

Part II

Fiscal Federalism & Intergovernmental relations

Fiscal Federalism

- **What is Fiscal Federalism?**
- Fiscal federalism studies the respective roles and interaction of governments within federal systems, with a particular focus on the raising, borrowing, and spending of revenues.
- Fiscal federalism can essentially be described as the choice and distribution of fiscal decision-making power across multi-leveled governments.
- It examines the functioning of these systems and tries to provide a principled basis for evaluating them.

- **The major issues of fiscal federalism are summarized as:**
- **1. Allocation of expenditure responsibilities**, deals with the issue of which item of power of spending should be carried by which level of government;
- **2. Allocation of revenue raising power**; deals with the issue of which types of taxes should be levied and non tax revenues should be assumed in which jurisdiction by which level of governments;

Concepts of Fiscal Federalism

- **3. Fiscal imbalance**, deals with the fiscal mismatch between the expenditure responsibility and revenue sources. The imbalance between the tiers of government and disparities between them in executing their respective responsibilities; vertical and horizontal imbalances; and
- **4. The intergovernmental financial transfer**; deals with the issue of financial flows between the federal and the states and among the states; vertical transfer and horizontal transfer in order to adjust the imbalance and keep a viable federal system.

Chapter Seven

Allocation of Expenditure Responsibility in Federations

7.1. Meaning of Public Expenditure

- The concept of public expenditure has various and interrelated meanings
 - In broader sense, public expenditure signifies the functions of government,
 - Narrowly, it implies government's identifying and prioritizing areas of spending and implementing those identified projects in particular fiscal year.
- It is incurred by the government for the attainment of public good.

Meaning of Public Expenditure

- Public Expenditure is incurred by public authorities – Central, State and Local Governments:
 - either for the satisfaction of collective needs of the citizens or
 - for promoting their economic and social welfare.
- They can finance expenditures through taxes , public debt, money emission, and international aid.

7.2.Objectives and Principles of Public Expenditure

- **I. 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 up gradation of social life in the community.
 - Provision of service that benefit the whole people
 - Helping economic and social development of the people
 - Establishment & running of public sector industries
 - Encourage investment to provide full employment
 - Increased public spending in backward regions to uplift their economy

Objectives and Principles contd...

- **II. Principles of Public Expenditure**
- also called “Canons of public expenditure”.
- Refers to the fundamental rules or principles governing the spending policy of the government. These are:
 - **1. 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.
 - **2. Canon of Economy:-** It implies that public expenditure should be incurred carefully and economically. Economy here means that wasteful and extravagant expenditure should be avoided at all levels. Public expenditure must be productive and efficient.

Objectives and Principles contd...

- **3. Canon of Sanction:** no public spending should be made without the approval of proper authority. More over, 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.
- **4. Canon of Surplus:** public authorities should aim at surplus of income over expenditure and they should avoid deficits.
- **5. Canon of Elasticity:-** 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.

Objectives and Principles contd...

- **6. Canon of Productivity:-** 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.
- **7. 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 cannon requires equitable distribution of wealth among rich and poor.

7.3.Main Areas of Expenditure Responsibility

- Technically, in the structure of a budget, most governments classify expenditure into two.
- **1.Recurrent expenditure** i.e. All sorts of administrative costs such as salary, and defense expenditure and debt services
- Also referred to as non-developmental expenditure.
- **2. Capital expenditure** (i.e. Expenditures on construction of dams, public works, state enterprises, agricultural and industrial development etc
- Contribute to increased productive capacity of the nation and so known as development expenditure

7.4.Roles of Each Layer of Governments In Public Expenditure

- 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 influences priorities in public expenditure.
- 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

Roles of Layer of Governments

- We have **three general models of state** to which public expenditure corresponds: There are:
- **A. the minimal state (Police 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;
- **B. 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.
- **C. 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.
- The expenditure of federal and regions on education health, agriculture, etc.

Allocation of Expenditure Responsibilities

- The division of expenditure responsibility means determining the responsibilities of the tiers of government as to where and on what they can spend their money.
- Theory of fiscal federalism suggests that the role of the federal government should be:
 - Stabilization (central bank currency etc)
 - Redistribution(income redistribution, control of rare resources (oil, gas, gold etc)
 - Regulation (regulation of international trade, commerce, communications and transportation)
- States will mainly be responsible for allocative function for delivery of local goods and services
 - Education, health care, water etc

Allocation of Expend. Resp...

- In the early times there was a strong emphasis on matching the population benefitting from a public good to the appropriate level of government as provider.
 - Eg. Look at defence and Local roads
- While the theory of public goods seems clear, its application in practice can be messy.
 - Eg. Many public goods, such as policing, health care , education, pension, etc serve national and regional publics in different degrees, so it is hard to draw boundaries.
- To whom should we give powers; Federal govt. or state or local govt.?
 - Cost efficiency, local responsiveness
 - Equity, program integrity and cross border mobility

Allocation of Expend. Resp...

