



Fiscal Federalism Note

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Objectives and Principles of Public Expenditure

A.Objectives of Public Expenditure

Dalton divided the aims of public expenditure in broader two parts *i.e.* the functions of government.

- 1.Security of life against the external aggression and internal disorder and injustice.
- 2.Development or upgradation of social life in the community.

These functions can be broken down in to more detailed functions as:

the public authority works in many ways for the benefit of the people. These include the generalized services like public health and education. The whole society is benefited by these functions of the State.

secondly, through public expenditure, the government influences directly or indirectly, the industrial and commercial system of the nation thereby helps towards the economic and social development of the society.

thirdly, in modern times, the responsibilities of the government are increasing every year. For the economic development of the country, the government has started, on its own accord, industries and commercial businesses. This sector of the economy which is under the direct control of State has come to be known as public sector. Expenditure on this sector is increasing rapidly every year. In an underdeveloped economy, this aim of public expenditure has attained great significance.

Fourthly, Dalton points out that the public expenditure should be carried on up to that limit where the marginal benefit arising from different branches of expenditure are equal. These marginal benefits must be equal to the marginal sacrifice incurred by the public.

Public spending should be designed to optimize the level of investment in such a way as to maintain full employment – with growth.

Public Spending may be incurred at an increasing rate in the backward region to uplift their economy.

Principles of Public Expenditure

In economic literature, the expression Canons of public expenditure is used for the fundamental rules or principles governing the spending policy of the government. The following canons of public expenditure have been laid down by many scholars on the subject:

Canon of Benefit: - this canon suggests that every public spending must ultimately be used for the cause of social benefit i.e. for the general well-being of the common people. In other words, the State spending should confer benefits on the entire community at large than on an individual group or section. It means public funds should be spending in such directions which pursue common interest and promote general welfare.

Canon of Economy:- It implies that public expenditure should be incurred carefully and economically. Economy here means that wasteful and extravagant expenditure should be voided at all levels. Public expenditure must be productive and efficient. Hence, it must be incurred only on very essential items of common benefit without duplication in a way that involves minimum cost. An efficient system of financial administration is therefore, very essential in any country.

Canon of Sanction: this canon suggests that no public spending should be made without the approval of proper authority. Only obtaining prior sanction is not sufficient. It must be properly inspected and examined whether the sanctioned amount of money spent on the purpose for which it is sanctioned by the highest authority and accounts properly audited.

Canon of Surplus: this canon suggest that saving is a virtue even for the government, so an ideal budget is one which contains an element of surplus by keeping public expenditure below public revenue. In other words, public authorities should aim at surplus of income over expenditure and they should avoid deficits. Frequent and huge deficits lead to uncontrollable financial situation with dire consequences of inflation. Therefore every government should attempt to balance its income and expenditure.

Canon of Elasticity:- this canon requires that the expenditure policy of the State should be such that changes must be possible in the expenses according to the changes in requirements and circumstances. In other words, there should be scope for changes in public expenditure according to the requirements of the country.

Canon of Productivity:- this canon or principle implies that the expenditure policy of the Government should be such that would encourage production in a country. That means a large part of public expenditure must be allocated for development purposes.

Canon of Equality:- one of the foremost aims of public expenditure is also to ensure the just and equitable distribution of income by conferring benefits on the poorer section of the community. This canon of equitable distribution is more significant for the countries where the gap between the highest income and the lowest income groups is very wide. Developing countries like Ethiopia, have given this aim a significant and particular importance in the economic activities of the State and in their fiscal policies.

2.3. Main areas of Expenditure Responsibility: capital and recurrent

Technically, in the structure of a budget, most governments classify expenditure into two.

Recurrent expenditure, and

Capital expenditure.

All sorts of administrative costs such as salary, and defence expenditure and debt services are called recurrent expenditure. They are also referred to as non-developmental expenditure. They are intended for continuing the existing flow of goods and services and maintaining the capital of the country intact. On the other hand, capital expenditures contribute to increased productive capacity of the nation and therefore, are known as development expenditure. Expenditures on construction of dams, public works, state enterprises, agricultural and industrial development etc., are instances of capital expenditure.

Though public expenditure is a means of maintaining the capital of the country intact, it is not merely a financial mechanism, it is rather a means of securing social objectives. Socialism can be realized only through progressive taxation and their distribution afterwards. Therefore, public expenditure is that expenditure incurred by the public authorities i.e. Central, State and Local governments, to satisfy those common wants which the people in their individual capacity are unable to satisfy efficiency wants.

2.4. Roles of Each Layer of Governments

Public expenditure is determined by political will of the leading forces in the state: their priorities, their desired state model, and their interpretation of current economic and political phase. Past choices have relevant impact on public expenditure because of inertia and instrumentalism. Bureaucracy may play an important decision role for the actual expenditure. Sometimes considered as a completely exogenous variable, the public expenditure would thus be fully in the hand of political decision-makers without dependency from the economic context.

