

CHAPTER-5 FISCAL FEDERALISM

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Brainstorming Question

➤ *Please don't turn to read this portion prior responding the following question!*

- Can you analysis the concept of constitutionally division of legislative and executive power by your own words?
- How you see the experience of USA, Germany, Swiss, and Indian Federalism in line with constitutionally division of legislative and executive power?
- What makes unique Ethiopian federalism when you compere an contrast with these countries?
- What is framework power and which power is belongs to this in FDRE-constitution?
- What is the point of demarcation b/n Dual-approach and Executive Approach inline with constitutionally division of executive power?

5.1 Introduction

- 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.
- The raising of public revenues follows from the necessity of incurring public expenditure. The huge amount of the expenditure of governments to perform their respective several functions for the welfare of the people requires financing through public revenue.

5.2 ALLOCATION OF PUBLIC REVENUE & EXPENDITURE

- Public income or public revenue: is the income of the government through all sources. It includes income from taxes, prices of goods and services supplied by public enterprises, revenue from the administrative activities, such as fees, fines etc., and gifts and grants.
- In general the government of any state has invariably two important sources of public revenue: taxes and non-taxes.
- Tax is compulsory contribution of the wealth of person or body or persons for the services of public power.

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. it refers do not take more than you give; but in this context it mean that no quid pro quo for payment of a tax. The taxpayer cannot also expect that he would receive the benefit just equal to the amount of tax he pays.
- In addition, the payment of tax cannot be imposed except by law; hence the maxim 'no taxation without representation'.
- Tax have general and specific purpose.

Specific purpose of tax

- **Financing government expenditure;** 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.
- **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.
- **Stabilizing economy:** As regards inflation, deflation and stagflation, taxes play an important role as they can reduce or stimulate consumption. Taxation, if applied properly, may take away the excessive capacity to pay the people, which mean demand pull inflation.

➤ **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.

Types of Taxes:-

- **Direct tax:** - 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. Examples, Income tax, profit tax, capital gain tax, property tax or wealth tax.
- **Indirect tax:** - are those taxes the burden of which may not necessarily be borne by the ultimate tax payer. 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).

Non-taxes revenue sources:

a. Commercial Revenues: is 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. Example, interest on funds borrowed from the government credit corporations, water, telecommunication, electric distributed by the government, rail, air, road and water transport services and the like. In addition, governments earn revenue from the production of commodities like steel, oil, minerals, etc.

b. Administrative Revenues: those arising as by-product of the administrative function of the government. Such as the receipts of administrative revenues include 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.

c. Gifts and Grants: Gifts are voluntary contribution from private individuals or non-government donor to the government fund for specific purpose, such as, relief fund or defense 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.

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.

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.

d. Loans: money borrowing made by institutions like WB and IMF form part of non taxable revenue sources for a state.

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 allocation of the entire revenue sources either to the center or the states has different problems in the general federal system.
- If a constitution provides exclusive authority over all aspects of revenue to the states, they will be required to transfer part of their revenue to the central government through '**upward revenue sharing' system; others call it as 'reverse revenue sharing'**'. This approach creates the central dependency on the state and it does not facilitate the principal function of the central government, such as income distribution through taxation, stabilizing role and tax harmonization policies.

- In addition, the states become reluctant to participate in central government where particularly there is a considerable regional disparity.
- The country following this method is forced to embark on excessive negotiation between the center and the states concerning revenue sharing.
- **Generally**, this approach needs confederal framework or weak federal system of federation or a country having a strong tradition of close economic policy coordination.

- ***If the entire revenue sources are retained by the center***, the state governments become fully dependent on the revenue transfer mechanisms. This approach deviates from the basic principles of federalism; the devolution of powers and function among the federating units and autonomy of each level of governments.
- Therefore, the usual trend followed by most federations is to divide the revenue sources between the center and the state. But this method is not as simple as the concept. In general principle, there should be a framework in which each tier of government can raise its own finances without a conflict between them.
- In practice, however, the degree of tax autonomy in each level of government is enjoyed demonstrates wide variation in federations. This may be attributed to the different of methods of allocation of revenue envisaged by the various constitutions.

