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Fiscal Federalism in Theory and Practice

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

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

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1. Introduction

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

Fiscal federalism is essentially the choice and distribution of fiscal decision-making power across multi-leveled governments. The policies and practices of fiscal decentralization have diverse features and maturity across countries and yet are characterized by their common tendency to move away from the practice of centralized fiscal system. The path from centralized to decentralized fiscal policy decision making system takes different sequences and speed and the reforming countries often attempt to pursue economic, political and social objectives. Some countries implemented fiscal decentralization whereas others opted for de-concentration of centralized decision making without actual fiscal decentralization (Bird, 1993; Martinez-Vazquez and McNab, 2001). In some cases, fiscal decentralization followed the political imperative of establishing federal political structure whereas in others fiscal decentralization was put in place within a centralized political regime to reform their fiscal system. It is also apparent that the choice and implementation of fiscal decentralization measures is preconditioned on the prevailing economic and political environment of the country under consideration.

Fiscal decentralization has both economic and political effects. It can serve as one of the mechanisms to promote democratic institutions and expanding the quality, quantity and diversity of public services that suit the priorities of local populations. Nonetheless, undertaking fiscal decentralization measures before local institutional capacity reaches some critical threshold level of policy implementation and evaluation capability at sub-national government levels might involve significant economic cost, inefficiency in resource utilization and contribute to breach of fiscal discipline (Tanzi, 1996, Prud'homme, 1995). After all, fiscal decentralization alone would not bring improved governance and accountability to the people at the local level without essential democratic institutions that responds to local priorities and preferences. Hence, fiscal decentralization requires a favorable environment of democratic political system to operate as accountable, credible and efficient manner of mobilizing and utilizing fiscal resources. In this process, a professional, honest and politically independent bureaucracy is important in the process of improving the performance of the public sector and yet could not substitute a genuine system of democratic institutions. This is true both in centralized as well as decentralized fiscal regimes and yet the relative importance increases in decentralized fiscal setting.

Most fiscal systems derive their federalist characteristics from the constitutional framework of their political system (Majeed et al., 2006). The constitutional origin of fiscal federalism sets the nature and characteristics of the system even if the actual implementation of fiscal policies largely depend on the nature and development of the national economy, the degree of fragmentation of the population, the degree of horizontal and vertical imbalances across regions and local administrations, the capacity of the system to design and implement economic and social policies and programs, and the relative power balance of centrifugal and centripetal forces in the system. Fiscal federalism has a more problematic side when it is adopted in countries with democratic deficit and where ethnic federalism is the defining feature of the political system.

This paper explores the theoretical and policy issues and conditions that shape the effectiveness fiscal decentralization in underdeveloped economies with democratic deficit and reexamines the potentials of fiscal federalism in improving the performance of the public sector, promoting fiscal discipline, and creating favorable conditions for macroeconomic stability and economic growth. The analysis contributes to the emerging theory of fiscal decentralization and the policy discourse. The theme of this article is that the potential benefits of fiscal federalism are conditioned on the institutions and political economy arrangements of a country in which decentralized fiscal decision making could be translated into effective instruments to address core economic, political and social problems. The rest of the paper is organized as follows. The next section reviews the main strands of the theory of fiscal federalism and develops a political economy argument on issues of fiscal decentralization. Section three reviews the main features of the fiscal system of Ethiopia. Section four discusses issues involved in the practice of decentralization and their economic implications in Ethiopia. The final section draws concluding remarks.

2. Fiscal Decentralization: Theory

Fiscal federalism and decentralization derive their nature and characteristics from constitutional provisions as well as the economic, social, and political environment of the nation. The level of economic development, population size and distribution, urbanization, ethnic fractionalization, geographical sectionalism, the pattern of income and resource distribution, the institutional capacity of the system, openness to domestic and international trade, and the interaction of political economy forces are some of the factors that shape the principal-agent relationship is the fiscal system (Bahl and Nath, 1986, Martinez-Vazquez and McNab, 2001; Majeed et al. 2006). The constitutional provisions define the framework within which decision-making would be exercised and establish the vertical and horizontal structures that find meaning within the prevailing socio-economic environment of the system.

Fiscal decentralization is defined by the degree to which fiscal decision-making autonomy is devolved to and exercised by independently-elected and locally accountable autonomous sub-national governments. Fiscal decentralization and how it is practiced also affects, besides the issues of fiscal resource allocation in the economy, the other objectives of public finance, namely income distribution and macroeconomic stabilization. Fiscal federalism and its practice involve considerable amount of resource and income redistribution across regions, economic sectors and households. The ultimate economic effect of fiscal decentralization on the performance of an economy hence depends on these interactions and how these variables influence the growth and distribution of income opportunities within and across local administrations, regional states and the national economy at large.

The theory of fiscal decentralization addresses three broad issues related to fiscal decision-making: assignment of responsibilities and functions between the federal government and the sub-national governments in terms of expenditure and resource allocation, the assignment of taxation power and generating fiscal resources to finance public expenditure requirements and third the design of inter-governmental transfers (subsidies) in the usual case of mismatch between expenditure responsibilities and revenue generating capacity across lower levels of government. These issues are closely related to the fiscal policy of the country and the extent and objective to which fiscal policy is directed. These factors give rise to a fourth issue of the relative size of the public sector in the national economy. It is therefore the dynamics of these processes and public policy choices that ultimately shape the effects of fiscal decentralization on public sector efficiency, macroeconomic stability and overall growth performance.

