taxes from state owned houses and other properties 7. Profit, sales, excise and personal income taxes of state owned enterprises 8. Consistent with provisions sub-article 3, income taxes from mining operations, royalties and land rental 9. Fees and charges from state issued license and services rendered by the State 10. Forest royalties
Jointly-owned sources of revenue 1. Profit tax, sales tax, excise tax and personal income tax 2. Profit taxes from companies and share holder dividends 3. Income taxes from large scale mining petroleum, gas operations and royalties	

Sources: Article 95, 96 and 97 of the Federal Constitution of Ethiopia.

It is quite evident from the above table that the Federal and Regional governments are assigned specifically delineated revenue bases. Tax base sharing and revenue sharing arrangements are therefore well articulated and enacted by legislative and constitutional provisions. Although this is a good step towards fiscal decentralization, a critical look into these laws reveals that there are contradictions in the design itself. For example, Proclamation No. 7/1992 gives an irrevocable right to regions in levying and collecting taxes assigned to them. However, Proclamation no.33/1992 puts a restriction on regions since it requires a uniform determination of tax rates by the federal government.

> *To avoid cascading incidence effect of the taxes levied by the center and regions and to enable harmonization implementation thereof, the tax system shall have a unified policy base... The Ministry of Finance, ensures that the tax laws at both levels adhere to the provisions of Sub-article 1 of this Article.*

Thus, one would argue that regions do not have full autonomy even over the resource base designated to them by constitution. Besides this is a clear deviation from the principles of Fiscal Federalism because the theory states that tax rate determination of those taxes belonging to the subnational government should be decided upon by both parties and not by the federal ministry like in the Ethiopian case.

A more interesting feature of the above revenue allocation is that the federal government has delineated for itself more productive and buoyant revenue sources. Given the structure of the country's tax system, the adequacy of revenues assigned to the regions is questionable especially in view of the numerous responsibilities decentralized to them. Although the federal government's share of revenue always exceeds that of subnational governments in any federally structured system, the Ethiopian case represents heavily biased tax assignments. An inevitable outcome of such a system is wide fiscal imbalance, which may have far-reaching repercussions.

On the other hand, the constitution provides that any residual tax base should be decided upon by the House of Federation and House of Peoples' Representative. This is important because it means the central government has no supreme right to collect any residual taxes. Obviously, there are a lot of such revenue bases yet to be determined as the constitution is not exhaustive. These may include recreation taxes, VAT, motor vehicle taxes and the like. Thus, in this respect the above provision is very important in the evolution of tax system between the two levels of government. It is also worth noting that a large proportion o the economy operates in the informal sector and hence there is a high potential for new tax sources. Regarding the allocation of joint revenues, the central government collects and shares them with regional governments. The ratio is 50:50 and 70:30 for direct and indirect taxes, respectively.

The following table illustrates composition and trends in federal and regional government revenues over a period of 7years. .

Table 4.2 Federal and regional government share of revenue from 1993/1994 to 1999/2000

Revenue Category	1993-94			1994-95			1995-96			1996-97		
	Federal share	Regional share	Total Revenue (mln. Birr)	Federal share	Regional share	Total Revenue (mln. Birr	Federal share	Regional share	Total Revenue (mln. Birr	Federal share	Regional share	Total Revenue (mln. Birr
Direct Taxes	55.5	44.5	945.216	59.6	40.4	1311.592	64.5	35.5	1753.862	61.2	38.8	1906.409
Indirect Taxes	88.2	11.8	834.14	87.0	13.0	945.5087	82.1	17.9	1155.592	82.1	17.9	1289.443
Excise Tax on Locally manf.Gds.	99.9	0.1	274.281	99.9	0.1	367.565	99.9	0.1	459.5	100.0	0.0	523.806
Sales Tax on Goods	87.4	12.6	436.286	81.8	18.2	403.5337	74.9	25.1	495.805	73.0	27.0	543.2537
Service Taxes	80.5	19.5	44.7	84.1	15.9	67.639	77.1	22.9	76.213	81.8	18.2	97.22447
Stamp Sales & Duty	56.5	43.5	78.873	64.1	35.9	106.771	47.6	52.4	124.074	47.5	52.5	125.1592
Foreign Trade Taxes	99.1	0.9	1297.161	100.0	0.0	1621.624	100.0	0.0	1813.937	100.0	0.0	2163.485
Non tax Revenues	81.0	19.0	862.278	88.5	11.5	2034.023	86.7	13.3	2242.707	84.6	15.4	2523.205
Total	82.3	17.7	3938.795	85.0	15.0	5912.748	83.8	16.2	6966.091	82.8	17.2	7882.543

Revenue Category	1997/98			1998-99			1999-2000		
	Federal share	Regional share	Total Revenue (mln. Birr)	Federal share	Regional share	Total Revenue (mln. Birr)	Federal share	Regional share	Total Revenue (mln. Birr)
Direct Taxes	54.3	45.7	1863.958	56.4	43.6	2008.762	58.2	41.8	2366.724
Indirect Taxes	80.7	19.3	1187.454	83.0	17.0	1204.349	81.1	18.9	1439.26
Excise Tax on Locally Manf.Gds.	99.1	0.9	415.514	99.4	0.6	419.93	99.6	0.4	433.6329
Sales Tax on Goods	74.0	26.0	533.2949	75.0	25.0	503.89	72.7	27.3	652.8852
Service Taxes	82.4	17.6	124.1703	86.0	14.0	174.294	89.7	10.3	232.88
Stamp Sales & Duty	43.0	57.0	114.4745	51.6	48.4	106.235	43.3	56.7	119.8606
Foreign Trade Taxes	100.0	0.0	2234.08	100.0	0.0	2378.52	100.0	0.0	2675.79
Non tax Revenues	83.4	16.6	3096.817	87.7	12.3	3860.221	87.0	13.0	3666.433
Total	81.0	19.0	8382.309	83.5	16.5	9451.852	82.9	17.1	10148.2

A number of interesting observations can be drawn from the above tables. The following are outstanding ones:

For regional governments, direct and indirect taxes are the first and second most important sources of revenue, respectively. Of direct taxes, the personal income tax and business profit tax are the two major revenue sources followed by agricultural income taxes and land use fees. On average the regional share of the above two major revenues, namely direct and indirect taxes, have been 41.5 and 16.5 percent. Regional share of the latter has however increased from 12 to 19% over the period under consideration.

On the other hand, for the federal government, foreign trade taxes are by far the most lucrative sources of revenue. Here, regions' share was almost nil. Over the period, the central government has also generated significant proportion of direct and indirect revenues. Central government share of these two revenue categories has been more or less constant.

Regional share of non-tax revenues is found to be minimal. The maximum proportion of such revenues collected by regions is 19% and that was in 1993/94. Since then, the central government continues to appropriate the lion's share of none tax revenues, particularly those generated from privatization proceeds, government investment income and extraordinary revenues. These are revenues that belong to the central government not by design but by default because there is no mention of such revenues in the constitution whether they belong to the center or regions.

As a result, the federal government owns disproportionately high share of public revenues as it controls almost the entire foreign trade taxes and non-tax revenues which constitute about 1/3rd and more than 35% of aggregate revenue, respectively. Although the Constitution provides for the sharing of revenues generated from large-scale mining and petroleum and gas operations between the central and regional governments, it has been learnt that there is not much revenue to be raised from such activities. This in itself requires large-scale survey and active private sector participation, both of which are at their infancy at the moment.

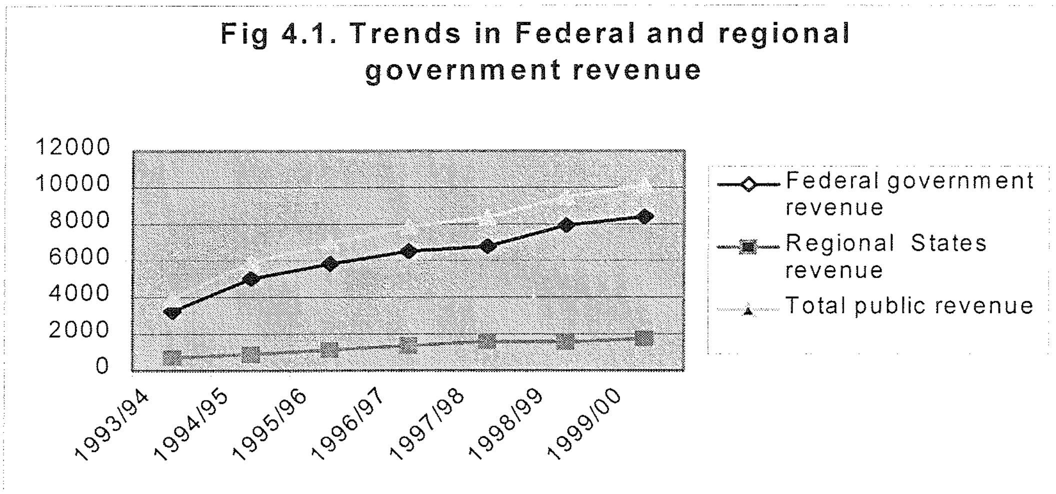
Therefore, in general one major conclusion regarding revenue is that the Federal government controls a considerably high volume of aggregate tax revenues, putting sub-national governments in a weak fiscal position over the period, resulting in a very high fiscal imbalance.