- The main allocation of expenditure responsibility in most federations was decided with little reference to the theories of fiscal federalism.
- Primarily the federal constitution determines the expenditure responsibilities.
- 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.
- In essence the manner of division of expenditure responsibility will be affected by the design of the federal system, particularly the division of legislative and administrative powers.
- Marked difference exists between dualist and integrated models

7.5. Division of Expenditure Responsibility: the USA and Germany Experiences

- **I. The USA Experience**
- The USA is a three-tier federation consisting of central government, states and local governments of various types.
- There are at least three unique features of fiscal system of the USA.
- First, it is one of the countries where fiscal federalism has **had a long history** and the fiscal framework is deeply embodied in the federalist spirit of the constitution.
- Second, it is the **most diversified** and complex system. We have a diverse state and local fiscal system.
- Thirdly, in spite of its high complexity and diversity, there has been much **stability**.

The Us Experience contd...

- The US Constitution provided neither assignment of particular expenditure functions to the various levels of governments nor did it prescribe what taxes should be used by them.
- It also refrained from setting specific limits to the expenditure functions of the federal government since the “general welfare” could be interpreted in extremely broad sense such that it would give much discretionary power to the federal government.
- The development of the doctrine of “**implied powers**” and the “**commerce clause**” has led to increased congressional power in the federation.

- The big items of US federal expenditure include social security (largely), defense and interest.
- The big items of state expenditures are education, welfare, social security, and transportation.
- By far, the dominant function at local level is education.
- Expenditures on welfare and transportation are made at state level, while education and policy are largely local functions.

The German Experience

- **II. Germany Experience**
- The German Basic Law defines a strict federal system whose three elements and actors are the *Länder* (states) and their *Gemeinden* (local administration), and on the top administrative level, the *Bund* (center).
- The Constitution is one of “moderate separation” or “cooperative federalism”.
- The Basic Law not only provides exclusive powers for the central and the regional governments but also extensively provides the **concurrent powers** of both levels of government, in general leaving their execution to the *Länder*.

The German Experience contd...

- The states can legislate on the subjects listed under the concurrent legislation so long as and to the extent that the federation has not exercised its legislative power by enacting a law.
- Concurrent powers can be exercised by the federation only when uniform federal legislation is required.
- If an issue of constitutionality arises, the constitutional court adjudicates the issue.

The German Experience contd...

- The Basic Law of German powers and functions of each level of administration are demarcated. What follows is a list of the constitutive functions of the *Bund*.
- To name some:
 - Burdens as consequence of the war,(reconstruction etc.)
 - Foreign affairs: proof of nationality and passport and visa;
 - Defense; Currency, coins (but not issuance of paper money: this is the task of the Central Bank);
 - Safeguarding the social insurance system;
 - Labour administration;
 - Federal Police; only tow specific troops, namely: border protection and anti-terror unit;

The German Experience contd...

- Other tasks are identified by the Constitution as the subject matters of the *Bund* which are fulfilled by *Lander*. These include:
 - Administrative tasks in the fields of federal highways, federal waterways, air traffic, defense and taxes.
- Landers are also exclusively empowered with the following task:
 - Police, Culture and education,
 - Transport, Construction and maintenance of (non-federal) roads and waterways,
 - Provision of water and energy,
 - Administration of *Lander* property, Supervision of the *Gemeinden*.

The German Experience contd...

- Tasks of a typical *Gemeinden* includes:
 - Administration of property of the *Gemeinden*, especially of its enterprises,
 - Tax administration, Regional planning,
 - Registration/Records, Social question, Security, Industry, trade and commerce/inspectorate,
 - Transportation, Environmental protection, Culture, Education, Sports.

7.6 Division of Expenditure Responsibility in Ethiopia

- **Division and Scope of Executive Power in Ethiopia**
- The administration of certain power has direct implication to the expenditure responsibility.
- Does the executive responsibility of the federal or the regional government correspond with its legislative power?
- Does each government has an expenditure responsibility in each areas in which it legislates?
- Can federal government participate in execution of state matters?
- Even though division of expenditure responsibility influenced by the allocation of legislative power, it does not always mean that the one who legislated bears the administrative costs. Executive competence must be seen.

Expenditure Resp. in Ethiopia

- In Ethiopia, 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.

Expenditure Resp. in Ethiopia

- 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.
- Those matters not mentioned under 'the powers and functions of the federal movement' (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.

Expenditure Resp. in Ethiopia

- 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."

Expenditure Resp. in Ethiopia

- 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.

Expenditure Resp. in Ethiopia

- 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.

Expenditure Resp. in Ethiopia

- 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.

Expenditure Resp. in Ethiopia

- 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.