2.1. Fiscal Function Assignment Issues

An important aspect of fiscal decentralization is the assignment of fiscal functions to the federal and the sub-national governments and the appropriate means of financing these responsibilities. The theory of fiscal decentralization does not provide a clear perspective on the optimal distribution of fiscal decision making authority and how such decisions are related to economic efficiency, growth and income distribution. The broad thrust of the theory is that expenditure responsibilities in areas of macroeconomic stabilization and redistribution functions should remain within the domain of the federal government whereas allocation functions should be assigned to lower levels of government (Oates, 2005; Shah, 1999; Musgrave, 1983).

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

The theoretical perspective broadly indicates that fiscal decentralization and the assignment of functions can potentially generate economic efficiency of the public sector. If preferences are heterogeneous enough across jurisdictions and local public officials can and do respond to local demands, decentralization can improve allocation efficiency by tailoring services to the preferences of the local population. It follows that local governments are closer to the local population and can identify their choices and preferences better than the central government (Basley and Coate, 2003). Accordingly, when the decision to provide a bundle of public goods is made by local officials and these officials are directly accountable to the local voters, there is an incentive for the local officials to provide the kind and amount of services that reflect the preferences of the local population. Moreover, as long as there is close relation between the benefits from public services and taxes on the local taxpayers, there is additional incentive to utilize resources efficiently and cost effectively. The decentralization theorem indicates that, under such assumptions and democratic political institutions, decentralization of fiscal decision-making authority improves allocation efficiency of the public sector. Whereas it is possible for both democratic and non-democratic regimes to implement some forms of fiscal decentralization, the practice sooner or later confronts tensions when democratic institutions are not operational and effective.

Once the allocation of expenditure responsibilities is conducted according to such broad principles, the fiscal system needs to address the issue of assigning taxing power that broadly identifies who should tax, where and what (Musgrave, 1983). It is the devolution of taxing autonomy that gives meaning and identity to the devolution of expenditure responsibilities. In the context of fiscal federalism, the assignment process needs to identify the comparative efficiency and effectiveness of providing the fiscal instruments to the multi-tier decision-making centers so as to finance public functions and activities in the most efficient manner possible. If taxation power is concentrated at the center, sub-national governments would become too dependent to pursue decisions and allocations that reflect local preferences and problems.

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

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

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

The decision making process is complicated by the fact that fiscal revenue generation objective, even though remains the dominant purpose in poor countries, involves redistribution and stabilization implications that are closely linked with the exercise of taxation. The fiscal policies of national economies are often used to address income and wealth distribution objectives across economic agents and families irrespective of their place of residence. The assignment of taxation power both at the federal as well as state governments would have in built feature of imposing tax obligation according to ability to pay and hence would influence the after tax income distribution. It is also important to recognize the economic stabilization role of fiscal policies where fiscal measures are taken to promote public sector investment to create jobs and growth but also to prevent the economy from inflationary pressures. It is evident that the emphasis on the resource mobilization objective alone overshadows the role of fiscal policies in the distribution and stabilization process that the federal government needs to undertake limiting the role of the sub-national governments to allocation responsibilities. It is therefore important to put the assignment function of fiscal roles within the broader perspective of resource mobilization, income distribution and stabilization objectives.

2.2. Intergovernmental Transfers

The distribution of the tax base and the demand for public goods does not follow symmetrical pattern and this gives rise to the emergence of fiscal imbalances. A number of reasons contribute to the mismatch between the expenditure responsibilities and the capacity of the lower levels of government to raise sufficient revenue to finance their expenditure. Vertical fiscal imbalances are the result of allocation of expenditure responsibilities with higher cost than the sources of revenue assigned to local governments. This indicates the case in which the level of revenue source decentralization is lower than the decentralization of expenditure responsibilities. Horizontal fiscal inequity emerges usually as a result of concentration of tax bases due to uneven distribution of economic resources and activity across regions whereas expenditure requirements are spread more evenly.

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

The practice of providing fiscal grants to lower levels of government essentially involves redistribution of fiscal resources from some regions and local administrations to another conducted through the federal government. The drive to finance not only the functions of the federal government but also to generate resources for subsidizing the operation of local governments necessitate extracting resources and assigning higher taxation burden on economic agents, sectors of the economy, regions, and households. Unless the consolidated government sector exercises fiscal discipline and limit the disincentive effects of excessive taxation, it would have adverse effects on the performance of the national economy and on macroeconomic stability. It is therefore very important to assess the fiscal burden that intergovernmental transfers create especially when fiscal deficit is a prevailing feature of the fiscal system.

Inter-governmental fiscal transfers involve two main decisions even if most federal systems pursue different approaches. The federal government needs to decide on the aggregate pool of federal grants and then the pool has to be distributed among the respective lower sub-national governments. The federal government can decide on the size of the federal grant pool based on certain parameters, on negotiations or on some ad hoc mechanisms. The vertical fiscal transfers need to be stable and predictable enough for local and state governments to plan their respective public projects and plans.

