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THE LEGAL FRAMEWORK FOR FISCAL DECENTRALIZATION IN ETHIOPIA DURING THE TRANSITION PERIOD

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Abstract: *The paper critically examines the system of fiscal decentralization in Ethiopia as defined in Proclamation 33 of 1992 from the legal point of view and precipitates the political and economic impacts thereof. Its findings are that the system is ambiguous, internally inconsistent and conflicts with the political paradigm of federalism as provided for by the different legislations including the Charter of the Transition Period.*

I. INTRODUCTION

The Transitional Government of Ethiopia (TGE) has embarked upon the task of revising the political and administrative landscape of the country. Starting early in its tenure and continuing thereafter, the TGE has been pursuing a policy of decentralization based on ethnolinguistic criteria. The Charter targeted and spearheaded the decline of the centre in favour of regional/national self-governments which are to assume the responsibility of managing the economy and society.

Along with the realignment of duties and responsibilities between the two tiers of government, the TGE has rearranged the fiscal paradigm. Under the new arrangement, revenue would be collected at both levels.

The political and fiscal model of the TGE is not unfamiliar in the long history of the country. It is more of a relapse into the customary and traditional mode of governance of bygone days. For the major part of the nation's history, the system of governance as well as the fiscal arrangement were closer to the federal structure under which warlords enjoyed complete autonomy over the regions they controlled. The minimum that the emperors required and the maximum the warlords were willing to concede was the payment of tribute and acknowledgement of the supreme political authority. Something of that nature is what is attempted by the current regime. What is significantly different is the flow of resources. Under the traditional regime resources were shared from the bottom to the top; the flow is reversed under the current arrangement.

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This paper evaluates the degree of fiscal independence conferred upon and possessed by the regional governments by focusing on the legal framework providing for fiscal decentralization.

The rest of the paper is structured as follows. Section II summarizes political decentralization both in theory and practice, while Section III focuses on the economics of the transition period. Fiscal decentralization in principle and practice are dealt with in Sections IV and V. Section VI suggests ways for strengthening the regional fiscal base, and Section VII summarizes and concludes the paper.

II. THE POLITICS OF THE TRANSITION PERIOD

A. Political Decentralization: The View from the Central Government

A conspicuous innovation of the Transitional Government is the reconstitution of the domestic political profile of the country on a mainly ethnolinguistic basis. The political and legal framework for such state formation is enshrined in Article 2 of the National Charter adopted in June 1991 [9], which reads as follows:

> The right of nations, nationalities and peoples to self-determination is affirmed. To this end, each nation, nationality and people is guaranteed the right to
>
> a) preserve its identity and have it respected, promote its culture and history and use and develop its language
>
> b) administer its own affairs within its own defined territory and effectively participate in the central government on the basis of freedom, and fair and proper representation
>
> c) exercise its right to self-determination or independence when the concerned nation, nationality and people is convinced that the above rights are denied abridged or abrogated.

This general principle was further enhanced by a series of proclamations which provided for the establishment of a three-tiered government structure and detailed the powers, duties and responsibilities of each tier. The most important of these proclamations is Proclamation 7 of 1992.

Proclamation 7 of 1992 created and defined the powers of a three-tiered government - central, national/regional and *woreda*. All three levels enjoy their respective political prerogatives and legal personalities - the central government by virtue of its status and nature, national/regional self-governments and woreda administrations by rights granted to them by the National Charter and Article 6 of this proclamation. The acknowledgement of legal personality further underlines the separation of powers between them and the central government. Based on Article 192 of the Civil Code [5], legal persons enjoy the rights of performing all acts of civil life applicable to capable physical persons. Such entities enjoy the power of independent decision and are responsible for the consequences of their actions and behaviour, all subject to legal limitations.

Such limitations are imposed on all the three tiers by this proclamation. The supremacy of the central government over the two lower bodies is acknowledged by Articles 5 and 9 (1) of proclamation 7 of 1992. Article 5 confers supreme political powers on the Council of Representatives of the Central Transitional Government, while Article 9(1) specifies activities appropriated to itself. These include

> defense, foreign affairs, economic policy, conferring of citizenship, declaration of state of emergency, deployment of army where situations beyond the capacity of national/regional transitional self-governments arise, printing of currency, establishing and administering major development establishments, building and administering major communications networks and the like.

Article 5 creates national/regional transitional self-governments and woreda administrations to give effect to the right of nations, nationalities and peoples to self administration and to implement rights of preserving the identity of the nations, nationalities and peoples, promote their culture and history, use and develop their languages, administer their own affairs and effectively participate in the central government.

Article 9(1) of the proclamation grants "legislative, executive and judicial powers in respect of all matters within their geographical areas" excluding those functions that were reserved for the central government. To exercise these rights, national/regional self-governments will structure themselves with the following offices (Article 5(1)): a) nation/regional council to legislate laws; b) executive committee; c)judicial organ; d) public prosecution office; e) audit and control office; f) police and security office; and g) service and development committee.

Under Article 38, the proclamation recognizes the woreda as the basic administrative hierarchy of all national/regional self-governments, provides it with (Art. 39) a council, executive committee, judicial organ, public prosecution office, audit and control office, security and police force office and a service and development office. Despite the legitimacy and extensive powers conferred on the *woredas*, they have no real significance or functions. They are totally subordinated to national/regional governments (Art. 40(2).

B. Political Decentralization in Practice

Pursuant to its pledge to share political prerogatives, decentralize functions and delegate responsibilities of managing society and economy with and from the centre to the regional/national governments, the Transitional Government created regional governments, reorganized organs of state and redefined their duties.