Of course, because of its stabilization and distribution roles, the central government is entitled to a larger share of public revenues. Nevertheless, such a pronounced imbalance may result in a) poor public service provision; and b) high degree of dependence by regional states, both of which stand against the very objectives of decentralization. If governments decentralize responsibilities without adequate resources, international experience suggests that services fall or deteriorate or local governments press for more transfers or loan from the federation (Litvack *et al*, 1997). A high degree of dependence obviously leads to low tax effort by local governments, centralized decision-making and federal domination in setting development priorities and areas of investment. In such a situation, decentralization does not only fail to serve economic purposes but it even fails to achieve its political objectives which it is designed for because low fiscal autonomy is likely to translate into weak political independence. Hence, the increasing trend of federal control has to be rectified.

As already noted, the principal reason for regions' excessive dependence on central government transfers has to do with the unbalanced constitutional allocation of tax bases. Federal government has been assigned more productive tax bases like foreign trade taxes, which nearly account for 27 % of aggregate tax revenues in the country. Therefore, a restructuring of tax bases is in order to improve the currently unbalanced distribution of revenue sources between the federal and regional governments.

In terms of revenue decentralization therefore, it can be argued that the share of sub-national governments' revenues in consolidated government revenue is considerably low and no meaningful improvements has been witnessed over the past 7 years. In fact, after

1997/98, shortly before the war with Eriterea broke out, regional governments share of revenue has been declining. In general, as can be learnt from the previous table, regions have never accounted for more than 20 % of public revenue ever since they were formed. Instead, the gap between federal and regional government revenue has been widening. Regionally generated revenue have never accounted for more than Birr 2000 (20 %) millions while that of central government grew from Birr 3242 million to more than 8400 in 1999/2000.



In sum, it is clear from the foregoing analysis that regional governments feature a very weak fiscal position in terms of controlling public revenue. This, as will be seen later, is a principal cause for the high degree of vertical imbalance, which is one of the characteristic features of the Ethiopian fiscal decentralization.

4. 2 Expenditure decentralization

Contrary to the previous regimes, the contemporary government has transferred quite considerable expenditure responsibilities to sub-nation governments in Ethiopia. Like I the revenue case, this was also enacted through legislative and constitutional measures. Accordingly, the constitution assigns the following set of responsibilities to regional states.

- Preparing, approving and implementing their own recurrent and capital budgets.
- Establishing, directing and monitoring social and economic development programs

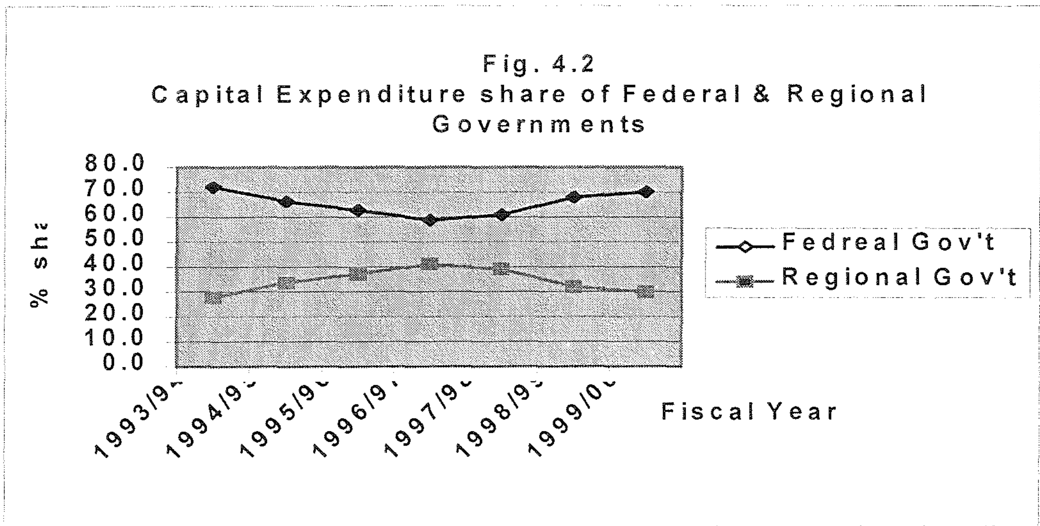
- Administration and preservation of natural resources
- Maintaining regional peace and order and establish regional police force
- Owning and controlling resources and properties of regional nature
- Owing properties and transfers of properties
- Formulating and executing civil service laws governing regional civil servants and their working conditions,
- Determining taxes and raising revenues from local sources, and
- Other activities not reserved for the federal government.

Similarly, responsibilities falling within the realm of the federal government include foreign affair, defense, national economic policy, conferring of citizenship, declaration of state of emergency, army deployment, printing currency, establishing and administering cardinal development programs and communication networks.

In addition, according to Article 94 of the Federal Constitution, it is the duty and responsibility of regions to plan and execute their respective policies, but with emergency, rehabilitation and development assistance of the federal government. It also emphasizes that the federal government has the power to audit and inspect utilization of grants.

The above delineation of responsibilities seems to be informed by the guidelines set by the Fiscal Federalist framework. Nonetheless, allocation of functions alone is not a guarantee for the efficiency gain and effective off-loading of spending responsibilities. Careful attention therefore needs to be paid to learn if the policy has been translated into practice. From the above list of activities, one may conclude that the government has decentralized almost all responsibilities that belong to lower levels and retained those that are naturally performed at the federal level. But, considerable expenditure devolution should accompany such a considerable shift of responsibilities.

Trends in sub-national expenditure patterns however tend to reveal that state governments' share of public spending is low especially as compared to a bunch of responsibilities entrusted to them. The following figure demonstrates the fact that the federal government still dominates public expenditure through it central ministries.



As can be seen from Fig. 4.2, the percentage share of public capital formation by regional government has been very low. The trend for regions had been rising until 1997/98, but started falling for the subsequent years. This has probably to do with the Ethio-Eriterean war, which broke out in 1998. During the war, the government increased its defense expenditure and consequent public investment was considerably low. Until 1997/98, public sector capital expenditure was steadily rising. Nonetheless, it stagnated in the FY 1997/98 and began to decline for the subsequent years. Therefore, one would argue that regional governments' share of public capital formation, which is one measure of subnational fiscal autonomy, is not significant. Even in those investment areas where local governments play an important role such as social development, it is found that the federal government increasingly encroaches on regional sates' responsibilities, especially after 1997/98. The following table reaffirms the above assertion.

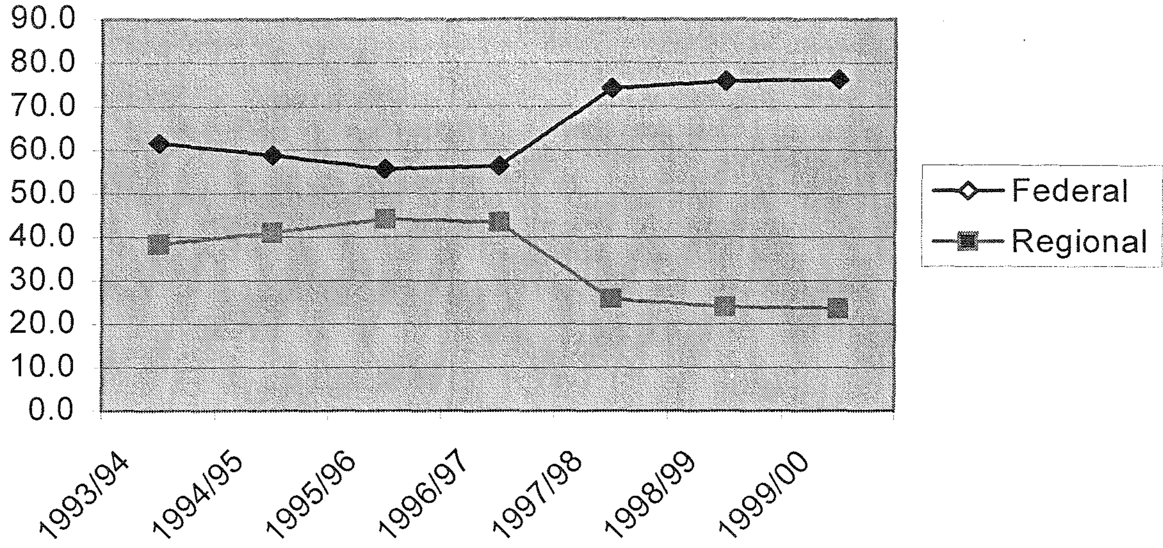
Table 4.2 Federal and Regional States Share of Capital Expenditure