Once the pool of federal grants is decided, the distribution of such grants across regions or local governments follows a number of possible arrangements. The federal government my reserve a certain portion of the federal grant total to compensate for regions that contributed the most in the generation of federal fiscal resources, such as mineral or oil producing regions. This would partially address the equity concerns of regions or local administrations that play vital role in the economy. With or without due consideration to such special cases, the government may make discretionary decisions to distribute the remainder of the federal grant fiscal resources. However, such discretionary allocation might be influenced by political considerations instead of real need for assistance at the local levels. The most conventional way is the use of some grant distribution formula that takes into account indicators of needs, fiscal effort and other factors at the sub-national government levels. The use of the federal grant formula to distribute fiscal resources between the federal and regional governments and between the regional and local governments would serve as a guiding instrument in an attempt to allocate limited funds to competing regional and local expenditure requirements.

The use of federal fiscal grant formula to distribute fiscal resources that would local fiscal deficits is commonly practiced but is not without limitations. The formula clarifies the way in which the fiscal pool is distributed across regions and the underlying forces behind the percentage share are needs and the necessities of providing basic public services and the limited own revenue generating capacity of at local levels. It is also important to consider relatively transparent ways of determining the size of the fiscal pool for subsidy in relation to the consolidated government revenue and grants collection. Addressing the vertical and horizontal fiscal resource distribution in the context of fiscal federalism constitute part of the central issue of how active and interventionist should the government be in the economy. Pursuing hard government budget constraint, for instance, necessitates systems with fiscal decentralization to strike a proper balance between the federal and sub-national fiscal resource allocation and at the same time contain the possible problems of fiscal deficit on the economy. This is a policy issue that confronts governments in their choice of the size and nature of the public sector in the national economy.

2.3. Decentralization and the size of the government

The appropriate role and relative size of government in national economies are controversial and evolving political economy issues. The actual size of government in national economies is influenced by a number of economic, social, and political factors (Lowery and Berry, 1987; Meltzer and Richard, 1981; Jin and Zou, 2001). Does fiscal decentralization have influence on the size of the government? The theoretical link between fiscal decentralization and the relative size of the public sector in national economies remains murky. The public finance theory traditionally identifies forces that shape the extent of government intervention in a national economy. These forces include market failure, imperfect information, incomplete market, externalities, public goods and significant unemployment of resources (Ehadie, 1994; Rodden, 2003). The possible impact of fiscal decentralization on the overall size of the public sector is moderated through a number of factors such as political institutions, constitutional limits, the extent to which the cost of providing public services is internalized at local levels, ideological position of the government in power, the autonomy of local governments, the level as well as growth of national income, the fiscal constitution, practice and institution of the system.

The process of fiscal decentralization can potentially improve efficiency in the provision of public goods by identifying the preferences of local population and internalizing the cost within the same jurisdiction. When political institutions enforce accountability and local officials are responsible to the local constituency, there is incentive for decision makers to achieve goals that are in line with the preferences of the local population. The internalization of the cost of public service provision would also provide extra incentive to discipline fiscal decisions and operate within hard budget constraint. If the expenditure choice of local governments is linked to taxation on the local population, there would be strong reason to maintain fiscal discipline and operate towards a smaller and efficient government size (Qian and Roland, 1998; Rodden et al., 2003). However, when an increasing share of local government expenditure is financed by inter-governmental subsidies and devolution of function is not accompanied by reduction of expenditure at the federal level, there is a tendency for faster growth in the size of the government (Rodden, 2003; Jin and Zou, 2001). This might lead to the expansion of the public sector without improving the quality of public services, growth of public spending without a corresponding growth in income beyond sustainable level, and a tendency for patron-client relationship to develop in the way the central-regional-local decision-makers interact. The effect of fiscal decentralization on the size and growth of the government therefore depends on the nature of fiscal federalism pursued in the system.

The theory of fiscal decentralization and its relation with economic policy issues is a growing field of research whose framework is evolving to guide and inform public policy discussions. How the process of fiscal decentralization is related to the size and efficiency of the public sector and how such relations influence national economic performance are topical issues of theoretical and policy interest. Fiscal decentralization has potentials to improve the efficiency of public resource utilization and such an efficient government creates the environment for fast and shared economic growth in the national economy. However, fiscal decentralization can also be the source of fiscal policy distortion and misallocation of limited economic resources with limited impact on the efficiency of the public sector, the growth performance of the regional economies, and the overall performance of the national economy. In the next section, a brief review of the fiscal system and the practice of fiscal decentralization in the Ethiopian economy is made to put the system of fiscal federalism in the country in its political economy context.

3. Features of the Ethiopian Fiscal System

The fiscal system of Ethiopia has historically been characterized by high centralization and concentration of fiscal decision-making power and fiscal resources at the center. The changes in political regimes did not have significant implications on the centralization and concentration of fiscal decision making power in the firm hands of the federal government (Moges, 2003). The government attempted to redefine its role in economic affairs within the broad policy framework of introducing market oriented economic system in which the private sector plays the central role. Accordingly, a series of economic and fiscal policy reforms were put in place including the amendment in the tax regulations and institutions, privatization of part of public enterprises, financial sector and investment law reforms. After initial signs of new economic policy direction, the pace of reforms lost momentum and the government has increasingly become reluctant to undertake reforms and clear tendencies to operate a parallel decision making structure from the center emerged over the years. Such a practice can precipitate the dark sides of fiscal decentralization measures where the reforms were used to promote centrifugal forces and weaken the potential benefits of decentralized fiscal decision making processes (Oates, 2005; Chanie, 2007). The current policy priorities of the government suggest that public sector investment-led growth strategy in which the role of fiscal policy is largely geared towards extraction of fiscal resources from the economy and channeling them to finance projects that the government considers priority areas.