Chapter Eight

Allocation of Public Revenue in Federations

8.1. Meaning of Public Revenue

- What is public revenue?
- Public expenditure, mainly the power of spending depends on the revenue of the government.
- It basically consists of determination of the source of revenue through legislation and the collection.
- Revenue is the force and instrument to ensure the effective performance of powers and functions of the government.
- The raising of public revenues follows from the necessity of incurring public expenditure.

Meaning of Public Revenue contd...

- Dalton has defined public finance in to two senses; broad and narrow senses.
- In wider sense, it includes all the income irrespective of the sources they are obtained from.
- 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.

Meaning of Public Revenue contd...

- In narrow sense, however, it includes only those sources of income of the government which are described as “revenue sources.”
- Public revenue 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.
- To sum up the meaning, the income of the government through all sources is called public income or public revenue.

8.2. 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 revenue.

- **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 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'. Legislative authority.

Tax Revenue Sources contd...

- Tax is one of the most important sources of revenue to every government.
- In earlier days, payment of **taxes was optional**.
- Discretions were given to the people to pay and to avail the benefit of social amenities in the form of education, health and sanitation, utilities and recreation facilities.
- But the option in the payment of tax created lot of problems for the governments in fulfilling their obligations to the society.
- Hence, in the modern times, the optional nature of the tax is withdrawn and the tax becomes a compulsory contribution by every citizen to their government to enable it to fulfill its commitments towards society.
- Taxes are of two kind: direct taxes and indirect taxes.

Non-taxes revenue sources

- **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:

- **1. 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.

Non-taxes revenues

- They are also termed as price, for they are collected in the form of price of goods and services provided by government.
- They include:
 - payment of postage, tolls, interest on funds borrowed from the government credit corporations;
 - dividends and profits from public sector enterprises, price paid for liquor in the government stores;
 - water, telecommunication, electric distributed by the government, rail, air, road and water transport services and the like. etc.

Non-taxes revenues

- **2. 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. i.e. it is not in the form of price.

Non-taxes revenues...

- **3. 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.
- 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.
- Sometimes, the government of one country receives a grant from another country, which is commonly called “foreign-aid”.

Non-taxes revenue...

- **4. Capital Receipts**
- Capital receipts constitute revenue from market borrowings, i.e. loans which have a maturity of fixed time.
- 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.

8.3. Purpose and types of Taxes

- **I. 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. Some are:
- **1.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.
- Thus, it is the tax potentials that cover the ever increasing expenditures of the state.

Purpose of Taxes...

- **2. 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.
- Companies and rich people are required to pay higher rate of tax and sufficient portion of wealth is taken away through taxation by the government so that the rich may not become richer and the poor, poorer.

- **3. Stabilizing economy**

- Tax also plays an important role in stabilizing the economy. Economic stability may be judged by the behavior of price.
- Unhealthy economic operation arises in price fluctuation due to disproportional output and consumption and through supply and demand in the market.

Purpose of Taxes...

- The instability of economy in the market is generally summarized as inflation, deflation and stagflation.
- Taxation, if applied properly, may take away the excessive capacity to pay of the people, which means demand pull inflation.
- Tax exemption on production and on savings has also effect in sterilizing cost-push inflation.

Purpose of Taxes...

- **4. 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.

II. Types of taxes

- In general taxes are classified into two major categories: (1) Direct taxes and (2) Indirect taxes,
- Sometimes taxes are, based on their source, also classified as tax in *personam* (individual) and tax in *rem* (property).
- **Direct taxes** are 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.
- According to John Stuart Mill “a direct tax is demanded from the very person who, it is intended or desired, should pay it”.
- Income tax, profit tax, capital gain tax, property tax or wealth tax are direct taxes.

Type of Taxes ...

- **Indirect taxes** are those taxes the burden of which may not necessarily be borne by the assessed.
- 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".

Type of Taxes ...

- Generally, the principal taxes currently in Ethiopia are profit tax, turnover tax (TOT), value-added tax (VAT), excise tax, customs duty, withholding tax and income tax from employment.
- While VAT has replaced sales tax, TOT and withholding taxes have been introduced recently.
- Other taxes include corporate tax, dividend income tax, royalties and stamp duties.

8.4. Principles of the Division of Taxation Power

- **Economist's Theory for Division of Taxation Power.**
- In relation to taxation, the traditional normative view set out by Musgrave are:
 - 1. Taxes suitable for economic stabilization should be central;
 - 2. Progressive redistribution taxes should be central;
 - 3. Personal taxes with progress rates should be levied by the jurisdictions which are most capable of implementing a tax on global base;
 - 4. lower level governments should tax bases with low mobility between jurisdiction;
 - 5. Tax bases distributed very unequally between jurisdictions should be centralized; and
 - 6. Benefit taxes and urban charges might be appropriately used at all levels.