With its prioritized structure and its peculiar decision-making processes, public

expenditure substantiates the prevailing kind of State. In democracy, public expenditure is an expression of people's will, managed through political parties and institutions. At the same time, public expenditure is characterized by a high degree of inertia and law-dependency, which tempers the will of the current majority.

In particular, as a very sketched framework, one may distinguish at least three general models of state to which public expenditure corresponds: There are:

1. the **minimal state**, where only justice, public order, foreign policy and some other basic functions should be carried out by the state, relying on private initiative for the others;
2. the **welfare state**, where the State cares about the people's well-being directly, also through expenditure in schooling, health, support for the poor, the old, the disadvantaged,
3. the **developmental state**, where the State takes the responsibility of fostering economic development, also through expenditure in infrastructure, support for firms, export and production in general.

Both the welfare and developmental state include the items of the minimal state. Military expenditure and special policies are common traits of the three models, maybe in different proportions. Comparing function shares in public expenditure, one can get insights in the kind of state under analysis. Needless to say, the State does not exert its influence on economy and society through public expenditure only, but also for example through laws.

Allocation of Expenditure Responsibilities

In the study of the system of the division of expenditure responsibilities in a federal system, there should be careful consideration of the following points. First, it intertwines with the system of distribution of powers between the federation and the states. In this regard, the constitutional techniques for the allocation of powers in general and the scope of the powers allocated to each tier of government in particular results the functions of each tiers of governments, then follows the need to implement those assigned function through policies which, in turn requires expenditures. The 'division' of expenditure responsibilities is also called the 'assignment' of expenditure responsibilities in much of the literature.

The distribution of expenditure responsibilities in a federal system corresponds with the division of legislative as well as executive powers between the tiers of government. Legislative costs are insignificant compared to administrative costs. However, legislative power is essential to understand the extent of a government's expenditure responsibility.

The actual division of expenditure responsibility deals mainly with the interrelated aspects of the division of legislative and executive powers. Central to this issue is which responsibilities or authorities are divided between the levels of government. In some federations, like the USA, the legislative, executive, judicial and financial powers are divided between the federal government and the states, and then the expenditure responsibility becomes coextensive with the legislative responsibility of

each level of government. In other federations, like Germany, the legislative power is mainly entrusted to the federal government while the executive power is mainly reserved to the states.

Allocation of powers and functions under FDRE Constitution

In the Ethiopian federal system, the Constitution follows an approach of listing the exclusive powers and functions of the federal government (Art.51). It also provides a limited list of exclusive powers for the states (Article 52(2)). It mentions the source and type of taxes for which the states may exercise exclusive power. In principle, the Ethiopian Constitution follows the USA model by enumerating the powers of the centre and allocating the residual powers to the states, but it also incorporates some features from India and Canada by listing some powers for the states.

In general, according to the Constitution, we can divide the powers and functions of the central government into four groups. The first group comprises those powers which by their very nature are considered to be the common concern of all the constituent units of the federation. In all federations, they are assigned to the central government. In this category of power, we may find national defence, international or foreign relations, citizenship, immigration and naturalization, and other powers that are supplementary to the main powers in this category. The Ethiopian Constitution (Article 55(7)) explicitly empowers the center to organize national defence, public security and the federal police force.

In the second group, several commercial powers that are essential for facilitating as well as international trade can be mentioned (taxation is independently dealt with in the next chapter). In this group, we find the largest category of powers, including interstate commerce; postal and telecommunication services; weights and measures; domestic currency coinage and foreign currency usage; and banking, insurance, patents copyright. These powers are assigned to the federal government primarily for economic reasons and for practical convenience. In all federal countries the central government power over currency and legal tender, but they may differ on regulating banking by giving a concurrent power to the states. In Ethiopia, however the central government has the power over monetary and fiscal policy, local currency, the administration of the national bank and foreign exchange. Under the Ethiopian Constitution regulating insurance is not specifically mentioned as the power of the center. Impliedly, extended from the exclusive mentioned interstate trade, the center assumes it.

Under the Ethiopian Constitution, rail, air and water transports and major roads linking two or more states are within the competence of the federal government. The legislative power of the federal legislature also extends to the labour and commercial codes. The FDRE Constitution does not enumerate those issues covered under the labour code such as employment contracts, trade unions, industrial and labour disputes. Nor does it mention various legal concepts included

under the commercial code, such as partnerships and bankruptcy.

The third group comprises legislation dealing with various aspects of social and political issues. In Ethiopia, the federal legislature (HOPR) may legislate on matters concerning electoral laws and procedures, as well as the enforcement of political rights established by the constitution. Some of the issues that may fall under the latter are press law, demonstrations and the registration of political parties.