The fiscal system of Ethiopia has dominantly focused on extracting the maximum amount of fiscal resources from all forms and accessible sources of revenue. The only formidable barrier to its extractive drive is the poor state of the economy, overwhelming poverty of the population, narrow tax base of the economy and the limited administrative reach of the fiscal system. In recent years, the government has sharpened its skills of appealing to foreign donors to generate considerable amount of resources that has increasingly been used to avoid the exercise of prudent fiscal policy in the country.

Table 1 summarizes the main features of fiscal aggregates of Ethiopia in recent decades. The fiscal aggregates remain stable despite a number of fiscal policy and economic policy innovations. The nature and structure of the economy, the resulting tax bases, the excessive dependence on international trade taxes and external grants, and persistent deficits all contribute to the prevailing features of the fiscal sector as do the fiscal policy stance of the government. The fact that the national economy has failed to achieve any meaningful structural transformation suggests that fiscal aggregates would have little scope for change.

For the period 1990/91-2010/11, the government sector on average extracted about 13 percent of GDP from the economy in the form of revenues and spent about 20 percent of GDP. This is a typical indicator of a fiscal system that has limited capability to generate sufficient resources mainly because the capacity of the economy to deliver employment opportunities and decent income beyond subsistence is quite limited. In terms of allocation of these fiscal resources, recurrent spending on average absorbed about 12 percent of GDP, which almost exhausted the revenue resources of the government. Capital expenditure requirements that would be essential for the provision of essential infrastructure, health and education services had to depend on foreign aid and loans. The government run budget deficit on average about 7 percent of GDP the financing of which generated various macroeconomic problems and accumulation of public debt. Despite efforts to contain the growth of the recurrent expenditure of the rapidly expanding public sector both at the federal and sub-national government levels, the sectors absorbs considerable amount of resources away from essential capital investment needs. A fiscal system that resorts to borrowing to cover about 36 percent of its spending appetite would sooner or later confront the consequence of its behavior. This behavior of fiscal spending has left its mark on the macroeconomic situation of the country in which aggregate expenditure persistently runs in excess of domestic production and the build-up of inflationary pressure.

The change in government in 1991 created the environment and opportunities for reforms in almost all sectors of the economy. Fiscal policy reforms were undertaken that could shape and refocus the activities of the government sector.

Table 1- Ethiopia: The Structure of Government Revenue and Expenditure 1990/91 – 2010/11 (Average share in GDP)

Period/ Fiscal Indicators	Tax	Non-Tax	External Grants	Recurrent	Capital	Deficit excl. Grants
1990/91-1994/5	7.00	2.75	1.80	11.51	5.21	-6.97
1995/6-2003/4	10.02	4.46	3.03	14.52	7.47	-7.50
2004/5-2006/7	10.82	3.22	3.84	11.35	10.67	-7.98
2007/8-2010/11	10.27	2.62	3.69	8.41	9.93	-5.45
2004/5-2010/11	**10.51**	**2.88**	**3.76**	**9.67**	**10.25**	**-6.54**
1990/1-2010/11	**9.47**	**3.53**	**2.98**	**12.19**	**7.86**	**-7.05**

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

The first wave of reforms focused on demand management and improving underutilized capacity in the economy. And yet, there was no major and genuine shift in the policy stance of the government with respect to the level of intervention in the economy. The current regime inherited a stagnant economy and a regime that had an ideological opposition to the market system and hence the private sector. The policy reforms during the 1990s partially addressed these problems and at least nominally admitted the critical role for the private sector. However, the regime has maintained its interventionist policy that has deprived the nation the emergence of a dynamic private sector and market oriented economic system. Despite the rhetoric of private sector promotion, the regime has increasingly resorted to policies and practices of government led development strategy.

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

The current government in power shares important characteristics and behavior in fiscal policy with its predecessor. Despite marginal changes in some aspects of the fiscal components, there has not been enduring and significant shift in policy. The current fiscal system of Ethiopia exhibits striking continuities with the previous fiscal policy regime (Moges, 2003). The data indicates that either the current regime is not willing to fundamentally change its fiscal policy stance or the fiscal system is governed by the structural features of the economy that are not easily amenable to fiscal policy reforms. A closer examination of the main features of the fiscal system suggests that both factors play a role in the process.

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

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

4. Fiscal federalism in Practice

The policy of fiscal federalism in Ethiopia has followed the political imperatives of establishing an ethnic federalist political structure. The overthrow of the military regime of Ethiopia in 1991 by a coalition of rebel forces set the stage for a drastic shift in the political landscape of the country. The process culminated in the formalization of the ethnic-territorial federal structure of government with the adoption of the Constitution of the Federal Democratic Republic of Ethiopia in 1994. The Constitution formalized the experiment of ethno-linguistic based structure of government into a federal structure. Nonetheless, the Constitution shares essential features from former constitutional or legal provision in practice in the country. The very spirit of these Constitutional provisions and their genuine nature has been limiting individual citizens and hence the society in the exercise of their political and economic rights and freedoms. Instead of limiting the actions and powers of the government, which is a defining feature of a democratic constitutional setting, the governments were allowed to exercise and often times abuse political power under the veils of constitution.