Division of Taxation Power

- The method of allocation of revenue in federal systems is theoretically intended to follow the division of the expenditure responsibilities.
- The **allocation of the entire revenue** sources either to the center or the states has different problems in federal system.
- In principle, there should be a framework in which each tier of government can raise its own finances without a conflict between them.
- In practice, the degree of tax autonomy in each level of government is enjoyed demonstrates wide variation in federations.

Division of Taxation Power

- Economic principles such as efficiency, equity, and administrative simplicity are important.
- Other factors such as constitutional provisions, history, regional politics, and the priority given self-financing can also shape arrangements.
- 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.
- **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.

Division of Taxation Power

- The federal and state governments have equal constitutional authority to levy the same kind of tax with respect to the same category of persons, businesses or particular things.
- This overlapping of specific types of taxes 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.

The Structure of Taxation Power in Ethiopia

- 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’.
- **I. Federal Power of Taxation**
- The FDRE Constitution under Article 96 enumerates the exclusive revenue sources of the federal government.

The Structure of Taxation Power in Ethiopia

- **1. Import and Export taxes and Customs duties**
- **2. Income Tax**
- Except customs duties and import and export taxes other revenue sources from income tax, sales and excise tax, property taxes and charges and fees are assigned to tiers of governments.
- 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.
- Personal Income Tax from employees of federal government, income from rail, air, and sea transport etc

The Structure of Taxation Power in Ethiopia

- **3. Sales and Excise Taxes** from public enterprises owned by the Federal Government
- **4. Fees and Charges** and stamp duties for services provided by federal organs
- **5. Other Revenues** from Federal Enterprises and Properties.
- **II. State Power of Taxation**
- 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.

The Structure of Taxation Power in Ethiopia

- **1. Income Tax of states,**
- Income from employees of the states; Profits of the state owned public enterprises, small business activities and sole proprietorships; Income from individual farmers or cooperative association; Income from water and transport services ;Rental income from properties owned by the state.
- **2. Sales and Excise Taxes from** public enterprises owned by them and individual traders within their jurisdiction.
- **3. Property Taxes** On houses which are privately owned, land which is used by *usufructuaries* and royalties from the use of forests royalties on small-scale mining activities, land lease payment from investors
- **4. Fees and Charges** on license issued and services rendered by different organs of the state.

The Structure of Taxation Power in Ethiopia

- **III. Concurrent Power of Taxation**
- The FDRE Constitution provides the source of concurrent taxes under Article 98. These sources are:
 - Profit, sales, excise and personal income taxes on enterprises they (state and Federal) jointly establish,
 - Taxes on profits of companies and on dividends due to shareholders, and
 - Taxes on incomes derived from large-scale mining and all petroleum and gas operations and royalties on such operations.
- Mobility and Redistribution Factors seem to be considered here.

8.6.Limitations on Powers of Taxation

- In federal system of taxation powers allocation between the federal government and the states, there are three limitations of taxations imposed on each federating units. These are:
 - Prohibition of federal discriminatory tax laws,
 - Prohibition of extraterritoriality of state taxes and
 - Intergovernmental tax immunity.
- **1. Prohibition of Discriminatory Federal Taxes**
- The first limitation imposed a prohibition on the federal government from dealing with tax between the states or other levels of government in a discriminatory manner.
- The limitation prohibits the imposition of different tax rates and tax privileges between the states.

Limitations...

- The significance of this limitation is that the people of different states should not be exposed to unfair treatment by the federal government on the pretext of the inequality of the states.
- But, in some federations, like Ethiopia, asymmetry between the constituent units of a federation cannot be overlooked. The constitution of Ethiopia requires the governments to provide special assistance to those states which are least advanced in economic development. One of the measures taken with regard to taxation is to provide different tax holidays for income from different states.
- For instance, persons who invest by establishing new enterprises in states such as Gambela, Benishangul-Gumuz, Somali, and Afar are granted an exemption for a period of five years.

Limitations...

- **2. Prohibition of Extraterritoriality of state taxes**
- Such prohibition has some purposes:
 - It prevents certain types of tax from shifting beyond the territorial boundaries of the states. This is because such taxes may impose burdens upon the economic and trade activities of other state, or they may result in duplication of taxes.
 - It also preserves the free flow of goods, services and capitals among the states.
 - But, more important in the Ethiopian context, is that the states should not enact tax laws that discriminate among taxpayers on ethnic grounds.
- Therefore, those taxes, which by their nature are extra-territorial, can be assigned to the federal government.

Limitations...

- **3. Intergovernmental Tax Immunity**
- The third limitation concerns the capacity of each tier of the federal government to tax each other. In the federal system, a question arises as to whether it is proper for one level of government to pay tax to the other.
- In principle, the two tiers of government having autonomous functions and taxing powers are deemed to operate in parallel so that one level of government cannot interfere with the power of the other.
- In Ethiopia, the directive on intergovernmental tax immunity is embodied in Article 100(3) of the Constitution.