The fourth group comprises civil and criminal laws. The FDRE Constitution enactment of the penal code is a federal matter. The states, however, may enact legislation on matters that are not covered by the penal code. The power over civil laws (e.g. the law of family and succession) is left to the states. The centre may enact civil law when the House of Federation considers that it is essential for employing uniform law in order to establish and sustain one economic community. In Ethiopia, those cases categorized under the fourth group mainly entail law-making power at the centre while, in practice, reserving the regulating and adjudicating power to the states.

The Constitution provides the states with a legislature, an executive and judiciary which are constitutionally independent from the central government in matters assigned to them. However, it is important to note that when powers assigned to each level of government are not mutually exclusive, there may be a greater possibility of encroachment on the power assigned to the other. This is because it is practically impossible to bring about a total power separation between the two levels of government, although the interrelationship between them may vary from one programme to the other. Accordingly, the Ethiopian Constitution reserves residual power to the states. Article 52 provides all powers not given expressly to the federal government alone or concurrently to the federal government and the states are reserved to the states. With regard to the residual power of taxation, however, the Constitution has another saving clause that does not automatically allocate it to the states: it is to be decided by a joint meeting of both Federal Houses (Article 99). Moreover, the Constitution reserves major policy matters governing education, health, environment, science and technology and development strategies to the centre which may broaden the power of the federal government over residual matters (Articles 51 (2 and 3), 89-92).

Under Article 52(2) of the Constitution, the states have enumerated powers and functions. These powers include the establishment of state police power, the maintenance of public peace and order, levying and collecting taxes and duties on revenue sources reserved to states, the administration of land and other natural resources based on federal laws, and the employment and working conditions of civil servants. The states also have power over such areas as education, health and agriculture although the federal government has the power to set national standards. In addition, the States have independent power with respect to matters not mentioned in the federal list. However, it should be noted that the states may not have legislative power over residual powers. The Constitution has two provisions which limit the residual power of the states. The first concerns the

taxation power, and the second is with regard to enactment of civil laws (Article 98 and 55 respectively). The regions cannot immediately assume the power of taxation that is not specifically provided by the Constitution either the centre, the regions, or concurrently to both. It has to be determined by a joint session and a two-thirds majority vote in the HOF and HOPR is required. Similarly, the federal legislature may enact civil laws if the House of Federation deems it necessary.

The constitutional framework governing the division of power between the two tiers of government, enable us to explore the mechanisms as to how the federal government and the states fulfill their expenditure responsibilities. In general, how far does the FDRE Constitution deal with the allocation of expenditure responsibilities to both tiers of government is the next question. the scope of the expenditure responsibility is dependent upon the extent of both the legislative and the executive powers assigned to each level of government.

According to the Constitution, each government has the power of legislation and execution on matters that fall under its respective jurisdiction. Each tier of government shall respect powers of the other. And both the federal government and the states have to cover the financial expenditures necessary to carry out all the responsibilities assigned to them by law (Article 94(1)). To this effect, the powers and functions of the federal government and the states are listed under Article 51 and 52 of the Constitution respectively. In addition to Article 51, the scope of the legislative and the executive power of the federal government are indicated under Articles 55, 74 and 77. According to the last two provisions, the executive power of the federal government is vested in the Prime Minister and Council of Ministers to follow up and ensure the implementation of laws, policies, directives and other decisions adopted by the HOPR.

Accordingly, those matters not mentioned under 'the powers and functions of the federal government' (Article 51), but included under the jurisdiction of the federal legislature (Article 55), are to be administered by the federal government. Federal laws are, therefore, implemented through the federal executive unless otherwise provided by the Constitution.

But the Constitution has the drawback of assuming complete separation of powers, the possibility of duplicating authority and not considering the efficient use of limited financial resources through administrative cooperation. However, the reasons for adopting this method of division of powers is related to the motive of the constitutional assembly which emphasized the values on 'self rule' rather than 'shared rules' or cooperation, as can also be seen in other provisions as well.

The question may be raised as to whether the Constitution permits the central government to reserve legislative power for itself and to leave its administration to the states. This is possible when the Constitution itself provides for an exception, or when the federal government delegates its powers and functions to be administered by the states, as prescribed in Article 50 (9). For example, the federal

government enacts law for the utilization and conservation of land and other natural resources, historical sites and objects, but its administration is reserved for the states." There are certain matters which refer to the legislative power only. For instance, the power to establish national standards concerning public health, education, science and technology is reserved for the centre though the provision of these services is left to the states (Article 51 (3)). In these cases, it has to be clear on what basis the states administer the federal laws, because this can have financial implications. If the states are delegated with the administration of federal powers and functions, the financial implications thereof must be dealt with accordingly.

However, with regard to the administration of federal laws by the states, the constitution is not always clear. This is because under Article 55 of the federal legislature, the HOPR, has also the power to enact laws in areas or subject-matters that are not included under the powers and functions of the federal government listed under Article 51. For instance, the HOPR has the power to enact labour, commercial and penal codes, and even civil laws on subject-matters which the HOF refers to. The Constitution specifically mentions those subjects allocated to the federal legislature; the problem, however, is how and who is to execute them.. In practice, there are also matters that cannot be administered by the federal government unless the states are responsible for their administration. These are cases of criminal law and regulating the possession and bearing of arms. Of course, this may have the benefit of a uniform application of laws by leaving room for local administrations. But, which provision of the Constitution authorizes the administration of these laws by the states is not clear.