The Ethiopian federal structure consists of nine regional states and two chartered city administrations. The administrative structure divides the nine regional states into 70 Zones and 550 Woredas (districts) with elected councils creating a four-tier level of government. The Woreda serves as the basic unit of administration. Moreover, there are municipalities in urban areas undertaking both taxation and public service provision functions. Since 2002/3, there was initial experiment to decentralize to the Woreda levels of government, in the process eliminating the role of Zones. The system has moved gradually towards a three-tier structure of decentralization: federal, regional and Woreda levels. And yet, the system remains highly centralized where real decision making power is exercised at the center by equally centralized political structure. The Tigrean People Liberation Front (TPLF) remains the dominant and operates the system as a one party system with increasingly dictatorial tendencies. Whatever decision making power left in the federal and decentralized decision making centers and institutions, exercise is confined to implementation of federal government decisions at local and regional levels. This structure creates a principal-multi-agent setting in the political and fiscal relationship in the country and can hardly serve the true spirit of decentralized decision making.

The 1995 Constitution divides responsibilities under the jurisdictions of the federal government and the regional governments. The federal government is provided constitutional power to formulate and implement the country's policies, strategies, and plans in respect of overall economic, social and development matters. Moreover, the power to enact laws for the utilization and conservation of land and other natural resources, historical sights, and objects. The Constitution defines and provides extensive decision-making legislative and executive powers and responsibilities to the regional states. The most notable ones are: enactment of state constitution and laws; formulation and execution of economic, social and development policies, strategies and plans; administration of land and other natural resources in the territory; levy and collection of taxes assigned to the regional states; designing standards for state level civil services and payment; and maintenance of state level security forces. The Constitution reserves all powers not provided to the federal government to the regional governments.

Fiscal federalism in Ethiopia has been put in place within the dictates of political imperatives. This has given rise to a unique system of fiscal constitution that is closely linked with the political constitution of the country. One of the effects of the redrawing of the political map of the country is forming extremely heterogeneous economic, demographic and political regions. The federal structure of Ethiopia carved regional states that exhibit significant variations and heterogeneity. These diverse circumstances of regional states have given rise to horizontal fiscal imbalances. The regional distribution of revenue sources is such that most regions could not generate enough revenue to cover their expenditure responsibilities. For the period 1993/4 – 2003/04, the regional states as a group managed to finance on average only about a third of their expenditure from their own revenue sources. Moreover, the responsibilities to provide public services at regional and particularly Woreda levels has increased considerably without a corresponding increase in the own revenue generation or a corresponding rise in federal grants. It is also apparent that the expansion of the role of the Woreda level of administration in public service provision was not undertaken with equivalent reduction in the role of the regional government fiscal policy decision making centers. This has evidently expanded and shifted the burden of responsibilities and fiscal resource needs of the Woredas without a compensating streamlining of the regional level of governments. Such a practice would have the effect of expanding the public sector and its absorption of limited public resources without necessarily improving the quantity and quality of public services available to local communities. Despite the reallocation of human and fiscal resources from Zonal administration to the Woredas, most of the local administrations do not have the resources as well as the administrative capability to exercise fiscal decision making beyond serving as implementation agents for the higher levels of administration.

The devolution of fiscal structure to the Woreda level, nonetheless, is an important innovation in the fiscal system of the country and could have significant influence on the fiscal performance of the public sector as well as in experimenting with the potential benefits of fiscal decentralization in the country. Unlike the regional states, there is a higher degree of shared challenges and similarities shaping the horizontal fiscal and policy priorities of local communities. This will also serve as a basis for future reorganization of the fiscal constitution of the country and its federalist attributes.

The critical hurdle for practicing fiscal decentralization and federalism in the country is the lack of fiscal constitution that allows the exercise of fiscal decision making at local levels in pursuit of the priorities and preferences of local communities. Such a fiscal constitution requires the existence of accountability and participation of local communities in decisions that are critical in their life. This could not be practiced when the very idea of fiscal federalism is derived from a political imperative that seeks to hold political decision making power at the center and runs a parallel structure of decision making process that overrides alternative arrangements. This is coupled with a parallel and highly centralized fiscal decision making structure that created clientelism in the relationship between the federal government relative to the local administrations (Chanie, 2007). The effect of such a parallel and over-ridding decision making power is to invalidate the autonomy of local administrations to pursue policies that reflect the priorities and concerns of the local population.

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

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

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

Despite considerable horizontal fiscal imbalances across regions, even relatively prosperous regions have problems providing essential public services to their constituents. This issue touches three important elements in the current fiscal policy of the country. First, the federal government needs to reconsider its fiscal policy and facilitate directly the provision of basic public services to all households irrespective of their residence across regions instead of just leaving the matter to financially dependent regional governments and woreda administrations. This is important in cases of public goods that have national character and different from local public goods that are distinguishable by regions or local units of administration. The need for nation-wide public goods beyond the basic is justified on the ground that even in Addis Ababa, where the own revenue is relatively high and does not receive federal grants, about 36 percent of its population live under the national absolute poverty line with limited access to basic public services as of 2008. Striking still, 61 percent of the labor force is engaged in the informal sector to earn a living.