The organs of state at the centre are made up of the legislative, the executive and the judiciary. Legislative functions are exercised by the Council of Representatives, executive functions by the Council of Ministers, and judicial functions by the Council of the Judiciary. The judicial organ is segmented into supreme, high and woreda courts. The executive organ is made up of 20 ministries and 4 commissions (Art.3 and 25 of Proc. 41 of 1993).

The same organs are replicated at the regional/national level with parallel functions. Article 1 of Proclamation 7 of 1992 divided the country into 14 regional administrations consistent with Article 2 of the Charter. These regions have in turn established their respective governments, and ratified their constitutions. The national/regional councils and the judiciary exercise legislative and judicial functions while the executive powers reside in the executive councils, and the bureaus and commissions are the functional organs. Regional/national governments have 17 bureaus duplicating the 17 ministries and 3 commissions (Article 33 of Proc. 41 of 1994). The three ministries and the one commission missing from the national/regional governments are those of defense, foreign affairs, foreign economic cooperation and the compensation commission, respectively.

Functionally, the ministries and commissions at the centre develop policies which, if approved by the Council of Representatives, define the policy parameter of the central government. On the other hand, the bureaus at the national/regional level have their functions defined for them by their executive council consistent with the policy framework of the central government. They are independent of their counterpart at the centre in all other ways except for cooperating with them where this is necessary.

The perception of the extent of powers and duties that have devolved to the regional/national governments seems to be vaguely appreciated. Their constitutions conceptualize and detail procedural rather than substantive elements of their powers. An excellent sample of such a constitution is that of Region 14 [12].

This constitution begins with a preamble, identifies the physical location of Region 14 in Article 1, recognizes the residents of the region as the supreme political authority in Article 2, defines the rights, duties and obligations of the people in section 2 (Article 3 - 20), establishes a four-tiered structure of government as regional, zone, *woreda* and *kebele*, (Article 20(1), and organizes the regional government into legislative, executive and judicial organs (Article 20(2).

Articles 22-27 recognize the Regional Council as the supreme political organ of the region and authorize it to organize and supervise the executive, judicial and legislative offices, plan and execute short to long-term socio-economic development projects, approve the budget, and raise resources to finance them.

Articles 28-36 detail the powers and responsibilities of the executive committee, the chairman, the deputy chairman and the secretary general of the council. Articles 37-43 underline the independence of the judiciary and empower it to adjudicate cases within the jurisdiction of the region. The final articles deal with miscellaneous issues such as the regional flag and emblem, its capital city, working language, amendment to the constitution, etc.

Three salient points emerging from the regional constitution are that: a) the regional governments are under the authority of the central government; b) they have full and complete autonomy from the central government; and c) supreme political power resides in the people, which is exercised on their behalf and for their benefit by the regional council.

Such a power sharing arrangement has implications of great significance. What the central government did in effect is to pass all powers and responsibilities with the exception of defense, foreign affairs, foreign economic relations, currency and monetary policy to the regional/national governments. In consequence, regional/national governments are responsible for their social and economic development, including the provision of education and health services, building and maintaining roads and other communication channels, protecting natural resources and the environment, regulating trade, commerce and industry, maintaining internal law, order and security, etc.

III. THE ECONOMICS OF THE TRANSITION PERIOD

Beginning with the economic policy of the transitional period [8] and subsequent policy and legislative pronouncements, the government has highlighted its intention to fundamentally change the role of the state in the economy.

The proposed radical shift in the role of the government is encapsulated in the installation of the market mechanism as the sole determinant of resource allocation. Within this environment, the burden of development on the central government is to be reduced in two ways.

The first strategy is to withdraw the state from activities that are deemed non-strategic and to focus its attention on regulatory functions. In consequence, state farms are to be distributed to the residents of the regions, given to employees or privatized [8, p.25], and Industries, with the exception of those considered strategic, are to be privatized [8, p.30]. Government intends, in the main, to withdraw from domestic and foreign trade as well as from transport activities. These activities are expected to be taken up by both domestic and foreign entrepreneurs, for which purpose the government has promised to create an enabling environment and provide incentives that would make the emergence of a strong and vibrant private sector possible.

The second avenue that would change and reduce the role of the central government in the socio-economic development of the nation is demonstrated in the idea of shifting the responsibility to regional/national governments, enshrined in the Charter and enhanced by the proclamation which provided for the establishment of national/regional self-governments.

The Charter states in its preamble that the "self-determination of all the people shall be [their] governing principle of ... economic life". This principle is further accentuated by Article 2(b) of the Charter which states, inter alia, that the Region "administers its own affairs within its own defined territory".

These general principles were accorded explicit recognition in the proclamation establishing national/regional self-governments. Article 2(c) of the proclamation [10] explicitly states that "national councils within a region shall themselves decide on their own ... social and economic development activities." Article 10 of the same proclamation vests the national/regional self-governments with the power to: a) plan, direct and supervise social and economic development programmes; b) establish, direct and supervise social and economic development establishments and enterprises; c) employ and administer the personnel of their government on account of their own powers and budgets; d) acquire, own and transfer properties; e) prepare, approve and implement their budgets; and f) borrow from domestic lending sources and levy duties and taxes in their respective regions.

These powers and duties have been well internalized in the legislations and operations of national/regional governments. For example, the constitution of Region 14 [6] echoes both the preamble and the substantiative elements of Proclamation 7. It begins by underlining self-determination as the basis for economic development in its preamble and goes on to detail the powers and duties of the regional government with respect to social and economic development under Article 24.

Under this article the regional government asserts its authority to approve short and long-run socio-economic development plans, approve the budget, identify sources of revenue, levy duties and taxes, ratify credit agreements with domestic creditors, protect the environment, and seek direct assistance from donors.

In conformity with Article 24(6), regional administrations have established the requisite institutions to effectively discharge and fulfil their commitment.