Chapter Nine

Fiscal Imbalances and Intergovernmental Revenue Transfer

9.1. Fiscal Imbalances

- **Meaning:** Fiscal imbalance is the fiscal mismatch between the expenditure responsibility and revenue sources .
- Emanates because different principles guide the allocation expenditure responsibilities in one hand and allocation of Taxation Power on the other.
- **There exists two Types of Imbalances:**
- **Vertical fiscal imbalances and Horizontal Fiscal Imbalances**
- **Vertical imbalance** is mismatch between revenues and expenditures that arise from fiscal relations between the center and sub-national governments.

Fiscal Imbalances

- 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 fiscal imbalances** refer to the fiscal disparity among sub-national governments.
- It 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.

9.2. Causes and Implications of Imbalances

- **I. Causes of Imbalances**

- The cause has two aspects: 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.
 - Tax sources which yield only a limited amount of revenue have been allocated to the states.
- **On the expenditure side:**
 - 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.
- The vertical imbalance in Ethiopia **shows that the centre dominates the fiscal power of the federation.**

- **II. Implications of Imbalances**
- **What does this imbalance imply?**
- **First**, it could lead to problems of inefficiency.
- As 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.
- **Second**, a higher degree of vertical imbalance implies that the states' autonomy is dependent on the transfer of revenue controlled by the center.
- **Third**, The horizontal revenue imbalance implies that the regions retain different capacities to generate revenue within the regions to cover costs of public expenditure.
- **Fourth**, It also reflects the extent of support they need in the form of federal transfers.

Fiscal Imbalance in Ethiopia

- As far as vertical fiscal imbalance is concerned, in the 1993/94 fiscal year, regions were only able to cover 26% of their expenditure so that the rest three quarter is covered by grants from the central government.
- During that period, the regions" own revenues were projected to finance no more than 47% of their recurrent expenditure, and 26% of their total expenditure.
- In the same period, regions were only able to claim 37% of the total expenditure of the government indicating that the bulk of the expenditure is allocated to the central government.
- On the revenue side, the share of the regions accounts for less than 10% of the total revenue.

Fiscal Imbalance in Ethiopia

- Regional fiscal imbalance is measured as the ratio between regions revenue and the total revenue generated by the regions.
- In Ethiopia the total revenue collected by the regions is very much concentrated in a few regions.
- Just four states account for more than 80 per cent of the total revenue generated by the states.
- For instance, in 2006/2007 fiscal year Oromia's share of the total revenue raised by the regions was 38.5 per cent, but Gambela had only 0.77 per cent.
- They accounted for 21.1 and 7.9 per cent of their respective financial expenditures.

Fiscal Imbalance in Ethiopia

- A better indication of the horizontal fiscal imbalance is given by the percentage of revenue raised by each region relative to the respective expenditure.
- The lowest percentage is recorded in the Gambela region.
- The lowest percentage of revenue compared with their own expenditure implies that they have the least revenue-generating capacity.
- The data also show that Tigray and Dire Dawa generate the highest percentage of their own revenue compared with own expenditures, accounting for 28 and 22.3 per cent respectively.
- Amhara, SNNPR and Harari showed about 15 to 20 per cent, while Somali, Benishangul-Gumuz and Gambela regions were able to account for less than 10 per cent of their expenditure.

Table 4.1. REGIONAL GOVERNMENT EXPENDITURE FINANCED FROM THEIR OWN REVENUE F.Y 2006.
(in Billion)

Region	Total Exp.	Own Revenue	% share of (2)	%share of total Regional revenue
	1	2	3	4
Tigray	695.7	194.9	28.0	12.0
Afar	332.0	38.0	11.4	2.3
Amhara	1899.7	380.3	20.0	23.5
Oromia	2958.3	624.3	21.1	38.5
Somali	506.2	31.0	6.1	1.9
Benishangul-Gumuz	229.0	22.1	9.7	1.4
SNNPR	1626.4	262.8	16.2	16.2
Gambela	156.2	12.4	7.9	0.77
Harar	119.0	20.5	17.2	1.3
Dire Dawa	153.9	34.3	22.3	2.1
Total/Average	8676.4	1620.6	18.7	100

Source: Ministry of Finance and Economic Development (MoFED), cf. The Federal Democratic Republic of Ethiopia, The New Federal Budget Grant Distribution Formula, May 2007.

9.3. Inter-governmental Revenue Transfer

- **The Objectives of Revenue Transfer**
- 1. 'Fiscal equalization': Addressing the states' financial constraints in executing their expenditure responsibilities. Both horizontal and vertical imbalances.
- 2. To enable equitable distribution of income and public services between individuals in various regions.
- 3. To reduce financial imbalances and inefficiency across the states in the interest of economic development of the whole federation.
- 4. To compensate for spill over effects of some local spending.
- 5. To enable implementation of federal policies at state or local level through conditional grants.