To overcome the problem; the f/f three methods are employed by federations Exclusive power of taxation, Concurrent power of taxation and Shared power of taxation.

- **Exclusive power of taxation:** - in this case the constitution assigns several taxes 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 of taxation:-** 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. Both 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. *Which approach is adopted in Ethiopian FDRE-constitution?*
- 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 provides *general directives on taxation* in Article 100 in which they must consider exercising their taxation power.
- As per sub-Articles (1) and (2) 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 up on 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

- Generally; the constitution ascertain the f/f model;

- ❖ Exclusive power of taxation art. 96 and 97
- ❖ Concurrent power of taxation art. 98 and
- ❖ Undesignated power of taxation. Art.99

- 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

Undesignated power of taxation art.99

- The HOF & HPR 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.
- Example, surtax and VAT. A joint session of the Federal Houses was held for the allocation of the latter two types of taxes before the center levies them.
- **How you see Ethiopian local taxation?**

Local taxation:

- In Ethiopia, the federal Constitution leaves the decentralization of power of the state to the lower level of governments to the respective states; but it gives emphasis to the importance of local governments having adequate power (Art.50(4)).

- Thus, the allocation of revenue sources to local government is a **state matter**. Most of the states are organized at zonal, wereda and kebele levels of administration below the state government. Accordingly, revenues are collected through the finance bureaus organized at the state, zonal and wereda levels where the latter collect taxes and they accrue to the state treasury. **The wereda have had no autonomy to spend the revenue they collected.**
- 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.

5.3 FISCAL IMBALANCE

- While public expenditure and revenue rising are common in public finance to all kinds of governments and states, fiscal imbalances and intergovernmental revenue transfers exclusively happen in fiscal federalism or public finance in federalism.
- These basically result from the devolution of financial power to different tiers of governments in federalism.
- **Fiscal imbalance means a mismatch of revenue and expenditure in state or among the states.** It is of two kinds: vertical imbalance and horizontal imbalance.

- In federations powers of the government are subject to constitutional devolution among tiers of the governments. This includes financial power of governments to satisfy the public services through expenditure responsibility and revenue rising.
- Though this allocation scheme is designed with many considerations, it is not immune from creating disparity between responsibilities and resources. *The fiscal mismatch between the expenditure responsibility and revenue sources is generally termed as fiscal imbalance.*
- In accordance with the level of governments and their relations, there exists mismatch between revenues and expenditures that arise from fiscal relations between the center and sub-national governments and from fiscal relations among sub-national governments. While the former constitute vertical fiscal imbalances, the later does horizontal fiscal imbalances.

- **Vertical imbalance:** is a mismatch between the expenditure responsibility and the revenue capacity of regional governments which opens a way to the center to interfere creates vertical relationship between the states and the center.
- The problem of vertical imbalance is also evident in the Ethiopian fiscal arrangement. This vertical imbalance is primarily generated by constitutionally assigned expenditure and revenue responsibilities. That is, while tiers of government have significant expenditure responsibilities, the major revenue sources remain concentrated at the center.
- In most federations, expansive and lucrative source of taxation lie within the center while the responsibility to provide for development, welfare and social activities like education, housing, health, agriculture etc. are primarily imposed on the states.

- **Horizontal imbalance;** is fiscal imbalance which is related to the fiscal disparity in providing equal public services among the states. It entails that individuals in different states have different access to the same public service. Hence, this creates horizontal comparison among the states.
- One of the objectives of the fiscal arrangement is to ensure that individuals residing in different regions or localities have equal access to public goods and services.
- However, the sub-national governments may not have equal fiscal capacity to provide public services although they are assigned with the same revenue sources.
- They usually have different capacities owing to the fact that single tax base may not generate the same amount of money in different places.