IV. FISCAL DECENTRALIZATION

It is apparent from the previous section that the national/regional governments enjoy a broad latitude of political autonomy and carry the heavy burden of engineering their socio-economic development. The central government has extricated itself from the management, expansion and introduction of existing or new socio-economic institutions and infrastructure, relinquishing these responsibilities to the sub-national governments.

The shrinking role of the central government and the expanded responsibilities of the sub-national governments are accompanied by fiscal decentralization. This section discusses the essence of the new fiscal policy and evaluates its capacity to match the burden of socio-economic development imposed upon the national/regional governments.

A. Fiscal Decentralization: The Principle

The elements of fiscal decentralization were enacted in two legislations - the proclamation to define the sharing of revenue between the central government and the national/regional self governments [11] and the proclamation to provide for the lease holding of urban lands [13]. Of these two proclamations, the one defining the sharing of revenue is the more important since it covers the fiscal relationship between the sub-national and the central governments while the lease holding of urban land is limited to towns and cities.

The proclamation detailing the principles of revenue sharing begins with a brief preamble and defines the substantive and procedural elements of the new fiscal arrangements in 14 articles. The introduction justifies the need for the proclamation by invoking the principle of the right of nations, nationalities and peoples to administer their own affairs as enshrined in the Charter and its implementation by virtue of Proclamation 7 of 1992.

B. Categorization and Sources of Revenue

Article 35 of Proclamation 7 of 1992 identifies the four sources of income available to the regional/national governments. These are a) revenue collected from taxes allocated to them, b) grants to be given by the central government, c) domestic borrowing, and d) other sources of income. Article 36 defines the principle governing grants from the central government. Grants would be given and necessary manpower allocated by the central government to those regions which, on account of their underdevelopment, cannot provide basic social services and undertake essential economic development programmes.

The implications of Article 36 should be obvious. In essence the idea behind the government's new fiscal arrangements is that the regional/national self governments should finance their socio-economic development and the central government steps in with grants only if the sub-national governments cannot finance basic social services and economic development projects on account of their backwardness and poverty.

Article 35, in addition to identifying the sources of sub-national government finance, promised legislation to identify and govern the shares and coordination of the collection and utilization of revenue between itself and the regional/national governments. The preamble to Proclamation 33 of 1992 claims that this legal instrument honours that pledge.

Proclamation 33 begins by defining the objective of revenue sharing as (Art.3) a) enabling the central and regional/national governments to efficiently carry out their respective duties and responsibilities, b) assisting national/ regional governments to develop their regions on their own initiative, c) narrowing the gap in development and economic growth between regions, and d) encouraging activities that are of common interest to regions.

The determinants of revenue sharing are highlighted in Article 4 and include a) ownership of sources of revenue; b) the national or regional character of the sources of revenue; c) convenience of levying and collection of the tax or duty; d) population, distribution of wealth and standard of development of each region; and e) other factors that are relevant to an integrated and balanced economy.

Under Article 5 the proclamation divides revenue into three categories - those belonging to the central government, those belonging to the national/regional governments, and those jointly owned.

The revenue sources allotted to the central government include: a) duties, taxes and other charges on imports and exports, b) personal income tax collected from employees of the central government and international organizations, including NGOs, c) personal income tax, profit tax, and sales tax collected from enterprises owned by the central government, d) taxes collected from national lotteries and other chance winning prizes, e) taxes collected on income from air, train and marine transport activities, f) taxes collected from rent of houses and properties owned by the central government, and g) charges on fees and licences and services issued or rendered by the central government.

The revenue sources allocated to national/regional governments include: a) personal income tax collected from employees of regional governments, b) rural land use fee, c) agricultural income tax from farmers not incorporated in an organization, d) profit and sales tax collected from individual traders, e) tax on income from inland water transportation, f) taxes collected from rent of houses and properties owned by the regional governments, g) profit, personal income and sales taxes collected from enterprises owned by regional governments, h) income tax, royalties and rent of land levied on small to medium scale mining activities, and i) charges and fees on licences and services issued or rendered by regional governments.

Those identified as joint revenues and are sources are: a) profit, personal income and sales taxes collected from enterprises jointly owned by the central and regional governments, b) profit, dividend and sales taxes collected from organizations, c) profit tax, royalty and rent of land collected from large scale mining, petroleum and gas operations, and d) forest royalty.

C. Revenue Distribution

Of the three categories of revenue, the least problematic are the revenues designated as those of the region since they are collected and used by the regions as they deem fit.

The joint revenue sources and those of the centre are to be used by the centre and the regions. The proclamation stipulates that joint revenue sources would be shared between the central and regional governments while those designated as belonging to the centre are to be used to finance the needs of the central government and distributed as grants and subsidies among the regions.

1. Revenue Sharing

The methodology for sharing joint revenue between the centre and the regions is to be developed by a committee established by the Prime Minister and accountable to the Council of Ministers. The committee, composed of representatives from the central and regional governments (Art.6(2)), would submit recommendations to the Council of Ministers (Art. 6 (3)) on: a) the percentages in which the joint revenue is to be shared between the central government and the regions, b) measures for resolving issues regarding the sharing of revenue, and c) amendments or changes to revenue categorization, subject to the objectives and basis for revenue sharing given in detail under Articles 3 and 4 of the proclamation.

2. Grants

The central government has pledged to share the revenue allotted to it with the regional governments where this is deemed necessary. According to Article 36 of Proclamation 7 of 1992, grants are provided to finance basic social services and economic development programmes that cannot be accommodated from the region's resources due to relative underdevelopment. Art. 7(2) of Proclamation 33 of 1992 further specifies regional activities that are eligible for grants. These include regional endeavours aimed at a) promoting social services and economic development, b) accelerating the development of the hitherto neglected or forgotten areas, c) narrowing per capita income gaps between regions,
d) controlling negative and expanding positive externalities within and between regions,
e) increasing foreign exchange earnings, and f) undertaking other projects of national interest.