Investment area	FY 1986 (1993/94)			1987 (1994/95)			1988 (1995/96)			FY 1989 (1996/97)		
	Federal share	Regional share	National Total*	Federal Share	Regional Share	National Total	Federal Share	Regional share	National Total	Federal share	Regional share	National total
ECONOMIC DEVELOPMENT	81.9	18.1	1974.905	73.1	26.9	2446.503	68.3	31.7	2618.735	67.3	32.7	3158.421
SOCIAL DEVELOPMENT	42.6	57.4	620.8635	39.3	60.7	507.4591	46.6	53.4	712.0451	26.6	73.4	694.4336
GENERAL DEVELPOMENT	61.8	38.2	98.5693	51.0	49.0	202.5123	49.5	50.5	231.8676	45.4	54.6	315.593
TOTAL	**72.1**	**27.9**	**2694.338**	**66.2**	**33.8**	**3156.475**	**62.8**	**37.2**	**3562.647**	**58.8**	**41.2**	**4168.448**

Investment area	FY 1990 (1997/98)[1]			1998/99[1]			FY 1992 (1999/00)[1]		
	Federal share	Regional share	National Total	Federal share	Regional share	National Total	Federal share	Regional share	National Total
ECONOMIC DEVELOPMENT	63.9	36.1	2379.303	70.4	29.6	2909.79	71.31	28.7	2104.3
SOCIAL DEVELOPMENT	37.2	62.8	950.629	49.2	50.8	931.04	53.68	46.3	614.236
GENERAL DEVELPOMENT	50.2	49.8	362.5053	51.1	48.9	418.32	56.08	43.9	333.088
TOTAL	**60.9**	**39.1**	**4187.437**	**67.9**	**32.1**	**4790.15**	**70.07**	**29.9**	**3456.324**

- National totals are in millions of Birr.
- [1] pre-actual

Fig. 4.3
Percentage share of Federal and Regional government reccurrent expenditure



A number of interesting features can be identified here. Primarily, like in the case of revenue and capital expenditure, the federal government accounts for the larger share of recurrent expenditure. Interestingly, the gap was narrowing until 1996/97, but it suddenly began to widen. For the subsequent three years, the share of regional governments gradually went down. Again, this can be somehow attributed to the war which resulted in low pubic spending as more and more funds were spent on defense. But still, it is interesting to note that fiscal decentralization in Ethiopia is characterized by a relatively higher degree of expenditure decentralization than revenue decentralization. In a comparative perspective, Ethiopian expenditure decentralization ratio, which on average has been 0.34, is still much higher than that of many developing countries (Nigeria, Zimbabwe, Kenya, Ghana, Brazil and Pakistan) and industrialized federations like Germany, Canada and UK.

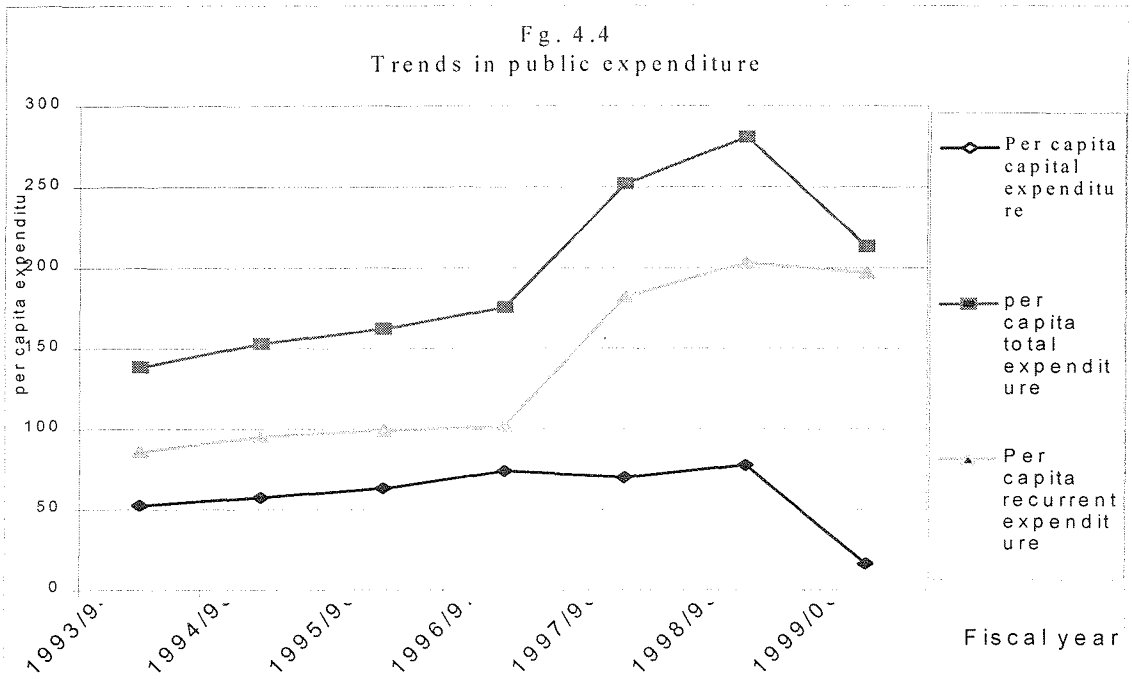
If one measures decentralization in terms of modified expenditure decentralization ratio, whereby defense and debt service are excluded, on average regions share increases to 45%, which is still very high. Nonetheless, this may not essentially mean high fiscal autonomy of regions because those funds come from the central government with all the obligatory strings attached to them. In this respect, financial autonomy ratio provides a better indication of how independent subnational governments are from federal funding. It measures the percentage of locally raised revenues in total local government expenditure. This appears to be a reasonably true measure of fiscal autonomy. By this measure, regions' autonomy was found to increase from 21.7% in1993/94 to 35% in1997/98, which suddenly dropped to 28 and then rose to 32%. On average over the period, subnational governments could finance less than one-third of their total expenditure from own revenues. The rest was covered by federal subsidies and this put Ethiopia among rather centralized countries like Indonesia (21% in 1993). A number of other countries with decentralized fiscal system exhibit far more subnational autonomy in this respect.

Thus, it can be concluded that despite a seemingly high expenditure decentralization, regions are heavily dependent on federal government as they are assigned weak revenue base.

Sector wise, regional share of recurrent expenditure has been higher in those sectors like economic services, social services and public order. In contrast, the federal government accounted for a larger share of recurrent spending in areas of defense, general services, public debt and various other expenditures.

The other observation pertains to the proportion of capital and recurrent expenditure by regional states. In this respect, it was found that average regional share of capital and recurrent expenditure has been the same, which was 34.4% over the period under consideration.

It is widely believed that decentralization increases public expenditure, as resources are efficiently utilized through effective targeting and since funds are used to the best benefit of the community. Although, this is logically sound the findings here don't provide a strong empirical evidence. Of course, following the current decentralization reform, total public expenditure has grown from Birr 7.09 billion in 1993/94 to 13.5 billion in 1999/2000. However, since a sheer increase in government expenditure does not express a real growth in pubic expenditure, per capita expenditures are computed to judge the validly of the thesis that decentralization increases public sector spending.



Interestingly, until 1998/99, there has been a steady increase in per capita total government expenditure. Nonetheless, the period was followed by a sharp decline from Birr 281 to 213. Largely, however, the findings here seem to support the above argument because total public sector spending grew from Birr 138.8 to 213.3, which is quite a promising trend. The increase is not however significant in capital expenditures, implying low rate of public capital formation. A plausible explanation for the low capital spending could be that, in order to avoid fiscal imbalance, governments find it easier to delay investment projects than to cut operational costs such as reducing wages and salaries of employees. In any case, due efforts need to be made by both regional and federal governments to raise the importance of their capital spending in total public expenditure. Alternative sources of such funds could be sought through increasing local taxes, effective tax efforts, cost recovery, voluntary contributions and, of course, borrowing.

4.3 Vertical imbalance

It is useful to raise the issue of fiscal imbalances as it is one of the distinguishing characteristics in intergovernmental fiscal relations in Ethiopia. Basically, there are two twin concepts of fiscal imbalance: horizontal and vertical imbalances. The former is concerned with inter-jurisdictional disparities between revenue raising capacity and fiscal needs at the same level of government, while the latter deals with a mismatch between revenue means and expenditure means at different levels in a federal system.