The replicated provisions (of Articles 51 and 55) listing matters that require federal legislation have aggravated the problem of identifying the expenditure responsibility of the central government. Compared to the wording of Article 51, the provision of Article 55 explicitly determines the law-making power of the federal legislature concerning the same subject matters. However, apparently there is repetition in the allocation responsibilities to the centre. As the contents of Article 51 indicate, there are administrative and legislative responsibilities belonging to the government. Thus, what is the difference between the powers of enacting law in matters listed under Article 51 and Article 55 specifying the legislative powers of the HOPR? For example, both provisions provide that the federal government enacts laws regulating the possession and bearing of fire arms, and laws governing political parties and elections, but only Article 55 mentions the legislative power over labour, commercial and penal matters. Does it mean that the federal government has no administrative power with regard to these powers? It seems that there is an intention to leave the administration of these laws to the state, For example, concerning interstate trade and commerce, a closer scrutiny of the relevant provisions implies that, under the general provisions of Article 51, the federal organs required to regulate interstate trade, whereas the federal legislature is specifically required to enact laws with the help of which interstate trade and commerce can be regulated. with this regard, the confusion as to the specific

meanings of the two apparently varying provisions may be resolved.

The allocation of legislative power is also the executive power except in cases where administration of federal laws is left to the states. But, as can be seen above, the administration of federal laws by the states is not clear. In practice, there is also direct involvement of the centre in the regions. This is partly due to the capacity problem in most of the regions. As a result, the expenditure responsibility of the central government may not be limited to its legislative powers. There can be cases where the executive power of a state extends beyond the scope of its legislative power. In such a case, the major factor that influences the expenditure responsibilities of both tiers of government will be intergovernmental relations through the use of conditional grants, executive agreements or other cooperative mechanisms.

At this juncture, it can be inferred that the allocation of expenditure responsibilities is part of allocation powers and it follows the root of other assigned powers since it enables the implementation of them. In addition, the center legislative power on some subject matter to be implemented or administered by the state increases the states expenditure responsibilities in addition to their own assigned functions.

Meaning of Public Revenue

Revenue is the force and instrument to ensure the effective performance of powers and functions of the government. In a federal system, it enables multiple tiers of governments to perform their constitutionally assigned powers and functions for the welfare of their respective subjects. Hence, proper division of revenue raising powers and responsibilities in line with the framework of the other constitutional divided powers and functions in the federation signifies the purpose of federalism.

. Dalton has defined public finance in two senses; broad and narrow senses. In wider sense, it includes all the income irrespective of the sources they are obtained from and receipts which the government happens to get during any period of time, which includes but not limited to, income from tax, price of goods and services supplied by public enterprises, revenue from administrative activities, such as fees, fines etc., and borrowings, gifts and grants. In narrow sense, however, it includes only those sources of income of the government which are described as "revenue sources."

To sum up the meaning, the income of the government through all sources is called public income or public revenue. However, as aforementioned, Dalton has defined 'public income' in broad and narrow sense, i.e. in terms of 'public receipts' and 'public revenue'. Public revenue includes income from taxes, prices of goods and services supplied by public enterprises, revenue from the administrative activities, such as fees,

finances etc., and gifts and grants; while public receipts include all the incomes of the government which it may be having during a given period of time, i.e. public revenue plus income from all other sources such as public borrowing from individuals and banks and income from public enterprises.

3.2. Revenue Sources of a Government: General

In general the government of any state has invariably two important sources of public revenue: taxes and non-taxes

i) Tax revenue sources: - tax is a compulsory levy by public authority for public purpose without expectation of direct return or benefit to the tax-payer. It is also said to be a burden which is only imposed by the legislative power on persons or property to raise money for the public purpose. It is exacted not on the basis of direct *quid pro quo* relations. In addition, the payment of tax cannot be imposed except by law; hence the maxim 'no taxation without representation'.

ii) Non-taxes revenue sources: - this category of public revenue consists revenue under many headings but constitute little portion of the total public revenue compared to taxes. These sources are discussed hereunder.

Commercial Revenues: the revenues, we call "commercial" are received in the form of price paid to government for produced commodities and services. These are revenues which are derived by government from public enterprises by selling their goods and services. They are also termed as price, for they are collected in the form of price of goods and services provided by government.

Moreover, in a country which implements free-market economy accompanied by privatization, these sources of revenues are minimal, for the substantial volume of goods and services are provided by the private sector.