The proclamation spells out the procedures regional governments should follow in their quest for subsidy and the decision making process in Articles 7(3) to (5). National/regional governments should submit to the Ministries of Finance and Economic Development and Planning their a) subsidy request, b) total expenditure, and c) revenue forecast prior to the approval of their budgets by their respective national/regional councils. The ministries would review the applications from the regions relative to the purpose for which funds are required and central government revenue. The subsidy to be granted to any region is to be proportional to the revenue collected by the region and available to it to finance its total expenditure.

A major problem raised with the procedure for granting or denying the subsidy is that the organ of state deciding on the issue is not identified. The Ministries of Finance and Planning and Economic Development would evaluate the request from the point of view of the needs of the regional governments and the capacity of the central government to provide the subsidy. Presumably they would submit their views to the Prime Minister and/or the Council of Ministers. It is also possible that the Council of Representatives may be involved in approving the grant and subsidy. But where the power of decision lies, whether there is an avenue for appeal, etc. are unknown. This is of crucial importance, considering the fact that the major source of revenue remains to be the central government, a point dealt with in detail later in the paper.

3. Domestic Borrowing

Proclamation 7 of 1992 recognizes the rights of national/regional governments to borrow from domestic sources under Article 35, a prerogative that is affirmed by the constitutions of the regional governments. Proclamation 33 details the conditions and procedures under which the national/regional governments exercise this prerogative under Article 10.

The law requires national/regional governments to submit to the Ministry of Finance(MOF) or the Ministry of Planning and Economic Development (MOPED), as the case may be (presumably the division of labour between the two is for the former to deal with recurrent and the latter with capital expenditure, although this has not been indicated by the proclamation), the amount they would want to borrow along with statements showing a) the relation of the requested amount to their revenue forecast, b) economic indicators of their region (presumably to authenticate the realism in their forecast and gauge their capacity to repay the debt), c) their consolidated budget, and d) the feasibility study of the project for which the loan is required.

The ministry to which the request is submitted evaluates the application based on the information provided by the regions and the impact of the borrowing on the overall national deficit, advises the appropriate organ of state, and communicates the decision to the concerned region and the National Bank of Ethiopia, which authorizes disbursement of the loan on request.

This raises a number of interesting issues. Again the legislation fails to identify the organ of state that makes the final decision. However, the more interesting issue is whether the law really allows the regional governments to borrow, and if so who the lender is as well as the mechanism of borrowing. These points are discussed later in the paper.

The administration of foreign currency is the prerogative of the central government (Art.11 of Proc. 33 of 1992). Regional governments need to apply to MOPED to acquire the foreign exchange they need prior to having their budget approved by their Council. The Council of Ministers makes the decision on the amount of foreign currency to be authorized to each applying region, which is communicated to it through MOPED.

Regional governments are required to submit to MOF their monthly, quarterly, semi-annual and annual revenue and expenditure reports in accordance with directives to be issued to them under Article 12.

4. Tax Systems and Collection of Revenue

The power to tax and collect revenue is granted to the relevant levels of government under Article 9. Revenues belonging to the central government and those jointly owned are to be collected by the central government, while regional governments collect their own revenue from the sources allotted to them.

A point of crucial significance is the necessity of avoiding the cascading effect of the taxes levied by the central government and the regions. This is particularly important from the perspectives of regions to increase their revenue as much, and the tax payer's interest to pay as little as possible. The idea of targeting maximization rather than maximum revenue is set out in Article 8 of Proclamation 33 which uniformalizes and unifies the tax system and grants the MOF the responsibility to see to it that the regions adhere to this requirement. Tax rates of those taxes whose proceeds are earmarked for the centre and are to be shared between regions and the centre are to be fixed by the central government. What taxes the regions are to levy and how much to charge is (presumably) to be decided by the regions and approved by the Ministry of Finance.

5. Financing Urban-Based Expenditures

High population growth due to the natural growth process of the urban-based population as well as migration have significantly strained capacity to provide the basic requisite services. The proclamation to provide for revenue sharing between the central and regional governments did not address the needs of the urban areas. To redress the situation and give towns and cities an independent revenue base, the Transitional Government has provided them with the right to collect and use the income derived from leasing urban land.

Proclamation 80 of 1993 mandates towns and cities to lease the land under their jurisdiction by auction and use the proceeds to finance urban development. The proclamation further identifies the activities on which financial resources collected from the leasing of urban land should be expended. According to Article 12, at least 90% of such income should be allocated to building urban infrastructure and for the construction and expansion of low-cost houses.

Although the proclamation provides urban centres with a distinct source of revenue, the feasibility and the benefits of the project remain questionable [3].

V. FISCAL DECENTRALIZATION: ISSUES, PROBLEMS AND PROSPECTS

Sections II to IV have outlined the system of political decentralization from the perspectives of the centre and regions, the changing functions of the state and fiscal decentralization from the legal point of view. What remains to be done and what is attempted in this section is scanning of the new fiscal landscape and assessing its likely impact on some important determinants of current and future welfare, including the degree of independence it confers on regional/national governments, its capacity and capability to enable them carry out their mandates effectively, its repercussions on allocative and distributional efficiency and its effect on macro-economic stability and economic development.

A. Fiscal Decentralization in Practice

Politically, regional governments are behaving as if they are sovereign states enjoying complete and unrestricted local autonomy. They have adopted their ethnic language as the official language, organized their bureaus (regional ministries), and have embarked upon the difficult task of socio-economic development.