In designing intergovernmental fiscal relations, usually allocation of functions or expenditure responsibilities and tax assignment are treated independently. Of course, the principles governing these assignments also differ. Accordingly, either the federal government faces a problem to fully finance its expenditure responsibilities from its own resources or sub-national units encounter the same problem. Weak administrative capacity of sub-national states, particularly in developing countries, is often taken as an excuse for centralizing major revenue resources. Besides, when a wide horizontal imbalance occurs in a federation, the center holds significant portion of resources on top of what it normally requires to discharge its responsibilities. In consequence, there exists a mismatch between expenditure responsibilities and revenue means.

In fiscal decentralization, the magnitude of such an imbalance is considered to be a good indictor of sub-national autonomy. There are several ways of measuring vertical imbalance. The following formula provides a measure of such an imbalance and at the same time indicate the degree of control the center exercises over sub-national governments.

$1-[(R^s/R)/(E^s/E)]$

:*where* R^s and E^s are State(Regional) Revenues and Expenditure; and R and E stand for aggregate Revenue and Expenditure, respectively. Here, a coefficient of zero implies absolute federal control while a coefficient of one indicates that lower level of governments are absolutely autonomous in their decision-making. However, neither of these two extremes exits in reality. In the first instance, sub-national units exercise a grate latitude of freedom in decision-making, whereas in the latter case (high fiscal imbalance), sub-national autonomy is virtually none-existent.

Table 4.3. Vertical imbalance in Ethiopia (1993/94 to 1999/2000)

Year	Regions' own revenue	Aggregate revenue	Regions' Total Expenditure	Aggregate expenditure	Vertical imbalance
1993/94	695.5	3938.80	2439.74	7093.89	0.49
1994/95	886.5	5912.75	3211.22	8372.01	0.61
1995/96	1129.3	6966.09	3797.04	9142.87	0.61
1996/97	1357.6	7882.54	4215.42	9906.85	0.60
1997/98	1595.4	8383.31	4448.94	15090.41	0.35
1998/99	1555.1	9498.21	4553.79	17328.13	0.38
1999/00	1739.0	10148.20	5526.97	15964.61	0.51

* Revenues and Expenditures are in million Birr

By this measure, Ethiopia can be categorized as a country with high degree of centralization with the central government exerting a considerable control over regional states. The coefficients range from 0.31 in 1997/98 to 0.61 in 1994/95 and 1995/96, the average being 0.51. The trend for the first few years seems to be increasing though the overall tendency appears to defy generalization.

For comparison purpose, if we compare Ethiopia with other federal countries, it is interesting to note that with the exception of Bolivia (0.66) and South Africa (0.88), the average vertical imbalance in Ethiopia is higher than federations such as Germany (.15), India (.28), Canada (.08), Australia (.24), China(.07), Brazil (.11) and Argentina (.03).

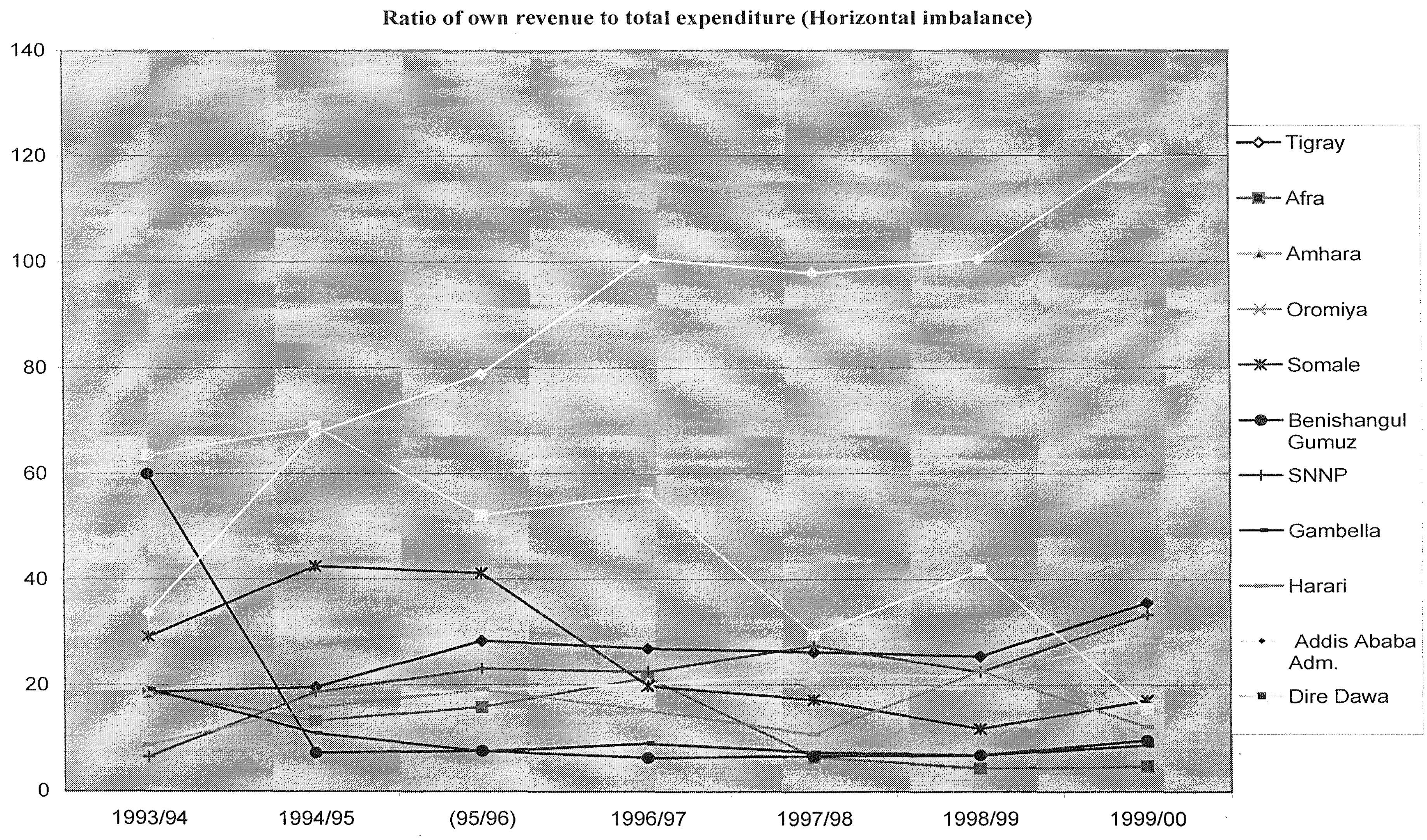
Such a high vertical imbalance is said to have a number of repercussions. Primarily, as the cost of public expenditures are not fully internalized by the jurisdictions, it entails efficiency problems. Under such circumstances, sub-national governments have no incentive to be efficient in spending public resources which come from other parts of the country. Moreover, accountability and participation is likely to be low. Conceptually, it may also entail a gradual loss of sub-national autonomy which naturally leads to central government domination in setting development policies and priorities, as the latter (the grantor of resources) can tune regional state policies towards its preferences and interest areas.

In any case, the problem deserves due attention. Its rectification lies either on the expenditure or tax assignment side. The present vertical imbalance clearly stems from the way resources are assigned to the two levels of government. Hence, in view of efficiency and other considerations, a relatively easier measure to rectify the problem is reallocation of revenue base. Thus, rather than assigning more lucrative and elastic revenue sources such as foreign trade taxes, which by the way constitutes the major proportion in total public revenue, the central government should consider sharing productive revenue sources with regions. The reallocation of revenues, be it through tax sharing or tax base sharing, should ensure that there is a match between expenditure needs and revenue means. Only then may regions assume significant autonomy in determining their respective development priorities and discharging the bunch of responsibilities decentralized to them.

Other options include reassignment of responsibilities, borrowing and, of course, transfers. The first alternative is less desirable as it stands in sharp contrast to the very objective of decentralization. Due to limited access to capital market, borrowing is also of less prospect. The obvious and the commonest mechanism of filling vertical imbalance are therefore intergovernmental transfers.

4.4 Horizontal Imbalances

Ethiopia is a large country with high diversity of resource endowment and potentials. One of the outcomes of the regionalization process is a wide horizontal fiscal imbalance because it resulted in the creation of jurisdictions, which considerably vary in their resource endowments and level of development. There has been a significant disparity in regional states' fiscal capacity and their expenditure needs. Wide variation is observed among regions in terms of revenue, expenditure and financial autonomy. In 1997/98, per-capita revenue ranged from a low of Birr 10 in Afar and Somali to a high of Birr 290 in Addis Ababa Administration, implying a pronounced interregional disparity in revenue raising capacity. In the same year, per capita expenditure ranged from Birr 51, 53, and 58, in SNNP, Amhara and Oromia to Birr 520 and 477 in Harari and Gambella, respectively. Per capita revenue and expenditure are not proportional because the latter is influenced by transfers. That is perhaps why less-developed regions spend more than what they generate.