Administrative Revenues: the receipts of administrative revenues includes fees, licenses, fines, forfeitures, escheats, and special assessments. They are characterized by more or less as a free choice on the part of the payer as to whether or not he will pay, and more or less on direct benefit conferred upon the payer. The amount of payment does not necessarily, however, bear a close correlation either to the value of the benefit obtained by the payer or the cost incurred by the administration.

Gifts and Grants; gifts and grants form another category of public revenue. Gifts are voluntary contribution from private individuals or non-government donor to the government fund for specific purpose, such as, relief fund or defence fund during a war or an emergency. Such contributions are made by patriotic, charitably minded, public spirited or conscientious person during war, floods and droughts or an emergency. Gifts have no significant place in modern revenue system except during such above mentioned natural or man made catastrophes.

Grants are government financial aid in the performance of governmental function at another level. In federal countries, for instance, central government traditionally gives grants-in-aid to the state governments and the state government to local governments in order to enable them to do their functions successfully or for undertaking specific activities such as construction of highways, dams, etc. and their maintenance in the interest of uniformity and efficiency in the working. Hence, these grants may be either conditional or unconditional or either for specific or general purpose.

Sometimes, the government of one country receives a grant from another country, which is commonly called "foreign-aid". It may be military aid, economic aid, technical aid, and so on

Capital Receipts; capital receipts constitute revenue from market borrowings, i.e. loans which have a maturity of fixed time. Receipts of this account would be considered as market borrowings even when some of these loans are taken by the central bank or reserve bank of the country. The borrowings also include special bonds, for example, the central government usually issues borrowing through special bonds and treasury notes under voluntary disclosure scheme that mature in different fixed time. The second means of capital receipts is external loan. In federal arrangement, only the central government is authorized to raise loans from abroad; from friendly countries. The third means of capital receipts consists of loans and advances made by the central government to state governments and non-government parties.

3.3. Purpose and Types of Taxes

Tax, as a major source of government revenue, in any economic policy and whatever the state may be, plays several roles. Tax covers the substantial part of the purposes of the public revenue in governments. In a federal system, it is a means of financial power division among multiple tiers of government. Therefore, it enables the government to attain specific and general purposes.

3.3.1. Purposes of Taxes

The purposes of taxes in public governance relates in all lives and functions of the governments and ranges from social to political through economic aspects.

Financing government expenditure responsibilities: together with other revenue sources tax is meant primarily to meet the expenditure of the state incurred in fulfilling its duties either in the form of social security or social amenities. Social welfare may be measured in terms of per capital expenditure incurred by the

government on providing amenities in the form of education, health, sanitation, recreation facilities, etc. and social security consist of peace and order maintained by police, military and the judicial machinery. These functions of the state are increasing from time to time. Thus, it is the tax potentials that cover the ever increasing expenditures of the state.

Income distribution: tax serves as income distribution mechanism. The distribution of income and wealth among the members of a society is one of the functions of the government. The government performs this function through the mechanism of tax policy. For instance, companies are required to pay high rate of corporate taxes on their own behalf and the dividend received by shareholders from the companies are subject to income taxes. Excise tax, high custom duty in luxurious goods, surtax, capital gains tax and progressive rate of income tax are some other taxes to reduce the incidence of socio-economic inequality. In this way the sufficient portion of wealth is taken away through taxation by the government so that the rich may not become richer and the poor, poorer.

Stabilizing economy: tax also plays an important role in stabilizing the economy. Economic stability may be judged by the behavior of price. The instability of economy in the market is generally summarized as inflation, deflation and stagflation. As regards inflation, deflation and stagflation, taxes play an important role as they can reduce or stimulate consumption.

Enhancing the purchasing power of the people through reduction of personal tax burdens during depression (deflation) may have favorable effects on the level of economic activity and employment. The third kind of economic instability is stagflation some times referred to as Recession, which is caused by increase in price while demand is falling. Effective progressive taxation on the haves discourage their capacity to pay, encouraging production by tax holidays and reducing the rate of commodity taxes such as sale tax, excise duties, etc., remedy the stagflation.

Encourage investment: in a market economy the government designs incentive schemes to maximize the use of private investment. Such incentives schemes can be achieved through taxation by introducing exemption, deduction and depreciation and by tax holidays to stimulate the private sector participation in the economy. Tax also plays a guiding role to the movement of private investment towards areas given priority within the economic policy; towards hardship and less developed areas.

3.3.2. Types of Taxes

Economists in general classify taxes into two major categories: (1) Direct taxes and (2) Indirect taxes, and sometimes taxes are, based on their source, also classified as tax in *persona* (individual) and tax in *rem* (property). According to Dalton, those taxes which are paid entirely by those persons on whom they are imposed are direct taxes. Direct taxes are those taxes which cannot be shifted to others.

“a direct tax is demanded from the very person who, it is intended or desired, should pay it”. Thus, if a tax is intended to be paid by the persons on whom it is imposed, it is a direct tax. More over, direct are taxes levied on permanent and recurring occasions. Usually, direct taxes are based on the receipts of income. Hence, direct taxes are levied immediately on the property and income of persons. Income tax, profit tax, capital gain tax, property tax or wealth tax are direct taxes.