These radical political and administrative transformations were accompanied by fiscal decentralization based on the simple and fundamental idea of fiscal independence. The regional/national governments are expected to finance their expenditure, with support from the central government where this is deemed necessary.

Regional governments have access to two sources of revenue, those which were designated as their exclusive income and those which they share with the central government. Two additional sources are grants from the central government and borrowing from domestic sources. The legal nature of these sources of revenue was discussed earlier. What remains is an assessment of the practical significance of these sources of revenue to the regions.

The implications of the division of the fiscal base and current fiscal stance between the regions and the centre are captured in Table 1.

Table 1: Revenue, Expenditure and Deficit of Regional Governments, 1993/94 Budget Year (Millions of Birr)

Regions	Own Revenue	Expenditure			[1] as % of [4]	Deficit
		Recurrent	Capital	Total		
	[1]	[2]	[3]	[4]	[5]	[6]
1	57.4	122.4	157.5	279.9	20.5	222.5
2	7.8	39.5	74.2	113.7	6.9	105.9
3	113.4	360.4	336.7	697.1	16.3	583.7
4	185.7	562.6	319.5	882.1	21.1	696.4
5	31.1	63.9	73.5	137.4	22.6	106.3
6	4.6	38.2	47.4	85.6	5.4	81.0
SEPA*	82.9	279.0	192.7	471.7	17.6	388.8
12	2.6	27.9	37.2	65.1	4.0	62.5
13	18.9	22.4	3.0	25.4	74.4	6.5
14	278.3	169.4	187.8	357.2	77.9	78.9
Dire Dawa	23.8	24.8	4.8	29.6	80.4	5.8
Total	806.5	1710.5	1434.3	3144.8	25.7	2338.3

Source: TGE, *Budget Proclamation for Fiscal year 1993/94*, various tables.
* = Southern Ethiopian People's Administration

Salient, features emerging from the table are:

a) The regions' own revenues are projected to finance no more than 47% of their recurrent expenditure, none of their capital expenditure, and 26% of their total expenditure.

b) The converse is that three quarters of the regional budgets are covered by central government grants.

B. Causes of Fiscal Dependence

The overwhelming fiscal dependence of the regional governments on the central treasury despite the celebrated autonomy is deeply rooted in the assignment of revenue bases between the centres and the regions as well as in the freedom of the latter to determine their own expenditure and develop their tax policies. These will be evaluated consecutively.

1. Revenue and Revenue Base

The entire revenue of Birr 861 million over which the regions had proprietary rights were entirely collected from those taxes and other sources of income assigned to them.

a) Own Revenue: The fiscal base assigned to the regional governments is very weak and generates revenue far below the level required to fulfil the objectives of fiscal independence. For all the regions, profit and sales tax on petty traders, charges and fees on licences issued and services rendered by them and personal income tax collected from their own employees are the most important sources of revenue and are likely to remain so for some time to come. The agricultural income taxes nationally add up to average about Birr 85 million, and are not expected to grow significantly without increases in productivity and raising the rate at which agricultural income is taxed.

Taxes to be collected from rent of houses, properties and enterprises owned by regional governments are virtually non-existent and would remain so until redistribution of assets between the central and regional governments and until the regional governments build up their stocks of these assets.

b) Shared Revenue: The second source of revenue for the regional governments includes taxes and royalty on jointly owned enterprises, and on large scale mining petroleum and gas operations and forests, none of which is of any current significance. This source of revenue has yet to be tapped by regional governments. The absence of revenue for the regions from this source may be more due to the unavailability of the formula that would determine the division of taxes and royalties on activities falling under this category. Mining activities in the Southern Ethiopian Peoples' Administration, *Tigray* and *Oromiya* are examples of potentially significant sources of income to these regions but are currently collected by the central government in their entirety.

2. Borrowing

Regional governments are granted the right to borrow from domestic sources. However, the exercise of this privilege is conditional, very stringent and above all problematic.

To begin with, regional governments can borrow only for the specific purpose of financing projects whose feasibility studies should accompany their request for credit to the Ministry of Finance or the Ministry of Planning and Economic Development. Secondly, the regions must prove, through revenue forecasts based on realistic economic indicators, their capacity to repay the debt.

The minister to whom the request is submitted recommends the amount each region can borrow after evaluating a) the debt servicing capacity of the region based on its revenue forecast and economic indicators, and b) the impact such borrowing would have on the national budget deficit.

Once decision is obtained on the credit application (from the Council of Ministers? the Prime Minister? the President? the Council of Representatives?) it would be communicated to the National Bank of Ethiopia(NBE) for authorization of the credit on request.

The law is not clear on who the borrower is and on the source of credit. Article 35 of Proclamation 7 and Article 10 of Proclamation 33 indicate domestic lenders as sources of credit to the regional governments. Article 10(3) of Proclamation 33 of 1992 requires the NBE to "authorize disbursement of loan on request" and not to make the resources available itself.

Considering the fact that the NBE has only regulatory power over banks and other financial institutions, it can not authorize them to make the credit available on request. This would be a clear violation of the autonomy and operational independence of banks and financial institutions.

Even if one assumes the capacity of NBE to order (authorize) banks and other financial institutions to lend money to the regional governments, two problems are likely to arise. The first relates to the identification of the borrower. If the central government borrows on behalf of the regional governments or the debt is guaranteed either by the central government or NBE, the process could be simple and disbursement quick. On the other hand, if the regional governments are to be the debtors, obtaining credit from banks and other financial institutions may not be that easy. Potential creditors may require guarantees and scrutinize the revenue raising capacity of the region and reevaluate the project for which credit is sought. Given the current low revenue capacity of regional governments, borrowing from the banks and financial institutions may not be an easy option.