Table 2: Ethiopia: Elements of Regional Horizontal Imbalances

Characteristics/ Regional Governments	Population Share (%)	Area Share (%)	Own-Revenue per capita (Birr) 2005/6	Poverty Index 2010/11	Urban Unemployment Rate (%)	Fiscal Imbalance (%) 2010/11
Gambela	0.42	2.40	45	0.320	12.57	11.53
Afar	1.89	7.07	29	0.361	15.13	12.19
Benisha-Gumuz	1.06	4.30	55	0.289	11.00	13.73
Somali	6.03	19.82	14	0.328	16.97	16.52
Harari	0.25	0.03	111	0.111	14.43	18.56
SNNPRs	20.24	10.28	18	0.296	13.83	22.56
Amhara	23.35	17.34	20	0.305	16.83	20.37
Tigray	5.85	5.53	70	0.318	19.40	24.61
Oromiya	36.60	33.05	24	0.287	16.43	26.05
Dire Dawa	0.46	0.15	84	0.283	26.63	25.13
Addis Ababa	3.71	0.04	991.85	0.36	22.50	79.51

Note: Population share according to the 2007 population census. Unemployment rate in urban areas is the average of three years 2008/9-2010/11.

Sources: Ministry of Finance & Economic Development; CSA, 2007 Population Census.

Second, if the current arrangement is to continue, it is imperative that in the allocation formula of federal grants, proper weighting is attached to the actual contribution of regions to the tax base of the revenues of the federal government. This is necessary because regions that carry the largest burden of taxation should be able to have sufficient financial resources to address their own problems under their jurisdiction. The mobilization of federal revenue necessarily involves the extraction of fiscal resources from regions with higher economic activity and redistribution to other regions without necessarily addressing the needs of low income families residing in relatively prosperous regions.

The third observation is the reexamination of the merit of block grants to regional states. The fiscal resources for the federal grants are generated from taxation, foreign aid and borrowing. This fiscal resource belongs to the citizens of the country and the federal government has the constitutional obligation to use it economically and effectively to promote economic, social and national objectives. It also has the obligation to justify its use and distribution across sectors, regions, and localities. Providing sub-national governments with block federal grants which has dominantly been used for paying for salary and administrative expenses of local officials and political cadres would have limited impact on the development of regions and the standards of living of the local populations except creating few job and benefit opportunities for local cadres. Unfortunately, such practice is not affordable for a subsistence economy and a public sector that runs on persistent fiscal deficit despite the inflow of foreign aid and loan to mitigate the deficit.

The assignment of revenue sources and expenditure responsibilities between the federal and the regional governments is such that almost all of the regional governments can not generate enough own revenue to cover their expenditure responsibilities. This is true even in regions where most of the sources of federal government revenue are concentrated. The absence of explicit consideration and recognition to such vital regions and the dominance of the central government in fiscal power deprive them off fiscal autonomy and the capacity to address the development priorities of their respective regions. This mismatch has given rise to the problem of vertical fiscal imbalances. The federal government spends about 58 percent of the aggregate public sector expenditure whereas the sub-national governments spend in combination the remaining 42 percent of public expenditure. Nonetheless, the less the assignment of revenue sources is highly centralized that the federal government handles about 80 percent of consolidated public revenue whereas the regions and local administrations collect about 20 percent of the revenue. As table 3 depicts, the regional governments have a combined expenditure responsibility of about 34 to 38 percent of total consolidated government expenditure whereas their share of own revenue was just about 17 to 21 percent. This is a clear indication of situation where revenue decentralization is by far narrower than expenditure decentralization the apparent consequence of which is the emergence of vertical fiscal imbalance.

Table 3: Vertical Fiscal Imbalances in Ethiopia [1993/94 – 2009/10]

Category/ Year	Combined regions' share of revenue (%)	Combined regions' share of expenditure (%)	Vertical Imbalance*
1993/94	17.8	34.5	0.484
1994/95	15.4	38.3	0.598
1995/96	16.6	41.2	0.597
1996/97	18.0	42.5	0.577
1997/98	19.7	39.6	0.503
1998/99	18.0	30.5	0.410
1999/00	18.3	23.3	0.215
2000/01	18.0	33.4	0.461
2001/02	15.3	30.8	0.503
2002/03	13.4	30.4	0.559
2003/04	17.5	38.9	0.550
2004/05	22.1	36.1	0.388
2005/06	23.4	35.6	0.344
2006/07	21.9	37.2	0.410
2007/08	20.1	37.7	0.467
2008/09	18.9	41.9	0.548
2009/10	20.3	43.2	0.529
1993/4-2003/04	**16.65**	**34.23**	**0.514**
2004/5-2009/10	**21.12**	**38.61**	**0.448**

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

The extent of vertical fiscal imbalance in Ethiopia is quite high and increasing. The situation has barely improved over the years. The dependence of regional governments on the federal grants is so significant that without federal grants most of the regions could not even cover their recurrent expenditures. Moreover, the dominant part of their expenditure is absorbed by recurrent payments such as salaries and allowances, which are difficult to reduce, and leaves little room for important anti-poverty reduction efforts. The idea of increasing the mobilization of own-revenue from local sources is somewhat ironic for local authorities because the majority of their population is toiling in poverty and earns a living from subsistence farming. In urban areas, a high portion of the economically active population is unemployed or scrapping a living from the informal sector. These situations leave little room for increasing own-revenue sources before the economic and policy environment for the local economies improve so that the informal sector graduates into the formal sector and employment generation accelerates. It is therefore clear that the fiscal policy stance of the federal government directly affects the policy choice variables that the regional and Woreda levels despite the nominal fiscal autonomy that the regional governments seem to exercise.