Whereas, indirect taxes are those taxes the burden of which may not necessarily be borne by the assessee. They can be shifted or passed to other persons’ shoulder. They are taxes which are levied on commodities and services other than personal services like custom duties, excise duties, sales tax or value added tax (VAT).

According to John Stuart Mill, “Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of the other”. Thus, if a tax is intended to be collected from other persons by those persons on whom it is imposed, such tax is an indirect tax. In relation to assessment, indirect taxes are when income is spent i.e. on goods or services purchased. These taxes are levied on occasional and particular events. They affect the income and property of persons on expenditure through their consumption.

3.4. Methods of Division of Revenue Sources between Federal, State and Local Governments

In relation to taxation, the traditional normative view set out by Musgrave enumerates the principles which, according to him, can secure independent autonomy and efficient utilization of resources by the federal and states governments. Accordingly, he proposes:

taxes suitable for economic stabilization should be central; lower level taxes should be cyclical stable;

progressive redistributional taxes should be central;

personal taxes with progress rates should be levied by the jurisdictions which are most capable of implementing a tax on global base;

lower-level governments should tax bases with low mobility between jurisdiction;

tax bases distributed very unequally between jurisdictions should be centralized; and

benefit taxes and urban charges might be appropriately used at all levels.

Concluding the different perspective approaches, in general they give the central government those taxes that can help to redistribute income and to stabilize the

economy, whereas those immobile taxes which primarily provide a benefit to the local governments are to be left to the sub-national governments. Specifically, they proposed taxes such as corporation income taxes and VAT to be assigned to the center. Whereas those taxes such as personal income taxes and retail sales taxes are to be left to the state. This classification is mainly based on the mobility/immobility nature of the tax bases. But, they are not hard and fast rules to be recognized in the constitutions forming different federations. Sometimes, immovable taxes may be assigned to the center, for instance, taxes on natural resources for they are unevenly distributed among the federating units and may substantially result in horizontal inequalities.

3.4.1. Constitutional Methods for Division of Revenue Powers in Federation

The method of allocation of revenue in federal systems is theoretically intended to follow the division of the expenditure responsibilities in order to accomplish the power and function assigned to each level of governments.

The methods employed by federations can be summarized into three: exclusive power of taxation, concurrent power of taxation and shared power of taxation. In the exclusive power of taxation, the constitution assigns several tax sources to the federal government and to the states separately, allowing each to have exclusive tax power within its sphere. It exists in the cases where each level of governments is constitutionally authorized to impose the same type of tax, but upon different subjects: things, businesses or category of persons.

Concurrent power exist when the constitution allows both levels of government to exercise the power to levy, collect and apportion in relation to some or all taxes. The federal and state governments have equal constitutional authority on to levy the same kind of tax with respect to the same category of persons, businesses or particular things. This approach entails the overlapping of specific types of taxes exercised by both level of jurisdiction, which may lead to competition and conflict between them. Shared power of taxation means the constitutional reservation of the power to levy taxes to the federal level, but it guarantees the states' right to some or all of the proceeds from specific taxes.

3.5. The Structure of Taxation Power in Ethiopia

The division of taxation power is a principal aspect of the Constitution that provides the legal framework of the Ethiopian federation. The FDRE Constitution divides the taxation power into three categories, namely 'the federal power of taxation', 'the state power taxation' and 'the concurrent power of taxation'. It also prescribes the conditions by which the regional governments could acquire revenue through loans and grant subsidies. Here, the analysis of the assignment of tax powers will focus on the tax

sources that constitute each category of power, and the manner in which the sources are divided makes each level between the three categories.

In Ethiopia, the federal Constitution declares that the federal government shall levy taxes and collect duties on sources reserved to it, and the state likewise exercise the same power with respect to sources that falls under their jurisdiction. Thus, the two tiers of government exercise their legislative and administrative powers within their respective taxation competence. Therefore, the revenue generated from the respective sources belongs exclusively to each level of the government. The power of taxation reserved to each level is subject to respect by the other. The FDRE Constitution does not explicitly limit the power of the state to change the tax rate in order to influence the tax base. However, it provides general directives on taxation in Article 100 in which they must consider exercising their taxation power. As per sub-Articles (1) and (2) of the same, both the states and the federal government have the obligation to ensure that any tax related to the source of revenue taxed; that tax should be determined upon proper consideration and tax imposed by them should not adversely affect their relationship. If any tax imposed by the state affects interstate commerce, the central government intervenes since the power is reserved to it. But, in practice, the tax legislations are uniform throughout the country. This is because of the fact that the states do not have the expertise to deal with the impact of imposing different tax rates.