Forms of Transfer in General

- Most productive sources of taxation are in the hands of the centre. As a result of this, it is necessary to transfer a portion of the revenue to the states.
- Most federal systems have sought to create a balance between states' functions and financial resources through transfer mechanisms.
- In general, there are two instruments which are devised for the transfer of revenue from the centre to the regions. These are equalization through :

– Revenue sharing and

Forms of Transfer

- **I. Revenue Sharing**
- Revenue sharing is a means of addressing vertical fiscal imbalance whereby one order of government has unconditional access to a specified share of revenues collected by another order.
- Revenue sharing becomes relevant when revenue sources are shared between the centre and the states, but administered by the former.
- The nature of revenue sharing heavily depends upon the constitutional division of revenue sources between the levels of government.
- Its principal purpose is geared towards increasing the revenue capacity of states in order to meet their expenditure assignments.

Forms of Transfer

- There are two basic approaches which have been adopted by countries in order to provide an answer to the above question:
 - the sharing of revenue on a tax-by-tax basis or
 - the sharing of revenue pooled by the central government from all the taxes destined to be shared.
- The first approach, *tax-by-tax sharing*, implies that the revenue collected by the central government from each tax base is divided between the centre and the regions using percentages set by the constitution or other pertinent legislation.
- The newly introduced revenue-sharing scheme in Ethiopia follows the first approach, sharing on a tax-by-tax basis.

Forms of Transfer

- In the second approach, the *sharing of the entire pool of the tax* levied by the central government, a single formula may suffice.
- The second approach for revenue sharing has been the major intergovernmental transfer mechanism where the total amount derived from the major tax sources that accrues to the federal account is divided between the centre, the states and the local governments.

Forms of Transfer

- In both methods the actual proportion of tax to be allocated to the respective states is determined by either the *derivation* or the *redistributive* principle.
- Derivative principle is that each state receives a share based on the amount of revenue collected in that specific state.
- In the *redistributive* principle, revenue from a specific tax base or from the entire pool retained by the centre will be apportioned to all states, irrespective of their capacity to generate the shared revenues.
- In this case, revenue sharing is very much like unconditional grants.

Advantage & Risks of Revenue Sharing

- **Advantages**

- Promotes the autonomy of the states through its lump sum and unconditional awards,
- Flexibility to serve as an equalizing factor, and
- Preserving a fully harmonized tax system

- **Risks**

- Gives no discretion to the states to have a say on the amount to be dispersed to them
- May not reflect the actual expenditure needs of the states
- Expose the states to the risk associated with unanticipated changes in the federal tax base

Forms of Transfer

- In Ethiopia, according to the Constitution, developing a revenue-sharing scheme may involve two major issues:
 - the sharing of joint taxes (to use the words of the Constitution, i.e., concurrent taxes Art.98), and
 - the sharing of federal taxes for providing subsidy grants to the states (or for equalization purposes Art. 62(7) and 95).

Table 4:2 Types and Sources of joint Revenue*

Types and sources of joint revenue			The share of the centre and the regions on a tax-by- tax basis from each type of tax in %	
			Share of the	Share of the Regions
1	Revenue from Enterprises jointly established by the centre and region		N.A. (not available)	N.A. **
2	Revenue from companies			
	2.1.	Profit taxes	50	50
	2.2.	Service, sales (V AT) and excise	70	30
	2.3.	Tax on dividends	50	50
3	Revenue from large-scale mining and all petroleum and gas operations			
	3.1.	Tax on profits	50	50
	3.2.	Royalties	60	40

* The revenue-sharing scheme as reported by the Ministry of Revenue, December 2003.

** Since there are no enterprises jointly established, the sharing of direct or indirect taxes from this source is not currently applicable.

Grant in Subsidies

- **II. Grant in Subsidies**
- Disparities between poorer and richer states are addressed through grants also known as 'equalizing transfers'.
- 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.
- By equalizing the revenue capacity, it is anticipated that the states can provide comparable public services for their inhabitants.
- **Types and the Nature of Grants in General**
- Generally we have two types of grants:
 - General purpose (unconditional) Grants
 - Specific purpose (conditional) Grants.

1. General Purpose Grants

- General purpose grants 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 main characteristics of general purpose grants is the incongruity between imposing the taxation burden on the federal government while benefiting the sub-national governments with the liberty of spending the money.
- That is the political unpopularity of imposing taxes and the political popularity of spending money is said to taster fiscal irresponsibility.

2. Specific Purpose (Conditional) Grants

- 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 centre.

Grants In Subsidy

- Further, it can also play a role in curbing financial embezzlement, inefficiency and corruption, as the federal government retains the power to set conditions, to control and audit the spending.
- **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.
- **Matching grants:** are given on a basis when states commit themselves to sharing the costs in order to receive a grant for a particular program.