The second problem relating to borrowing is the failure to mention the instrument of debt. For example, the central government could borrow from domestic sources by issuing treasury bills and bonds. No such instrument is acknowledged by or identified for the regional governments.

Could the central bank be the source of credit? Legally credit from the central bank is available only to the central government pursuant to Article 27 (1) and (3) of Proclamation 83 of 1994, so that this line of credit is not directly available to regional governments.

A very generous interpretation of the credit clause of the regional governments would have to transfer the exercise of this right to the central government. What may happen under such circumstance is that once the volume of credit to regional governments is approved, this is passed over to the National Bank of Ethiopia for disbursement. If such is the case, then the borrower and therefore the debtor is the central government and the source of credit would be the National Bank.

How much can the regions borrow, albeit indirectly form the central government? Not very much. The volume of credit to the central government from the central bank is limited. It can borrow (Article 25(3) (a), (d) and (e) of Proclamation 83 of 1994) no more than 15% of its average annual ordinary revenue of the past three years at market interest rate in direct advance. Repayment of all previous advances is a precondition for new advances. The central government can of course borrow as much as it possibly could through treasury bills (repayable within 12 months) and bonds (repayable within ten years) from the capital market. Given the absence of a capital market, the one major source remains the central bank, which is however limited to a maximum holding of 25% in treasury bills and 50% in bonds of the previous three-year average of the central government's ordinary revenue. These do not seem to provide significant volume of credit to finance regional development activities in addition to covering central government deficits.

Although the law does not limit how much regional governments can borrow from domestic sources, it is likely to remain insignificant, given the circumscribed arrangements through which these sources of resources could be tapped.

3. Central Government Subsidy

By far the most important source of revenue to the regional governments is and will likely remain subsidy or grants from the central government until the recategorization of the revenue base and redistribution of productive assets. As is evident from Table 1, no less than 47% of the recurrent and the entire capital expenditure are to be financed by the central government during the 1993/94 fiscal year.

Three issues of relevance at this juncture are the causes for such disproportionate fiscal dependence of the regional governments on the central treasury and the method of determining the share of the revenue that is to be granted and the mechanism for its distribution among the competing beneficiaries.

The cause for the significant mismatch between the revenue and expenditure of regional governments, as already pointed out, lies in the fact that the most lucrative sources of revenue are appropriated by the central government. The categories of revenue allotted to the central government and the estimated yield are shown in Table 2.

The Central government collects all tax revenue levied on international trade (including customs duty and taxes on imports and exports, excise and sales taxes on imported goods) which accounts for 40% and 32% of its own income and country-wide revenue, respectively.

Indirect taxes (which include excise, sales and service taxes on locally produced goods and stamp sales and duties) contribute 29% of the centre's and 23% of the total tax revenue. Non-tax revenues of the central government are collected from charges and fees, sales of goods and services and

Table 2: Categories of Revenue Sources Allotted to the Central Government and Annual Yield 1993/94 (Millions of Birr)

Revenue Base	Yield		Total
	Centre	Region	
Direct Tax	497.0	535.0	1032.0
Indirect Tax	892.7	120.6	1013.3
Taxes on Foreign Trade	1264.0	-	1264.0
Non-Tax Revenue	425.4	145.6	571.0
Capital Receipts	50.8	5.1	55.9
Total	3129.9	806.3	3936.2

Source: TGE, *Budget Proclamation for Fiscal Year 1993/94*

government investment income (of which more than 50% are the residual surplus and dividends from public enterprises) and account for 14% of its income and 11% of total revenue.

The net effect of the centre's control over these sources of revenue amounts to its appropriation of 80% of the country-wide revenue, leaving only 20% to regional governments. Consequently, this fact in combination with their expenditure responsibility which is imposed on them by the centre, makes the regions overtly transfer-dependent. An interesting implication here is that the near to sovereign status of internal autonomy regional governments enjoy is checked by financial constraints. This may be a strategy for maintaining the territorial integrity of what is left of the country. If this is the case, the political control of the previous orders is substituted for by the financial instrument of the current government.

The second question germane to central government subsidy is how the proportion of the revenue to be given to the regions is determined. We know from Article 36 of Proclamation 7 and Article 7 of Proclamation 33 that the central government has pledged to provide grants/subsidies to regional governments, but how much or what share of its total revenue this is to be is not given. If one may speculate, the decision of who gets how much is to be arrived at on a case by case basis, and whatever this amounts to would be distributed among the regions and the rest used by the central government.

The third issue focuses on the determinants of the grants to each region. To begin with, grants/subsidies are purpose driven. In general, grants are equity-based and aim at accelerating socio-economic development, with an accent on those areas that have so far been disadvantaged.

Article 7(5) of Proclamation 33, together with Article 7(2) of the same proclamation and Article 36 of Proclamation 7, give hints on the determinants of the flow of resources between regions. The beneficiaries would be those regions that cannot provide basic social services and undertake economic development activities of their own. According to Article 7(5) of Proclamation 33, the amount of subsidy to be granted would be proportional to the regions' revenue.

While the general determinants of grants are identified, no specific method or formula is given. In the final analysis, who gets what is likely to be decided through bargaining and negotiation, a strategy at which particularly the most disadvantaged may be very weak.

C. Impact Analysis

The new fiscal paradigm is bound to impact on various development parameters in a significant way. Before concluding this section, we would reflect very briefly and in a general way on the effects it is likely to engender on allocative efficiency, macro-economic stability and the economic development of the regions.

1. Effect on Allocative Efficiency

The idea of imposing the freedom and obligation of fiscal self-sufficiency on the regional governments has the potential to improve efficiency in resource use, impose the discipline of transparency and accountability on those in authority and transform the quality of governance.