- This leads to another problem of fiscal imbalance which is related to the fiscal disparity between the states, usually referred to as **horizontal fiscal imbalance**
- The problem of horizontal imbalance occurs when the revenue capacities of different sub-nationals vary so that they are not able to provide their citizens with services at the same level on the basis of comparable tax levels.
- This problem is related to the varying fiscal capacities of the individual member states of the federation

- **Intrastate Imbalance:** - If we continue the comparison, the imbalance exists not only between the regions (inter-state). There is also an imbalance between zones and local administrations within a region or in comparison with those in other regions. In other words, the horizontal fiscal imbalance refers not only to interstate but also intrastate imbalances between the sub-regional governments.
- In order to analyze the actual imbalances of revenue-generating capacity vis-a-vis the expenditure share there should be a clear assignment of sources and responsibilities. Although the powers and responsibilities of the sub-regional administrations are not constitutionally delimited, the zone and wereda administrations have, in practice, expenditure responsibilities.
- Hence, there exist horizontal imbalances among zone, wereda and even Kebele's. It suffices here to see the first two cases which are the major ones.

What are the causes and Implications of Imbalances?

Causes of imbalances:- The cause of vertical imbalance that the regions are facing has two aspects:

1st when revenue is low while expenditure needs are high.

With regard to revenue, the dominant and lucrative sources of revenue are reserved for the federal government under its exclusive jurisdiction, or through the concurrent powers on the basis of which it has the ultimate power to levy and collect the taxes. The major sources of revenue, such as customs duties and other charges on imports and exports, which account for the lion's share of the total revenue generated in the country, are placed under the exclusive jurisdiction of the federal government.

The center has also been levying and collecting other taxes levied upon companies which are concurrently assigned to the center and the states.

2nd when tax sources which yield only a limited amount of revenue have been allocated to the states. The sources of revenue held by the states neither generate a substantial amount of taxes nor reveal signs of growth relative to the total revenue and their expenditure needs.

- The regional governments generate a small amount of tax from trade activities and indirect taxes such as sales tax.
- The regions' revenue receipts are mainly from those types of sources which are easier for the administration, such as employment income tax, pension contributions and charges and fees for services rendered by government office.
- For the regions, the source of tax which is easiest for the administration is personal income tax paid by government employees.

- The insufficient revenue of the states is not only the result of *limited tax bases, but also of tax administration incapacity and taxpayers' unwillingness or inability to discharge their obligations.*
- With regard to expenditure, the low level of development in the country leads to particularly high expenditure needs in the regions.
- If it was not for federal grants most regions could not even cover the salaries of the civil servants.
- That is a further reason why fiscal con

- ***Causes of horizontal fiscal imbalance in the same fashion is caused by the revenue and expenditure aspects among the states, specifically,***
 - ✓ The variation of regions in terms of per capita revenue and per capita expenditure. This is calculated as the ratio of total revenue and expenditure to the total population of the region independently.
 - ✓ Difference in natural resource endowments that gives rise to variation in revenue sources.

Implications of Imbalances: - Whatever the causes may be, the vertical imbalance in Ethiopia provides evidence that the center dominates the fiscal power of the federation. The imbalance is also higher than in many other federal systems.

The implications of vertical imbalance include:-

- ❖ It could lead to problems of inefficiency: - because the costs of public expenditure are not fully internalized by the regions and are supported by transfers from other parts of the country, there is a reduced incentive to provide public services in an efficient manner.
- ❖ Very low level of vertical imbalance generally implies that the states vigorously exercise their decision-making autonomy, as their revenue capacity matches their expenditure responsibilities to a great extent.
- ❖ In contrast, a higher degree of vertical imbalance implies that the states' autonomy is dependent on the transfer of revenue controlled by the center. When the states remain with a small amount of revenue compared to their expenditure needs, they will be prone to the influence of center.

The implication of horizontal imbalance include:

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- The regions retain different capacities to generate revenue within the regions to cover costs of public expenditure.
- It also reflects the extent of support they need in the form of federal transfers, but before taking any corrective measures, the fiscal disparities between the regions should be effectively measured. Thus, there should be a method to measure both the actual (what is collected) and the potential revenue capacity.
- The degree of financial imbalances can also be influenced by imbalances in the expenditure needs. The need for public services of different types can differ between states and the cost of providing them may also differ.