Ratio of own revenue to total expenditure (Horizontal imbalance)
140
120
100
80
60
40
20
0
1993/94
1994/95
(95/96)
1996/97
1997/98
1998/99
1999/00
Tigray
Afra
Amhara
Oromiya
Somale
Benishangul Gumuz
SNNP
Gambella
Harari
Addis Ababa Adm.
Dire Dawa

Over the period, if we disregard Addis Ababa and Dire Dawa, three groups of regions stand out with similar characteristics. The first group comprises of regions whose ratio is consistently below an average of 10%, namely Benishabgul/Gumuz and Gambela, while the other category consists of regions whose ratio ranges roughly between 20 and 30% (Tigray, Amhara and SNNP). Falling under the third group are regions like Harari, Somali and Afar. What do they have in common? Regions in Group I are those regions which are considered 'backward' and hence receive higher subsidies from the center, while Group II represents richer regions capable of financing about a quarter to one third of their expenditure from own resources. The third group, which except Harari, comprises again less developed regions which are also accorded special treatment by the central government, exhibits a generally declining trend. One major difference is that the ratio is declining much faster for Somali than for Afar and Harari, which tends to defy generalization though the general tendency is not difficult to establish. One more characteristic of the last group is high fluctuation in the ratio, the explanation of which can be the fact that there have been constant changes in their expenditure as they are just beginning to experiment with decentralized power and decision-making which they have not had in the past. Addis Ababa is unique in that it exhibits a generally increasing trend which is as high as 121%, signifying that it is more than self-sufficient and therefore has to transfers some of its revenues to the center. This is, of course, an outcome of a disproportionate concentration of investment and human resource in the region. Dire Dawa, despite having a more or less similar advantage, exhibits a consistently declining tendency, which is not easy to explain but probably has to do with some changes in expenditure or revenue base.

A more interesting point is that, the ratio for almost all regions for the last two years of the period is increasing which does not necessarily imply regions' increased degree of self-financed expenditure. The underlying fact is however the reality that in those years (during Etho- Eritrean War), public expenditure was low and consequently the ratio was pushed up, depicting a distorted impression that regions' ability to finance their expenditure has increased.

In sum, it might be argued that the regionalization process has resulted in wide inter-regional disparities in resource endowment, investment opportunities and level of development, which in turn, caused correspondingly high disparities in regions' generation of revenue relative to their expenditure needs. This has an important policy implication because given such a wide gap in fiscal and economic disparities, regional equity will continue to dominate the fiscal policy of the federal government. Thus, to narrow down the present gap, the federal government, using tax, expenditure and targeted transfer policies, should redistribute away resources and opportunities from big cities and richer regions in favor of poorer ones.

The big difference in regions' revenue-raising potential and expenditure needs is also an indicative of the need to design an effective equalization grants and intensification and rewarding of own revenue generation efforts by regions.

Table. 4.4 Horizontal fiscal Imbalance 1993/94-1999/00

Region	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00
Tigray	18.65	19.65	28.33	26.90	26.22	25.43	35.56
Afra	8.79	13.25	15.89	21.42	6.46	4.34	4.64
Amhara	18.76	17.45	18.90	20.31	21.98	21.69	29.20
Oromiya	29.18	27.44	30.70	28.28	31.61	30.94	45.81
Somale	60.04	42.53	41.19	19.81	17.25	11.73	17.06
Benishangul Gumuz	6.50	7.24	7.56	6.29	6.65	6.79	9.51
SNNP	19.26	18.70	23.14	22.52	27.41	22.47	33.32
Gambella	8.71	10.87	7.50	8.97	7.34	6.77	8.57
Harari	33.69	15.77	19.17	15.28	10.71	22.69	12.02
Addis Ababa Adm.	63.57	67.61	78.81	100.59	97.91	100.52	121.31
Dire Dawa	94.13	69.02	52.15	56.29	29.58	41.76	15.46
Average	32.8	28.1	29.4	29.7	25.7	26.8	30.2

SOURCE: Computed based on data from Ministry of Finance

- *Horizontal Fiscal imbalance is calculated as the ratio of own-revenue to total expenditure of a region*

4.4 Intergovernmental Transfers/Subsidies

The preceding sections emphasized that the regionalization process and the constitutional arrangements in expenditure and revenue assignment have resulted in wide horizontal and vertical imbalances. Consequently, over the period federal transfers financed about 71% of subnational expenditure. Such a gap-filling measure is theoretically rational because revenue shortfall for regional governments will result in structural imbalances causing far-reaching consequences. Before the present system of allocating transfers came into effect, central transfers passed through various stages and at present with a renewed interest in subnational autonomy, direct central government expenditure seem to give way to general-purpose grants. This section presents the evolution and evaluation of the transfer system in Ethiopia from the perspective of its stated objectives and principles of Fiscal Federalism.

Theoretically, the fundamental goals of transfers are closing the vertical and horizontal fiscal gaps, thereby ensuring fair distribution of public goods and stimulating local tax efforts (Musgrave 1984; Oates, 1991; Shah, 1994).

The objectives of transfers, according to Proclamation No.33/92 are to narrow interregional growth disparities, promote foreign currency generating investments, speed up development of disadvantaged regions; encourage activities with positive spillover effects and control those with external diseconomies; enhance equitable socioeconomic development; and implement projects/programs of national significance.

In 1992/93, transfers were *ad hoc* in nature and regions received capital budgets for project, depending on need assessment and approved regional budgets. To make the grant allocation method more transparent and objective, a formula was devised in 1994/95. Grants were then determined based on five criteria, namely, population (30%); tax effort (20%); previous year capital expenditure (15%); area (10%); and I-distance composed of eight indicators representing level of development. In view of enabling regions at least, to maintain their previous year expenditure share, the incorporation of previous year capital budget was an important step.

In 1995/96, it was improved and regions total expenditure was allocated based on three factors with equal weight: population, budgeted regional revenue and I-distance. This was again replaced by another formula where the I-distance was made to represent five more objective indicators (primarily schools, electricity, roads, telephone and clinics). Here each individual variable was given a weight of 33.3%.

Finally, in 97/98, a change in the weight of the variables was made and population was given 60%, development index 25% and revenue effort 15%. Education level, health sector, roads, electricity, water and telephone coverage are employed for estimating regions' level of development. Thus, the currently in use grant allocation formula is expressed as follows:

$$\mathbf{Gi} = \frac{(0.6\ pop_i) + (0.25*Dev_i)+(0.15*Rev_i)*100}{\sum[(0.6\ pop_i) + (0.25*Dev_i)+(0.15*Rev_i)*100]}$$

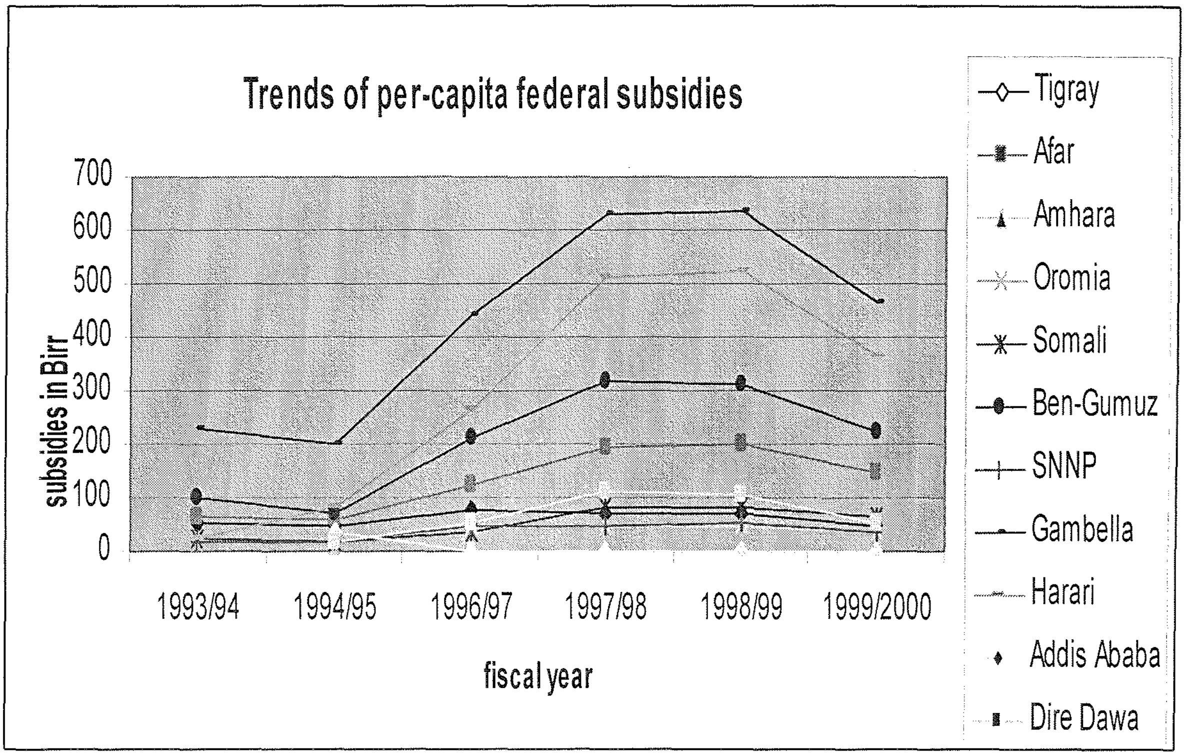
As can be learnt from the above overview the formula has been revised many times with the purpose of making it more transparent, simple, less data demanding, yet efficient and equitable. Since 1997/98, grants were thus provided in a lump-sum so that regions decide on its use depending on their needs and priorities. A number of remarks can be made concerning the method.