The FDRE Constitution provides exclusive revenue sources under the title 'federal power of taxation', 'state power of taxation', 'concurrent power of taxation', and 'undesignated power of taxation' in the Articles 96, 97, 98 and 99 respectively. Although the titles refer to the 'power of taxation', strictly speaking they do not only deal with taxes. The lists also include other non-tax revenues like fees, charges, rents and other revenue sources. The Constitutional arrangement on division of revenue raising power in Ethiopia is mainly structured according to the categories of tax payers or particular things as a source of revenue. The exclusive domain of each government is not the tax base but the tax source. Hence, it does not result in taxing the same tax source by both levels of governments.

3.5.1. Federal Power of Taxation

The FDRE Constitution under Article 96 enumerates the exclusive revenue sources of the federal government. Among them, revenue sources such as customs duties including import /export tax and other duties exclusively reserved to the federal government. However, other revenue sources from income tax, sales and excise tax, property taxes and charges and fees are assigned to tiers of governments. The federal government in this respect only differs in the category of the taxpayers or a particular thing from which the revenue is collected.

It seems universal in federations that customs duties are exclusively given to the federal government. There are many reasons in relation to international and national trades to this assignment of revenue. A country may have to fulfill international obligations by reducing tariffs or impose restrictions on unfair trading practices to protect the sudden influx of import of specific items (anti-dumping measures) and on controbandas, to control importation of prohibited items, etc. In addition in order to protect trade distortions within the country and for efficient tax administration the power of custom duties remain in the hand of federal government. The same is true in Ethiopia so that import and export duties, taxes and other charges on imports and exports are exclusively levied and collected by the federal government pursuant to Art.96(1) of FDRE Constitution. Tax on foreign trade is a major source of revenue in Ethiopia. However, in countries like Ethiopia, the nature and type of export items are few in number and they may also originate from specific regions. The major export items are coffee, skin and hides and some raw materials. The reservation of such resources and other natural resources to the federal government enables income redistribution and equalizations schemes effective.

The FDRE Constitution provides prominent place for income taxes as the source of revenue reserved to the federal government. Unlike customs duties, the constitution does not exclusively assign income tax to the federal or to the state governments. Accordingly, with regard to personal income from employment, exclusive federal taxation applies to the income of employees of the federal government, of the public enterprises owned by the federal government and of international organizations (Art.96 (2) and (3)). The exclusive tax power of the federal government also extends to income from other sources than employment. Income or profits of the federal public enterprises are taxed by the federal government (Art.96 (3)). The federal government also exercises exclusive power over income arising from rail, air and sea transport and income from chance winning from national lotteries (Art.96 (4) and (5)). Income obtained from leasing its own property and houses are subject to federal taxation (Art.96 (6)). The accrual of tax from the employees of government-owned, however, is expected to shift from the federal government to the states as a result of the on going privatization program. But, this transfer will benefit Addis Ababa and the surrounding areas, for most of the enterprises reside there.

The area of sale and excise tax so far as they pertain to the sale and production or services of public enterprises owned by the federal government are exclusive power of the federal government (Art.96 (3)). In addition, the introduction of VAT broadens the federal taxation to the sale and production or services of individual traders.

The other areas of federal revenue assigned by the Constitution are fees and charges.

The Ethiopian Constitution provides the federal government the power to determine and collect fees and charges relating to licenses issued by organs of the federal government (Art.96 (7)). It also empowers the federal government to levy and collect stamp duties provided that the organs of the federal government render the service (Art.96 (9)).

State Power of Taxation

Unlike the federal government, the states have no exclusive tax bases assigned to them by the FDRE Constitution. The lists under Article 97 entitled 'state power of taxation' enumerates those tax bases shared from the federal tax competence based on different category of taxpayers or particular things. Therefore, except custom duties, all tax bases are also the source of state revenue. Hence, the states income taxes, sale and excise taxes, property taxes and fees and charges are discussed hereunder.

The Constitution assigns the power to levy and collect income taxes to both tiers of governments, in which each of them is conferred with exclusive power over specific sources. Accordingly, with respect to personal income from employment, income from employees of the states and from employees of private enterprises are subject to the exclusive authority of the states (Art.97 (1)).

The exclusive tax power of the states on income extends to other sources than employment (payroll tax). The income or profits of the public enterprises owned by the states are taxed by the states (Art.97 (7)). Profit or income from small business activities and sole proprietorships (the nature of the business activities determined by the Commercial Code and other relevant laws) is left to the states (Art.97 (4)). Income from individual farmers or cooperative association, income from water transport service provided within the boundary of the state and rental income from properties owned by the state are exclusively taxed by the state (Art.97 (3), (5) and (6)).

There are sales and excise taxes reserved to the states. The states can levy and collect excise and sale taxes against public enterprises owned by them (Art.97 (7)). In addition, the states can levy and collect these taxes from individual traders within their jurisdiction (Art.97 (4)). However, the exclusive power of the states is restricted in some cases since some individual traders are subject to federally administered VAT law.