5.4 Inter-governmental Revenue Transfer:

- The outcome of the overall greater fiscal imbalances has led to the implementation of the transfer system that can be considered as the major revenue source of states in many federations. The transfer system in Ethiopian federation operates within its local context.
- Transfer in crude sense is a mechanism which involves a vertical flow from the center to lower governments or the vice versa and horizontally from wealthier regions to poorer regions in order to maintain fiscal stability that creates broad correspondence between revenue resource availability and expenditure functional responsibility.

Objective of revenue transfer.

- To address the states *financial constraints* in executing their expenditure responsibilities. **Fiscal equalization** system' refers to the process of adjusting the horizontal as well as vertical imbalances. This process is required, for large differences in economic circumstances between regions are likely to threaten the cohesion of the federation, and to distort federal policy making and the operation of the internal market.
- Addressing financial disparities between governments is sought **for equity reasons and promoting an economic union.**
- The interest of an economic union at the same time necessitates an **equitable revenue transfer system and collaboration** between the constituent units of a federation.

- To make sure there exist equitable distribution of income between individuals.
- To reduce, if not to eliminate, financial imbalances and inefficiency across the states.
- To compensate for local spending which provides significant extra-territorial benefits or spill over but has unrecognizable local benefits or increases the local burden due to the goods and services provided for the neighboring state or local territories.
- federal government may also transfer revenue for local spending on condition that it can be spent on specific services or targeted objectives. This type of conditional transfer will at the same time enable the implementation of federal policies at the state or local level.
- It serves to achieve political goals.

B. Types of transfers:

- a. **Revenue sharing**: The nature of revenue sharing heavily depends upon the constitutional division of revenue sources between the levels of government. In general there are two cases:
- 1st in some cases, besides assigning independent revenue sources to the center and the states, revenue sharing applies to ***specific sources the revenues of which are jointly owned by the federal government and the states.***
- 2nd In other cases, most or all revenue from federally assigned taxes are shared between the levels of government.

b. Grants: Apart from systems of revenue sharing, disparities between poorer and richer states are addressed through grants also known as '**equalizing transfers**'. In principle, the objective of allocating such grants is to reduce the ***horizontal imbalance between the states***.

- It also has the effect of reducing the vertical imbalances by increasing the revenue capacity of the states. Grants can be classified into general purpose (unconditional) grants and specific purpose (conditional) grant.

i. **Unconditional grant:** - are allocated to states to spend the money in any area of public purposes designated by them. It is characterized by the absence of significant restrictions on the use of funds, as it is at the region's discretion to spend the money for any preferred purposes. The choice of a general purpose grant not only maximizes the financial capacity, but also broadens the area of spending which may be considered essential by the states.

- General purpose grant is widely used as an instrument to equalize the revenue capacity of states. Thus, it should be ***equitably distributed between the sub-national governments***.

ii. **Conditional grant**: - These grants are also referred to as ***categorical grants***. They are aimed at spending in a specific sector supported by the central government.

The grantor may require, for example, a state to use the funds for a specific activity in the education sector, such as the construction of post-secondary institutions or the purchasing of books, with a possibility of further specifications.

As the conditions become more specific, the states will in effect be left with no option but of spending the money in the area specifically required by the center.

Objectives of conditional grant:-

- It imposes conditions on the use of grants in order to maintain nationwide standards for the provision of services such as health and education.
- It addresses the problems associated with the provision of public goods in the less developed and asymmetrical societies by allocating funds to scarcely endowed areas.
- It can also play a role in curbing financial embezzlement, inefficiency and corruption, as the federal government

Conditional grants may also be further classified as matching (cost-sharing) and non-matching:

- **Non-matching grants:** are conditional transfers from the federal to the state governments but without any matching requirement on the part of the latter.
- The states are not required to spend a portion of their income to match the funding by the central government.
- **Matching grants:** are given on a basis when states commit themselves to sharing the costs in order to receive a