First, in a country with a long tradition of centralism, this is a major breakthrough in terms of promoting subnational autonomy. Yet, de facto, there is little or no difference between regional and federal priorities despite the aforementioned autonomy. Although an argument can made that for a growing country like Ethiopia, there might not be much divergence between national and regional priorities, anecdotal evidences suggest regions are not free to make independent decisions. Through implicit manipulations of regional politics, transfers are tuned to reflect federal government interest. Directives, guidelines and at times commands on budget spending are among the widely used instrument of the center about which regional officials complain a lot. While this is a clear infringement of their constitutional right, regional governments hardly refuse to adhere to those federally prescribed regulations and directives because this is a one-party system, which is characterized by clientele politics. The more regional officials comply with the demands of the center, the longer they stay in power and the visa versa. According to Olowu (1993), "in such systems, party loyalty are rewarded by jobs in regional and local administration to insure the continuity of one-party rule".

The abovementioned practice does not only undermine the democratic spirit of decentralization, but also clearly stands against the very assumptions of Fiscal Federalism. Fiscal federalism presumes democratic and egalitarian system, which is not the case in Ethiopia where a single party rules the country for more than ten years. In general, therefore, one would argue that subnational autonomy in making independent expenditure decision has remained an elusive goal, despite a constant revision of grant allocation mechanisms.

The other dimension to view the transfer system is from its stated objectives. One of such objectives is efficiency. To encourage regions' own-revenue raising effort, an element rewarding such an effort was introduced with the purpose of enhancing efficiency. However, a critical look into the implementation of the method reveals a serious weakness. This is theoretically sound but in practice regions' own revenue estimates are deducted from their budget subsidies when net transfers are determined. Thus, it can be assumed that regions might engage in a cost-benefit analysis and choose to reduce their tax effort or under report own revenues to maximize their share of the central transfer. Hence, increased transfer may have a 'substitution effect' on subnational revenue, inducing what Bird (1998) calls 'fiscal laziness'. Therefore, the tax effort clause is playing a harmful role, encouraging an inefficient resource allocation.

Another objective of transfers is equity. Thus, allocated funds are expected to vary positively with fiscal need factors and inversely with taxable capacity of each jurisdiction. Equity consideration is also among the policy objectives of the Ethiopian grant system. As depicted in the preceding graph, less-developed regions appear to be favored by the grant system. Over the period under consideration, Gambella, Harari, Benishanul/Gumuz and Afar have been the four major recipients of high per capita government subsidies. In these regions, grant accounted for nearly 90 percent of their total expenditure. Flow of federal subsidy has been increasing at an increasing rate before it stagnated in 1997/98 and started declining a year after. The stagnation and subsequent decline in federal subsidy can be attributed to the war, which resulted in significant reduction in flow of public funds to regions. Largely, however, there has been high dependency of those regions on transfers with no significant move towards self-sufficiency.



Thus, from the point of view of the relative weights of elements in the formula and the foregoing analysis, one may conclude that the present grant allocation system in Ethiopia favors equity over efficiency. This has a serious implication because such an objective is attained at the expense of relatively richer and potentially fast-growing regions. Heavily taxing businesses in these regions, as it is the case nowadays, may result in low rate of return and consequently, investment may shy away from the regions. Redistribution or balanced growth is not bad in itself. However, for a poor country like Ethiopia, national growth should precede equity at least at present level of development. Redistribution would come later after attaining higher degree of economic growth like the welfare states of Western Europe. While the present policy option might have some political significance, it may not provide a lasting solution to regional imbalances in economic terms. Thus, there must be a trade-off between equity and national growth.

Besides, unless one resorts again to political explanations, it is not rational to allocate higher per capita subsidies to regions where the percentage of population below poverty line is relatively lower. By this measure, Tigray, Amhara and SNNP should have been recipients of higher per capita subsidies because the proportion of their population living under poverty line is 57.9, 56.7 and 56.5 percent, respectively. (See appendix III).

Rather, a grant system that selectively targets strategic development areas is more likely to enable less developed regions to catch up, yet without hampering national growth. This might take a form of investment that builds human capital and infrastructure. Hence, those regions should give more priority for social development programs while better-off regions need to invest in directly productive activities so as to increase their comparative and competitive advantages.

The other problem that limits the effectiveness of the current grant system in peripheral regions is human resource constraint. Regions do not have adequate human capital and experience in project/program implementation to effectively utilize the subsidies. For example, professionals available as percentage of required in regional planning bureaus is 35 in Gambella, 34 in benishangul/Gumuz, 44 in Somali and 57 in Afar. Such a constraint resulted in underutilization of resources and misappropriation of public funds by local officials notably in Gambella, Somali, Afar and SNNP. Currently, corruption, which extended its network up to the key federal officials and politicians, is widely aired by state media and an anti-corruption commission was set up to deal with such harmful practices. Thus, transferring block grants to subnational governments where there are acute deficiencies of trained and responsible manpower and where strong property control mechanisms and institutional frameworks are not yet in place, the present grant system is may undoubtly lead to inefficiencies and misappropriation of public funds. This would in turn, as some argue, result in macroeconomic instability and debt burden as those funds are borrowed from international lending institutions (Asmelash, 2000).

Therefore, parallel to the block grant system the federal government should also consider filling in the human resource gap to ensuring efficient and responsible utilization of public resources.

A final weakness apparent in the grant system is the issue of budget offset. This mechanism was designed to protect the country from distortion caused by external flow of funds. It involves deductions in the grant share of a region that is equal to the amount obtained from external sources. Moreover, as these funds involve too much details and official procedures in planning, procurement and reporting, regions are not so zealous for them. The same as the revenue effort factor built in the formula, the budget-offset clause therefore penalizes regions for seeking external assistance. In consequence, additional resources that would have made a difference in overall development as well as technical expertise and practices go to waste. Hence, strategies that maintain additionality without hampering government's equity policy are in order. External resources mobilizing efforts should as well be rewarded.

4.5 Subnational Borrowing

In almost all federations, not all subnational governments can finance their expenditure needs from own revenues. Even where revenue sharing arrangements and transfers are in place, some degree of gap between means and needs continues to exist. This justifies the need for subnational borrowing. Although this is a contentious issue and there is no specific guideline for subnational government borrowing, it is generally argued that loan is useful as long as it generates rate of return that is sufficient enough for the repayment of principal plus its interest (World Bank, 1999).

However, as pointed out earlier in this paper, one major debate is whether subnational governments are allowed to have access to capital market at home or abroad. International experience shows that both are possible. Nonetheless, in Ethiopia regional governments are allowed to borrow only from internal sources. The Federal Constitution explicitly makes it clear that regional governments can borrow from domestic sources under terms and conditions set by the federal governments (Article 51). Hence, the emphasis in this paper is only domestic borrowing.

Subnational governments in Ethiopia are permitted to borrow by Proclamation No. 7/1992. This was further spelt out by Proclamation No. 33, which stipulates terms, conditions and procedures to be followed. Accordingly, Regions are required to submit their loan requests for capital and recurrent expenditures to Ministry of Economic Development and Coopration (MEDaC) and Ministry of Finance, respectively. The requests are then evaluated in the light of feasibility, debt repaying capacity, economic indicators, the ministry's total budget as well as its revenue forecast. After assessing its macroeconomic impact, the concerned ministry recommends the loan which is to be disbursed by the National Bank. These are the technical procurers that every region has to undergo. Nevertheless, it makes the process of borrowing quite awkward and at times impractical. Consequently, only few regions have been able to exercise their borrowing power as it is highly constrained by the law.