Grant in Subsidies

- The objective of specific purpose grants is to impose conditions on the use of grants in order to maintain nationwide standards for the provision of services such as health and education.
- Normally, the greater the degree of the federal interests in the project to be covered by the matching grant, the larger the federal share.
- Matching grants also enables the central government to influence the states instead of directly interfering in their autonomy.
- They also have the objective of encouraging recipient states to 'maximize the initiative for self-financing'.

Constitutional Framework for Federal Grant to Regions in Ethiopia

- **Basis for Grants and assistance for Regions**
 - Article 41(3) Every Ethiopian national has the right to equal access to publicly funded social services.
 - Article 43(4) The basic aim of development activities shall be to enhance the capacity of citizens for development and to meet their basic needs.
 - Article 89 (1) Duty to formulate policies which ensure that all Ethiopians can benefit from the country's legacy of intellectual and material resources.
 - Art.89(2) Responsibility of Government to create comparable life standards across the country;

Constitutional Framework for Federal Grant to Regions

- Art.89(4) Obligation to provide special assistance to NNPS least advantaged ;
- Art.90 (1) Right to equitable access to public health, education , clean water, food& social security;
- Art.91(1) Right to clean environment
- **Federal Grant to regions**
 - Art.62(7) Revenue sharing and Grant System;
 - Art.94(2) Federal grant for emergency, rehabilitation and development assistance and loans to states;
 - Art. 94(2) Power of Federal govt. to audit and inspect regional spending of federal grant;

Objectives of Federal Grant to Regions

- According to the Proc. 33/1992, the objectives of grants to the regions are:
- To promote social services and economic development of the National/Regional Governments;
- Accelerate the development of the hitherto neglected and forgotten regions;
- To narrow income disparities between regions;
- To encourage activities with positive externalities and control those with external diseconomies, and
- To encourage foreign currency earning projects and other projects of national interest.

The Ethiopian Federal Grant System

- The grant formula used in Ethiopia has been amended on several occasions since 1992, the variables used and the weight attached to them are the main factors inherent in the system.
- In 1992/93, no precise grant formula was implemented because in late 1991/92 and 1992/93, the major 'breakthrough' was the process of the formation and organization of regional governments, organizing offices and the transfer of staff and projects to the regions.
- During this period, no precise formula was used for allocating resources to the regions. Aim was rehabilitating war-torn zones.

The Ethiopian Grant Formula

- The allocation of grant subsidies in the 1993/94 and 1994/95 fiscal years followed the format of general purpose grants divided into grants for recurrent and for capital expenditures respectively.
- The formula that has been operational for the last thirteen years was based mainly on subjective weights given to variables that indicate size of population, differences in level of development, revenue collection effort and sectoral performance.

Variables used in previous Grant Formulas before 2007

Year	Variable	Weight in Percent
1995	- Size of population	30
	- I - distance (index of development)	25
	- Regional revenue collection	20
	- Capital Budget allocation for EFY 1994	15
	- Area	10
1997	- Size of population	33.3
	- Level of development	33.3
	- Ratio of regional revenue collection to budget	33.3
1998	- Size of population	60
	- Level of development	15
	- Ratio of regional revenue collection to budget	15
	- Area	10
2000	- Size of population	55
	- Level of poverty	10
	- Level of development	20
	- Revenue collection effort and sector performance	15
2004 - 2007	- Size of population	65
	- Level of development	25
	- Revenue collection effort	10

Source: Ministry of Finance and Economic Development, Macro Economic Policy and Management Department, February, 2006.