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

The Constitution, as well as the various laws related to fiscal policy, does not specify the absolute or relative magnitude of aggregate budgetary pool for the federal grant. The Constitution, (Article 90), states a general principle in which, given the resource constraints, policies shall be aimed to provide all Ethiopians access to health and education, clean water, housing, food and social security. The actual execution of such principle has been constrained by the budgetary allocation preference of the federal government. In practice, the federal government develops an envelope public expenditure budget. The allocation of funds between the federal and the regional governments has been made on an ad hoc basis combining budget requests from regions and the budgetary preferences and allocation decisions of the federal government. This makes the pool of the federal grant somewhat unpredictable from the perspective of regional governments. It has also created fiscal behavior on the part of the local administrations to request higher budgetary requests with little incentive to balance their expenditure with their own capacity to generate the necessary revenue from local sources. So long as the federal government provides fiscal grants, regional states and local administrations always tend to maximize their spending with little consideration to exporting the cost of their decisions to other regions and economic agents. The combined effect of such behavior is the expansion of public sector spending that is financed by extracting fiscal resources from the economy in the form of taxes and non-tax revenues, foreign aid and loans, and perhaps investment income from public enterprises.

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

To address this problem of fiscal imbalance, the federal government has used grant formula to distribute federal grants that take into account a composite of several indicative variables. Table 4 depicts the summary and relative weights of these variables including population, composite index of level of development, sector performance and an index of poverty situation in the respective regions. The grant distribution formula has been frequently adjusted to improve fair distribution of resources and encouraging efficiency and effort of regional governments to mobilize resources from local sources. The grant distribution formula has gradually shifted from needs based to more of fiscal equalization objective and the formula incorporated these priorities in its subsequent revisions.

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

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

Source: Ministry of Finance and Economic Development

Despite the use of federal grant distribution formula to allocate fiscal resources and block grants from the federal to state governments and then to woreda administrations, the formula was not strictly followed in practice. The adoption of a revised grant formula in 2003/4 revealed that some regions were allocated with funds far below their needs to run their increasing and expanding expenditure responsibilities. As a short term solution, the government followed ad hoc methods of maintaining the nominal value of the previous year recurrent budget of the respective regions and distributing the rest of the federal grants pool according to the distribution formula. The regional governments found themselves in serious shortage of funding for public services and most of the funds were absorbed by recurrent expenditure needs with pretty little left over for capital expenditure requirements. And the resort to such practice has the direct effect of distributing more fiscal grants per capita to small regions often at the expense of large regions with high population concentration.

Fiscal decentralization measures to woreda levels since 2002/3 has expanded the fiscal expenditure and public service provision role of the local levels of government. Woreda level administrations are increasingly playing important role in the delivery of services to local areas and regional governments were reluctantly allowing funds to flow to local administrative units to cover their expenditure needs. The regional governments use a formula similar to the federal grants formula to distribute resources across Woredas. The 2007 amendment of the federal grant formula took into account the shortcomings of the previous formula and switched gradually to fiscal equalization across regions that combine both equity as well as needs based assessment of the regions for receiving federal grants. The overall objective of the new practice is to move gradually to a largely fiscal equalization focused federal grant allocation formula from 2011/12 onwards.

Moreover, the further decentralization to the Woreda levels since 2002 created pressure for and higher requests for additional funding from the federal government because the own revenue sources of regions and lower levels of government, except Addis Ababa Administrative Region, remains quite weak. The federal government is also running fiscal deficits at unsustainable level despite the significant inflow of foreign grants and aid. The regional and Woreda governments are assuming an increasingly important share of the non-discretionary portion of government expenditure, particularly a dominant share of the recurrent expenditure of the government. This is driven by the expansion of public sector employment to fill the various new offices that are opened following the decentralization process. In an economy where employment opportunities are very limited, it provides attractive opportunities for loyal cadres to a secured source of livelihood. This process also create a mechanism by which patron-client relationship is established and consolidated through the fiscal system and the lower levels of government increasingly become dependent on federal grants as well as lost any meaningful autonomy in fiscal decision making.

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

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

Year/ Regions	1993/4	1998/9-2000/01	2001/2	2006/7-2010/11	2011/12 - 2014/15
Tigray	10.58	7.61	7.68	7.58	7.18
Afar	4.92	6.85	4.72	3.81	3.15
Amhara	20.09	21.80	21.58	23.16	23.17
Oromiya	32.25	27.34	30.14	32.25	32.50
Somali	3.09	9.00	7.33	6.72	8.14
Benishangul-Gumuz	3.29	4.76	3.68	2.62	2.10
SNNPRs	15.85	16.07	17.95	19.13	20.10
Gambella	2.77	3.97	2.80	1.92	1.50
Harari	0.83	1.76	1.49	1.24	1.00
Addis Ababa	6.27	0.01	0.85	0.0	0.00
Dire Dawa	0.06	0.82	1.78	1.56	1.16