However, some regions have attempted to exercise this power for providing credit to small peasants. The lending institutions are Commercial and Development Banks which set up a new rural agricultural scheme in1997. Under this program, the banks provide rural credit services to farmers with a guarantee by the regional government rather than individual peasants. The regional government then uses its annual budget as a collateral for the loans. Although the program is said to have resulted in increased rural credit availability especially in Oroimia, Amhara and SNNP, the practice exposes regional governments to risks emanating from crop failure, natural disasters and default by farmers (World Bank, 1999). In view of high risk involved in agriculture in general and the vulnerability of Ethiopia to recurrent droughts, the risk of regional government involvement in credit is quite evident. Under such circumstances, regional governments put pressures on zonal administration, which in turn does the same to woredas. If that fails to work out, regions cut zonal budget and zones in turn cut annual budget of woredas depending on the default rate in their area.

The above measure has a serious collateral damage because deducting budgets from zones and *woredas* means undermining development in those areas, thereby denying people's access to school, heath care and other necessities to which they are naturally entitled as long as they are paying taxes.

By and large, one would argue that borrowing as a genuine alternative to close fiscal imbalances is not a fully utilized mechanism in Ethiopia. It seems that subnational borrowing is discouraged for fear it would cause problems of macroeconomic management. In addition, there is no data available to suggest subnational borrowing as an alternative financing instrument in Ethiopia. Thus, admittedly the analysis is less in-depth and inconclusive on this part of intergovernmental fiscal relations in Ethiopia.

Nonetheless, based on the preceding discussion and reference to the legislations, it might be argued that with developing domestic capital market, regions that are potentially capable of repaying debt should be permitted to borrow because loan finance has the advantage of enhancing efficiency. Undoubtedly, loans are more efficient than grants because they should be paid back and hence they must generate resources to service them. Shah (1994) argues that if local governments need to contribute towards their development, borrowing is conceptually an option to increase their spending capacity. Yet, maximum care must be paid not to permit irresponsible subnational external borrowing as it would render fragile economies like ours into macroeconomic deficit and inflation as recently evidenced by some Latin American countries.

Chapter Five

5.1 Conclusions and Policy Recommendations

The central endeavor of this study is to examine issues and trends in intergovernmental fiscal relations in Ethiopia over a period of seven years. More specifically, the paper was set out to investigate if 1) decentralization in Ethiopia has resulted in significant subnational autonomy and 2) there is parity between decentralized responsibilities and revenue power. To explore the degree of regions' independence from federal government influences, the topic was broken down into four components, namely, expenditure, revenue, transfers and borrowing and finally specific indicators were set. The analysis was guided by the Fiscal Federalist framework of public finance and the following conclusions were reached.

Generally, basic issues in Fiscal Federalism appear to be addressed. The various legislative and constitutional provisions attempted to make clear assignment of expenditure responsibilities and revenue means. These assignments seem to be somewhat consistent with the broad framework set by the Fiscal Federalist model discussed earlier. Critical insight into the system, nevertheless, reveals some shortcomings and contradictions that make the Ethiopian fiscal decentralization apparent rather than real.

Revenue and expenditure allocation are reasonably in line with economic principles outlined by fiscal federalism. Nevertheless, the findings in this study seem to support the view that decentralization has not resulted in significant subnational autonomy. Evidences for the above assertion come from various measures of fiscal decentralization. Therefore,notwithstanding constitutional provisions, subnational governments have been unable to take full advantage of the federal setup. Decentralization is much higher in spending than in revenue, creating an instance of high vertically imbalance, the main cause of which is centralization of revenues. The center delineated for itself more productive revenue sources, making regions excessively dependent on federal transfers.

Consequently, the federal government raises about 80% of total revenue as it controls those buoyant revenue bases like foreign trade taxes and non-tax revenues, which together account for more than 60% of the aggregate revenue.

Hence, a subnational, which does not have the power to raise a substantial portion of its revenue from sources it controls, is hardly considered autonomous. Of course, regions are constitutionally independent but they maintained their "independence" only by consistently becoming dependent on federal subsidies. A little has changed over the period in question and the central government continued to exert significant influence in a number of respects.

On the other hand, the Ethiopian fiscal system features an apparently high expenditure decentralization, with regions accounting for an average of 40% of total public spending. In fact, constitutionally, the center has transferred practically all duties and responsibilities except for those that are naturally performed at national level. This seemingly high politically autonomy however is not found to correlate with fiscal autonomy. Trends in subnational expenditure pattern reveal that regions share of public spending is still low as compared to the enormous responsibilities entrusted to them. For example, regional governments' share of public capital formation is found not only to be insignificant but also diminishing after 1996/97. Similar patterns emerge from analysis of recurrent expenditure. Moreover, the federal government has been encroaching on the regions' responsibilities even in those investment areas where local governments could play an important role like in social development programs. While modified expenditure decentralization ratio raises average regions' spending share to 45%, financial autonomy indictors disclose weak subnational autonomy, rendering Ethiopia one of the least decentralized country compared with other emerging decentralized fiscal systems.

The mismatch between responsibilities and revenue power is quite evident, causing a pronounced vertical imbalance. Using this measure of fiscal decentralization, again Ethiopia can be categorized among highly centralized countries. This imbalance coupled with wide interregional disparity in turn entailed a resort to unconditional federal grants/subsidies. However, the grant system favors equity at the expense of efficiency. It generally penalizes tax effort, discourages local initiatives to solicit external resources and wrongly targets regions with lower percentage of population under poverty line. Consequently, high dependence on federal subsidies still prevails, with no significant move towards self-sufficiency. Although there was an increase in financial autonomy over the last two years of the period, in reality the reason behind was found to be cutbacks in public spending because of high defense expenditure, which pushes the ratio up, giving a distorted impression that regions' ability to finance their expenditure has increased. Subnational borrowing as an alternative to close vertical imbalance is not a practical mechanism in Ethiopia. The law is so constraining and awkward that only few regions exercised their borrowing power. Over all, decentralization of borrowing power is almost nonexistent.

Although the introduction of block grant system is a step forward, the use of such funds is subject to several implicit controls hindering its effective and efficient utilization. Through guidelines, directives and at times commands on budget spending, the center still dictates regions' development priorities and policies. After all, this is a one-party system with a single party ruling for more than a decade, which clearly stands against fundamental assumptions of fiscal federalism.

High spending decentralization, therefore, took place mainly through delegation, which together with marked centralization of revenues, resulted in weak subnational financial autonomy. This in turn can lead to further erosion of the latter's fiscal and politically responsibilities since accountability follows revenue sources.

In Ethiopia, decentralization is largely designed to serve a political purpose. Yet, there exists a logical relationship between fiscal and political independence, as finance is the means of realizing decision-making autonomy. As weak fiscal power would gradually translate into weak political power, the reform is likely to fail to achieve even its prime objective.

5.2 Policy Recommendations

Decentralizing a fiscal system with long history of centralism is a radical move in the right direction. The formulation of a constitution articulating the duties and powers of the different levels of government indicates the country's desire to depart from centuries-old tradition of central administration and finance that left no room for self-administration. However, numerous shortcomings need to be addressed by the new system of administration.

Revenue:

The present revenue allocation arrangements are highly biased, rendering subnational governments fiscally weak and dependent on the federal government. Rearranging tax powers in favor of regional governments is therefore suggested to reduce the high dependence rate and fiscal imbalance. This might be achieved through improving those revenue bases where regional governments have the largest claims. This may include a) developing better cadastral or property registration mechanisms b) enhancing the agriculture sector productivity to increase agricultural income tax and, c) privatization of public enterprises. The latter is especially important as change of ownership of the public enterprises to the private sector expands the regions' tax base as regions are constitutionally entitled to those taxes. Besides these non-fiscal measures, introduction of a comprehensive value added tax (VAT) could contribute to lower regions' dependence on federal subsidies. Finally, it is recommended that regional governments be entitled as well to the most lucrative sources like taxes on foreign trade and indirect taxes which constitute significant proportions in aggregate revenue.

Expenditure:

Central government interference in regions' internal affairs and resource utilization jeopardizes horizontal accountability and efficiency. Regions should therefore be free to decide on their priorities and strategies. Apart from government, some functions need to be decentralized to the non-state actors and this suggests a favorable environment be created for development of the private sector and civil societies. The low rate of public capital formation also calls for the need to increase spending on investment projects in addition to operational costs. Alternative sources of funding include expanding local taxes, rewarding tax efforts, cost recovery, voluntary contribution and borrowing. To effectively take over the constitutionally granted responsibilities, regions should as well embark on human resource development through training and workshops.