The political paradigm has successfully transferred the responsibility of managing the economy and society to regional governments. But this has not been balanced with commensurate fiscal capacity. As shown earlier, more than 80% of the revenue is controlled by the centre, of which an unknown proportion is to be given to regional governments in the form of grants. Furthermore, the principle behind grant determination seems to favour equity more than efficiency.

While the idea of redressing inequality and supporting regions to broaden their fiscal base is acceptable, this should however not penalize efficiency and capacity in favour of equity.

If such an arrangement is implemented as the exclusive determinant of grants, it may discourage local revenue raising capacity, decrease local expenditure and otherwise suppress local initiatives, increasing the burden of financial support on the central government in the final analysis or decreasing the volume and quality of services provided by the regional governments. It would therefore be necessary to strike a balance between equity and efficiency.

2. Effect on Macroeconomic Stability

The changing role of government and fiscal decentralization were inaugurated under very difficult macroeconomic conditions. The huge government deficit needed to be trimmed, inflation controlled and the balance of payments positioned maintained at a sustainable level. The new fiscal paradigm is structured in ways that would support initiatives at maintaining macroeconomic stability.

The central government has passed the responsibility of providing goods and services to the regional governments. What this means from the perspective of fiscal balance is that the deficit has been pushed downstairs.

At the same time, regional governments have no way except to operate on a balanced budget basis. They have no recourse to financing fiscal deficit. Grants and borrowing are targeted to specific activities and projects while recurrent and any additional capital expenditure must be financed from their own revenue.

Under conditions of hard budget constraints, options available to finance regional government deficits, if and when they arise, are indeed very narrow. In the absence of a deficit financing mechanism, the resources available to regional governments are increasing taxes or reducing expenditure. They could of course accumulate arrears over short periods but this is an unpleasant stop-gap short-term measure rather than a genuine deficit financing instrument.

Under conditions of financial difficulty of the central government, grants and borrowing as currently structured are compressible, i.e., when the central government needs to decrease its expenditure, it would reduce grants and subsidies. Consequently, the burden of maintaining fiscal prudence and stability is to be borne by regional governments. And, as pointed out above, the budget balancing strategy lies in increasing local taxes and/or decreasing the quality and volume of services provided.

Increasing local taxes and revenue may be difficult for three reasons. The first is the degree of freedom regional governments have in deciding what to tax and at what rate. Article 8 of Proc. 33 seems to restrict their freedom in the interest of avoiding cascading of taxes and uniformalizing tax policy.

The second point that may impinge on the taxing capacity of regional governments is its impact on tax payers. Regional governments would undoubtedly like to raise as much revenue as possible. But this could negatively affect the business environment by increasing cost and depressing the profit of enterprises. So the objective here would need to be maximization rather than maximum tax revenue, which inherently limits the volume of collection.

The third reason that affects revenue raising capacity is the extremely narrow fiscal base available to regional governments. With the exception of Region 14, taxable activities are extremely limited to personal income taxes of their own employees, taxes on petty traders, agricultural income tax and land use fee. The revenue productivity of these activities is small.

Consequently, the budget balancing mechanism seems to rest on decreasing sub-national government expenditure under conditions of fiscal crunch, a mechanism that would ease the central government's burden of reducing its expenditure to restore fiscal balance.

3. Effect on Socio-Economic Development

An assignment of enormous consequence thrust upon and assumed by the regional governments is the responsibility of socio-economic development. Beginning with the Charter and in subsequent legislations, the Transitional Government extricated itself from the duty of producing and distributing goods and services, limiting itself to regulating the market process.

Henceforth the tasks of supplying health and education services, building roads, establishing and managing industries, providing housing and other amenities, etc. are effectively transferred to regional governments.

To what extent would the regional governments succeed in their quest for socio-economic development? Given the current fiscal arrangement and institutional capacity, a realistic reply would be: not very.

As suggested earlier, the regional governments are likely to operate under stringent fiscal constraints. Their revenue base is too narrow to provide them with sufficient financial resources to effectively carry out these awesome responsibilities.

A major constraint, in addition to the narrow fiscal base, is the capacity constraint. Regional governments lack trained and experienced manpower in exploiting the revenue base, identifying, prioritizing and preparing projects and implementing them. This constraint is mainly due to the politically motivated retrenchment policy in which people with training and considerable experience are dismissed from their posts and are not eligible for employment at all levels of government.

VI. SOME SUGGESTIONS TOWARDS A STRONGER REGIONAL FISCAL POSITION

A cursory reading of the assignments of responsibilities and financial capacity reveals the considerable gap between means and ends. The central government has shifted many of its responsibilities downstairs without giving commensurate fiscal capacity. These need to be revisited and means and ends reconciled if unpleasant consequences are to be avoided. The following are some suggestions that could be looked into in the course of revising the revenue sharing mechanism between the centre and the regions. The objective is to enhance the financial capacity of the regions to effectively carry out their responsibilities and improve the welfare of their people.

The basic message of this section is that the revenue base assigned to the regions needs to be reassessed and revised in light of the enormous responsibility assumed by them. The fiscal adjustment should begin with recategorization of the revenue base and include reclassification of specific taxes between the centre and the regions, and develop a formula that would determine the volume of central government revenue to be distributed among the regions.

A. Own Revenue

In addition to the categories of taxes, duties and fees assigned to the regions, they should be given the authority to collect revenue for their own use from activities that are region- based. Sales and excise taxes on imported and locally manufactured goods are in the main assigned to the centre, regardless of where they are used or consumed. However, the regions provide essential services and infrastructure for their distribution and utilization and therefore should also benefit from the taxes imposed on these goods.