The Ethiopian Constitution gives the states a power to levy property taxes upon houses which are privately owned, land which is used by *usufructuaries* and royalties from the use of forests (Art.97 (2), (6) and (10)). The states are also empowered to levy and collect taxes and royalties on small-scale mining activities (Art.97 (8)). One of the most

important property tax of the states could be revenue from land lease payment from investors, for the Constitution provides that land is publicly owned.

Similar to the federal list, the taxation powers listed for the state also have provisions authorizing the collection of fees and charges on license issued and services rendered by different organs of the state. Hence, the states are empowered to determine and collect fees and other charges for the service rendered by the state organs (Art.97 (9)).

The allocations of taxes have some rationales and differences from federation to federation. Solomon Negussie argues that the levying of tax from personal income is primarily for the purpose of providing local public goods and infrastructure. It follows, therefore, it is recommended to assign the levying of income tax from employees of federal public enterprises and NGOs to the states in order to enhance their revenue capacity and thereby to ensure the efficient provision of public goods. The Ethiopian Constitution assigns exclusive power to the federal government due to the general principle applied in federal countries that imposes a tax limitation on each level of government to tax income from the respective property and income of their employees. However, this should be reconsidered in cases where states retain a very limited tax power.

In general, the fixed nature of real property makes it easier to administer by the subnational governments. But, there are exceptions. Mineral taxes and royalties are in most cases assigned to the center. This is because natural resources are unevenly distributed between the states. Thus, if taxation of minerals is assigned to local governments, it may aggravate horizontal imbalances.

3.5.3. Concurrent Power of Taxation

The constitutional acclamation of the concept of concurrent power differs from federation to federation. Constitutionally, however, the concurrency of power signifies that the center as well as each state has the right to enact laws concerning the subject-matter under its jurisdiction.

in the Ethiopian case, the title 'concurrent power of taxation' may mislead readers since it is different from its application in other systems. At present, it gives the states only the power to share revenue from concurrent sources.

The said Article provides 'The federal government and the states shall jointly levy and collect....' The main issues raised are: how can both the federal and states jointly levy and collect taxes at the same time? Would it enable each state to enact its own tax on sources listed under concurrent power of taxation? Do all states benefit from these taxes irrespective of the place where the sources of the tax are located? The power of taxation comprises of two specific powers: the power to legislate tax laws or to levy, since the maxim 'No taxation without representation' and to collect the tax. Likewise,

the concurrent power of taxation presupposes the above mentioned two powers to be decided by the federal and state governments concerned. In doing so, the problem of tax competition may arise between the federal government and states. As it is said, unwisely treated concurrent power is a source of conflict. And the FDRE Constitution prefers silence if conflict arises between the federal and state laws. The main issue is which law prevails. Therefore, the concurrency of laws on the same source of tax would not be effective.

On the other hand, the literal interpretation of the provision of Article 98 would mean that tax legislation would be enacted by a joint meeting of the federal and the state legislatures.

The concurrent power of taxation in general would have lead to inter-jurisdictional competition (federal-state, or state-state) or conflict concerning a better control of taxes. It might have as well created a serious inconvenience to the taxpayers, a greater possibility of tax evasion and inefficient administration which may have a direct consequence up on the law and limited revenue source of the country. In most cases, countries that do not have a developed tax administration system avoid this complicated approach by allocating the power to the central government only.

For these reason, it is said that the Constitution has been “amended” whereby the power is delegated to the federal government. Accordingly, the provision has been interpreted in such a way that those tax sources listed under the concurrent power have to be levied and collected by the federal government and the proceeds are compulsorily shared with the states. As the result of this interpretation, the federal government has become fully empowered to levy and collect taxes on the mentioned sources and to retain the proceeds and dispose of them based on the decision of the HOF.

3.5.4. Undesignated Power of Taxation

Article 99 of the Ethiopian constitution reads: ‘The House of Federation and the House of peoples’ Representatives shall, in a joint session, determine by a two-thirds majority vote on the exercise of powers of taxation which have not been specifically provided for in the constitution.’ An interesting aspect of this provision is the distinct method of power division it creates from residual power reserved to the states. As per Article 52 of the Constitution, all powers that are not exclusively given to the federal government alone or concurrently with the states are reserved for the states. The former provision is specific to taxation while the latter refers to the general allocation of all powers and functions of both tiers of government. Therefore, it implies that states necessarily have a residual power concerning matters other than taxation. With regard to exercising residual tax, either level of government can only acquire the power of taxation after a decision is reached by the joint meeting of the two Houses of the Federation.

It has to be noted that the joint session of both Houses is to determine which level of government can exercise the power of taxation. The Constitution allocates independent powers of taxation to the states and the federal government, and taxes shared by both levels of governments. The joint session therefore determines the residual tax to be shared by both levels of governments or to be assigned to either of them. Therefore the power over residual taxes is an exception to residual powers of the Constitution.