Source: Ministry of Finance and Economic Development

When fiscal imbalances arise, regional states could bridge their finances in one of the three ways: levy additional charges, such as user fees and charges, to generate additional non tax revenue, borrow from domestic or foreign sources, and secure federal grants to finance their budget deficits. The practice in Ethiopia is that regions are not allowed to borrow and the user charges are not commonly practiced. This leaves the federal government grants as the dominant source to finance regional expenditure. The federal government also uses the fiscal subsidies to redistribute resources through the fiscal system. Whereas making resources available for regions that commensurate their expenditure responsibilities is necessary, the use of unconditional block grants for the purpose of resource redistribution has serious limitations. Such an approach assumes the regional states have the capability as well as the commitment to allocate such funds to the purposes that reflect the preferences of the local population. This would be a critical issue especially when accountability is weak and fiscal decision autonomy is limited. So far regional governments and woreda officials have been content with their role of implementing central government programs and maximizing, whenever possible, their share of the fiscal cake without practicing or introducing the genuine elements of fiscal decentralization that focuses on the priorities and preferences of the local population.

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

The current practice uses a hybrid formula of fiscal equalization accompanied with special funds towards equity across regions and woreda administrations. The federal government still concentrates fiscal decision making power and allocates funds on ad hoc basis for regions. There is no clear principle that indicates the proportion of the aggregate fiscal resources of the country that would be available for regional and woreda administrations. It is in practice within the discretion of the federal government to decide how much to provide for the lower levels of government. The Woreda administrations, which are increasingly responsible for the delivery of basic public services, are not sure enough how much fiscal resources would be available at their disposal to carry out development and social services. Despite the variations in the extent of economic and social challenges across regions and local administrations, it is clear that poverty and lack of economic opportunities remain to be nationally shared problem that deserves to be the responsibility of both federal and local governments. This suggests the need for transferring both the responsibility, the man-power capability, as well as funding from the federal to the local governments with minimum leak at the regional centers.

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

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

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

The second impact is related to public resource allocation behavior. There were important shifts in the allocation of public resources. The most important shift was the reorientation of public expenditure from defense related expenditure to social services and economic development expenditures. Expenditure reorientation towards health and education sectors improved the efficiency of public resource allocation. The practice of fiscal federalism contributed positively in the process since the sub-national governments allocated an important share of their budgets for poverty and social development oriented activities. However, there is a clear tendency to push expenditure responsibility to the sub-national governments without a commensurate allocation of fiscal resources. This would have adverse effect both on the quantity and quality of public service provision in local areas where the local capacity is quite limited. It has also reduced the pressure on the central government to reduce its expenditure in line with its reduced role in the provisions of public local goods that are being carried out by local governments. The overall outcome is the increase in consolidated public expenditure in the economy and the marginalization of the private sector and market forces.

The third element of policy interest is how the behavior of the public sector and the practice of fiscal federalism affected the overall performance of the economy and the behavior of other economic agents in the system. The reorientation of the public sector to areas in which the private sector is reluctant to operate or market failure is predominant would have a crowding-in effect on the private sector. There were important shifts in the policy stance of the government from a policy that categorically discourages the private sector to that, at least nominally, encourages and acknowledges the role of the private sector in the economy. Policy measures were taken that opened space for private sector participation in various areas of economic activities. However, there are still considerable ways to go. Reluctance remains on the part of the government to create the policy environment in which self-driven private sector initiatives and market forces could serve as engines of economic prosperity and employment generation. Most of the economically active population is employed in subsistence agriculture where disguised unemployment is high and in urban areas most of the labor force remains in the informal sector. Facilitating the policy environment for a vibrant private sector development is necessary and more effective in addressing the problems of poverty instead of government led initiatives.

The introduction of fiscal decentralization has had mixed effects on the participation of the private sector in economic activities. The practice, accompanied by the underlying tone of ethnic federalism, has introduced a political risk factor in the investment decision-making process. The private sector still tends to avoid long-term investment activities in which routine interaction with political decision-makers and hence interference is unavoidable. Domestic saving rate by the private sector, which is an indicator of sustainable capital accumulation effort and growth, has been extremely weak and investment projects are increasingly been financed by external loans through the public sector. The government has recently attempted to improve the allocation of its resources in favor of capital expenditure backed by generous inflow of foreign aid and yet sustainable economic growth necessitates the active involvement of the domestic private sector. It is therefore clear that despite the overall improvement in the policy environment in which the private sector operates, the relative expansion of public sector consumption in the economy has given rise to the predominance of a large and yet inefficient government in the economy. In this process, fiscal decentralization and expansion of the public sector expenditure at the lower levels of government have contributed to the recent trends in the mobilization and allocation of fiscal resources.

5. Concluding Remarks

Ethiopia has introduced a unique form of fiscal federalism in the context of ethnic federalism. The regional governments have been constitutionally vested with extensive decision-making power and yet there is a highly centralized and parallel political decision making structure that dominates the nominal provisions of the Constitution. Moreover, the fact that the federal government still centralizes the fiscal means of executing fiscal responsibilities indicates that there is a de facto centralization of fiscal decision-making. This is reflected by excessive dependence of regions on federal grants to finance even recurrent expenditures within their jurisdictions. The fiscal system is characterized by both vertical and horizontal imbalances that require further decentralization of revenue sources that commensurate the expenditure responsibilities of the regional and particularly local governments.

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

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