It seems more appropriate for the central government to limit itself to customs duties on imports, introduce the value added tax (VAT) for domestically produced goods and empower regional governments to collect and use the proceeds from those taxes which are paid by residents on the basis of where they are utilized and consumed. These would release considerable volume of revenue to the regions.

In addition, resource-based activities should be taxed at their origin. The current arrangement assigns revenue not on the basis of where the activities are sourced from or located but on the size of their operations. For example, in the case of large-scale industrial and agricultural activities, the regions provide the resources, the central government grants the licences and also collects the entire revenue from taxes and duties. Clearly there is no reason for such an arrangement, and a more equitable disposition requires, at the minimum, sharing such revenue or - even better - ceding it to regional governments.

Such a recategorization of the revenue base should be accompanied by some redistribution and transfer of assets from the centre to the regions. Currently, the central government appropriates for itself excise and sales taxes on public enterprises but also collects the profits. This does not seem to be a fair arrangement. The regional governments are liable to incur costs due to, for example, negative externalities such as pollution, the provision of housing and building infrastructure, the provision of health and education service for the children and those people working for these enterprises, without benefiting from the activities generating these additional costs. Even if there is no full asset transfer, regions should share the revenue with the central government.

However, in the process of asset transfer, care should be taken not to empower regional governments to develop protectionist policies in favour of enterprises located in their jurisdiction. The current arrangement, which assigns taxes from small operators and petty traders, may increase the desire of regional governments to discriminate against large establishments in favour of these activities since they, and not the bigger ones, contribute to their income.

Grants from the central government should be sourced from nationally-based taxes rather than revenue collected from the regions. While poorer and more backward regions should be supported to increase their financial capacity, this should not be at the cost of other regions. Transfers should not penalize capacity and efficiency in favour of equity. Where grants are equity-driven, regional revenue raising efforts may be stifled.

Furthermore, grants and subsidies from the centre to the regions should be transparent and based on some kind of rule or formula instead of their current discretionary nature. The distributional formula should determine what percentage of the revenue is to be distributed, and what the share of each region would be. Such an arrangement, in addition to making transfers transparent, would put the burden of fiscal adjustment on both the centre and regions.

Given the cyclical nature of tax revenues, regional governments should be granted the power to borrow from the central bank and other domestic sources of credit. These should however be limited in volume to avoid excessive borrowing, impose fiscal discipline, and avoid crowding out the private sector out of the credit market.

VII. CONCLUSIONS

This paper had the task of analyzing the nature and degree of fiscal decentralization in Ethiopia during the transition period by examining the appropriate legal instruments. It was found that fiscal independence is highly correlated with political decentralization. The latter defines the essence and the former the means of realizing the autonomy of sub-national governments.

Politically, the regional governments enjoy an autonomy that is close to that of a sovereign state. The central government has transferred practically all duties, responsibilities and powers of governance to the regional governments, with the exception of defense, foreign affairs, currency, and foreign economic cooperation. Consequently, these sub-national governments are responsible for the provision of essential services and socio-economic development of their respective regions.

The Transitional Government has synchronized the devolution of political power with fiscal decentralization. Consequently, the regional governments formally have control over revenue bases that are ceded to them for their use along with the privilege of sharing revenue collected from specific activities with the central government. This access to revenue is further supplemented by grants/subsidies from the central government and the privilege of mobilizing resources from local credit markets.

Unfortunately, these formal concessions by the central government fall very short of the basic tenets of fiscal autonomy as well as the volume of revenue required by the regional governments to effectively fulfil their enormous responsibility. The productivity and elasticity of the revenue base assigned to the regional governments are too small to generate a significant volume of revenue. With the central government controlling all the productive assets, there has been no revenue sharing between the two. Consequently, the central government collects and controls 80% of the national revenue. With revenue falling considerably less than the regional governments' budgeted recurrent expenditure, the sub-national governments depend on the central government not only for their capital but also for their ordinary expenditure.

Grants from the central government are projected to finance 47% of their recurrent and 100% of their capital expenditure. Grants, in addition to significantly eroding the heralded fiscal autonomy, are discretionary and compressible. No formula or rule exists to determine what percentage of the total revenue collected by the centre would be allocated to grants, and how this is to be distributed between the different regions. Presumably, which region gets what is to be determined through bargaining and negotiation between the central and regional authorities. This process not only clouds transparency in distributing grants but also denies regional governments the opportunity of long-term planning.

The second problem in grants is their compressible nature. With no prior commitment on the percentage of central government revenue to be distributed, it is likely to be used as the adjustment factor in the process of correcting any fiscal imbalance.

Borrowing by regional governments seems to be more of a smoke screen rather than a genuine financing mechanism. The articles governing and defining the procedures involved and the sources of credit are muddled and vague. The most generous interpretation of the sentiment (and definitely not the appropriate legal provisions) leans towards a working arrangement whereby the central government borrows on behalf of the regional governments from the National Bank of Ethiopia.

An overall assessment of the fiscal stance of the regional governments as provided for in the various legislations is that they lack autonomy, are conspicuously underfunded relative to their responsibilities, and are expected to pursue a regime of balanced budget with no option to finance even the shortest of the short-term deficits.

An additional constraint on the activities of regional governments is their manifest lack of institutional capacity mainly because of shortages of trained and experienced manpower.

Genuine fiscal autonomy would require serious reconsideration of assignment of revenue base redistribution of revenue-generating assets and reformulation of the grant assessment and distribution mechanism.

Without commensurate fiscal base, the political, administrative and developmental responsibilities thrust upon the regional self-governments are likely to flop, with possibly unpleasant consequences. If the central government is attempting to use fiscal instruments as tools to maintain the territorial integrity of what is left of the country, it has selected the worst possible means. A more mature and beneficial approach is needed to effectively implement fiscal decentralization and keep the nation together.

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