Grants/ subsidies: The present grant allocation formula appears to harbors many shortcomings. It is thus recommended that tax effort be rewarded, budget offset mechanism that discourages external resource mobilization be rectified; and parallel to block grants, selective conditional grants be introduced to enhance efficiency in backward regions. A compromise should also be sought between equity considerations on one side and efficacy and national growth on the other.

Borrowing: Sub-national borrowing is an important component of the devolution of fiscal powers. Regions that are potentially capable of repaying debt should be permitted to borrow because loan finance has the advantage of enhancing efficiency. Yet, a well-designed regulatory framework should be in place.

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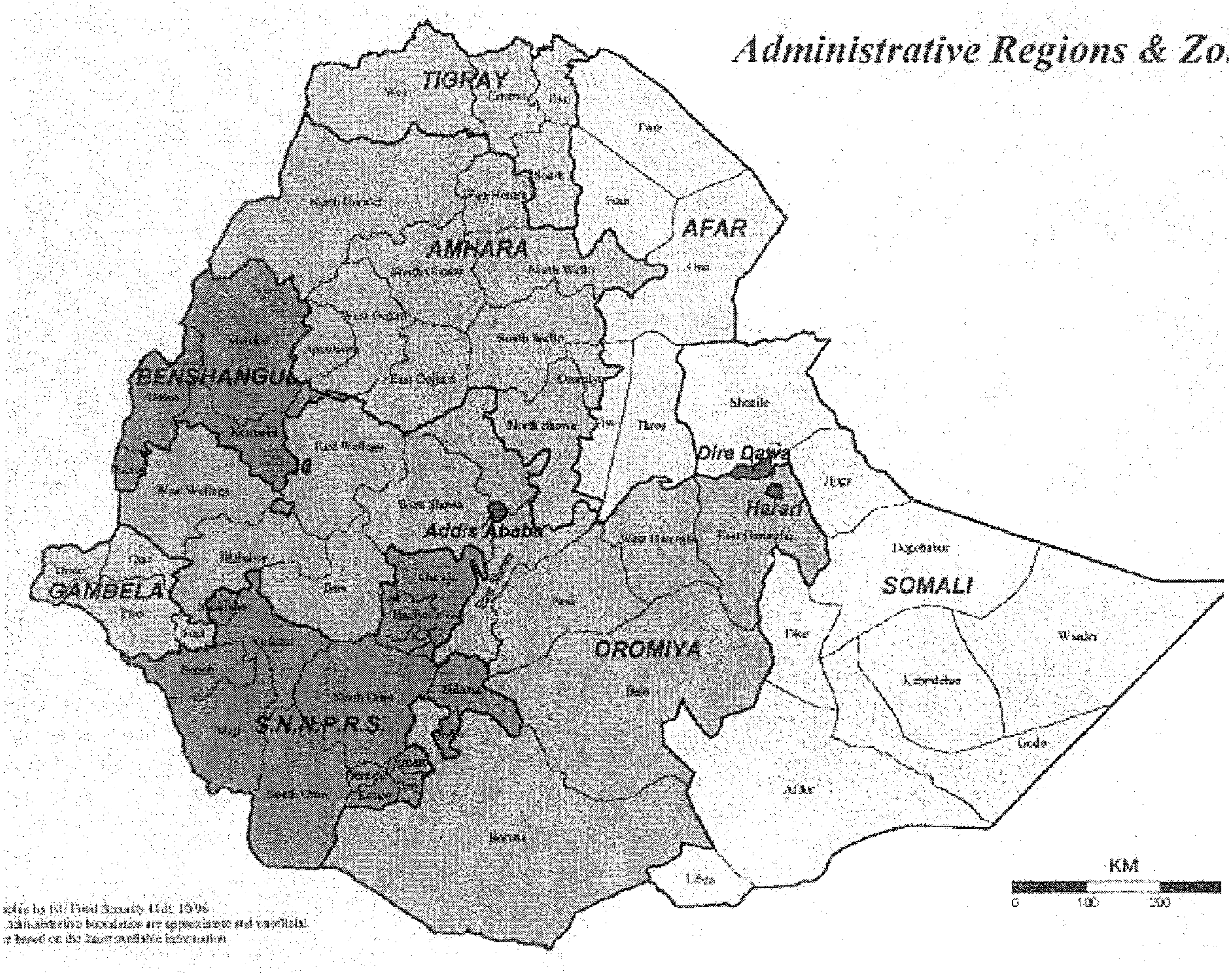
APPENDIX I

Table 4.2 Federal and regional government share of revenue from 1993/1994 to 1999/2000

DESCRIPTIONS	1993/94			1994/95			1995/96			1996/97		
	Federal share	Regional share	National Total	Federal share	Regional share	National Total	Federal share	Regional share	National Total	Federal share	Regional share	National Total
Administrative & General Services	73.2	26.8	1353.069	67.4	32.6	1657.259	62.0	38.0	1949.562	66.2	33.8	1880.606
Organs of the state	28.1	71.9	150.775	29.0	71.0	255.751	21.9	78.1	343.368	24.7	75.3	254.3167
Justice	17.0	83.0	45.313	14.8	85.2	58.505	15.9	84.1	66.676	47.1	52.9	152.3503
Defense	100.0	0.0	662.982	100.0	0.0	736.558	100.0	0.0	771.616	100.0	0.0	834.759
Public order	35.0	65.0	212.823	27.9	72.1	243.972	31.0	69.0	347.39	8.7	91.3	263.1157
General Services	72.2	27.8	281.176	63.3	36.7	362.473	57.7	42.3	420.512	73.0	35.6	346.5712
Economic Services	41.1	58.9	445.732	34.2	65.8	567.202	34.6	65.4	620.515	34.3	65.7	662.9621
Social Services	25.0	75.0	1212.075	23.5	76.5	1402.712	18.7	81.3	1419.914	19.0	81.0	1501.667
Various Expenditures	88.4	11.6	1335.35	88.4	11.6	1374.825	88.4	11.6	1447.54	85.2	14.8	1436.622
External assistance	100.0	0.0	53.322	100.0	0.0	213.536	99.2	0.8	142.692	100.0	0.0	256.55
TOTAL	**61.6**	**38.4**	**4399.548**	**58.9**	**41.1**	**5215.534**	**55.7**	**44.3**	**5580.223**	**56.4**	**43.6**	**5738.406**

Descriptions	1997/98			1998/99			1999/2000		
	Federal share	Regional share	National Total	Federal share	Regional share	National Total	Federal share	Regional share	National Total
Administrative & General Services	76.0	24.0	3107.269	83.9	16.1	5604.098	89.5	10.5	8325.318
Organs of the state	19.8	80.2	304.9557	17.8	82.2	385.53	23.5	76.5	362.504
Justice	56.5	43.5	154.887	55.8	44.2	180.16	55.4	44.6	192.534
Defense	100.0	0.0	1955.49	100.0	0.0	4232.9	100.0	0.0	6842.23
Public order	10.0	90.0	318.717	14.0	86.0	385.57	12.5	87.5	398.52
General Services	60.4	39.6	373.2188	57.9	42.1	419.938	68.6	31.4	529.53
Economic Services	24.8	75.2	675.175	29.9	70.1	777.93	34.2	65.8	813.84
Social Services	22.3	77.7	1709.722	20.8	79.2	1897.33	29.7	70.3	2105.241
Various Expenditures	95.4	4.6	5043.007	98.2	1.8	3446.02	94.2	5.8	1263.89
External assistance	100.0	0.0	367.8	100.0	0.0	812.6			
TOTAL	**74.2**	**25.8**	**10902.97**	**75.9**	**24.1**	**12537.98**	**76.3**	**23.7**	**12508.29**


Administrative Regions & Zo.
TIGRAY
AFAR
AMHARA
BENSHANGUL
GAMBELA
Dire Dawa
Harari
Addis Ababa
SOMALI
OROMIYA
S.N.N.P.R.S.
KM

APPENDIX 3

Poverty Variable

Region	No. of Population Below Poverty Line (1997/98)	% of Population Below Poverty Line (1997/98)	Compared against the average	Index of poverty
Tigray	2.26	57.90	1.27	*0.1330*
Afar	0.66	51.80	1.14	*0.1190*
Amhara	9.76	56.70	1.25	*0.1303*
Oromiya	8.22	34.70	0.76	*0.0797*
Somale	1.35	34.60	0.76	*0.0795*
Benshngul-Gumuz	0.27	47.60	1.05	*0.1093*
SNNP	7.51	56.50	1.24	*0.1298*
Gambela	0.09	41.80	0.92	*0.0960*
Hareri	0.05	29.10	0.64	*0.0669*
Dire dawa	0.08	24.60	0.54	*0.0565*
Total/ Regs. Aver.	30.25	45.50	9.57	*1.0000*

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