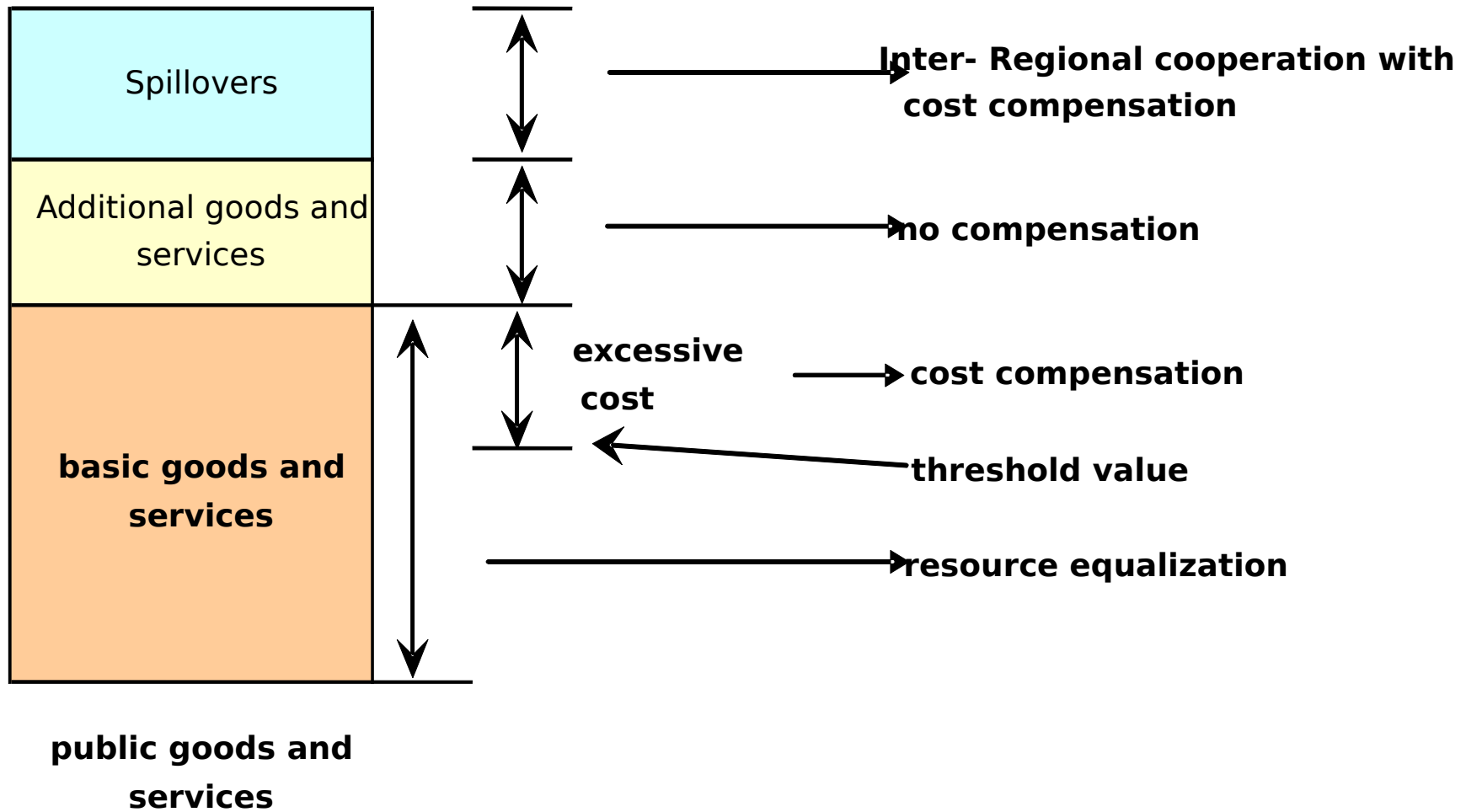
The Ethiopian Grant Formula

- **Shortcomings of the Previous Formula**

1. The subjective nature of the variables used and the weights assigned to these variables to estimate the expenditure needs of regions.
- 2. The formula gives much weight/focus to capital expenditure, without due consideration to recurrent expenditure needs.
- 3. The formula fails to consider the potential revenue raising capacity of regions.
- It is therefore not possible to identify the difference between the actual revenue collection, and the potential revenue raising capacity of the regions.

- The new formula is based on the objective of the Constitution of the Federal Democratic Republic of Ethiopia and has three principles:
- **Principles of the New Formula**
- **Principle One:** Every Ethiopian living in any part of the country is entitled, by and large, to similar range and level of public services. (Equitable standard of living)(Art. 41(3)& 89(2))
- **Principle Two:** The annual budget grant distributed to regions is independent of their tax effort or expenditure level, i.e. it is effort neutral.
- Special incentive not as general grant but conditional
- **Principle Three:** Regions that are forced to spend more than the standard regional expenditures are entitled to budgetary support to finance the gap. (Fiscal Equalization) (Art. 89(4))

Concept of financial equalization



- **The new formula has the following characteristics:**
- 1. The objective of the formula is based on the creation of comparable financial capacity among regions in order to provide standard public services, (in addition to the effort to be put by each region to collect average revenue)
- 2. In order to assess the expenditure needs and revenue capacity of regions, the formula is based on actual/potential revenue and expenditure fiscal data rather than on subjective variables.
- 3. The tax bases of regions differ mainly due to differences in economic activity, area and natural resource as a result of which, the tax capacities of regions also differ. The new formula, by assessing the revenue base of regions equalizes their

- 4. To enable regions discharge their constitutional mandates of expenditure assignments, the new formula assesses the recurrent and capital expenditure needs of regions rather than depend on subjective variables and weights.
- 5. The formula also addresses the problems of expenditure disabilities, factors which force regions to make higher outlays than the regional standards.
- 6. It indicates the relative position of each region vis a vis sectoral expenditures and reveals anomalies.
- 7. The formula evolves overtime, easily accommodating additional and revised variables and data which contribute to its simplicity and transparency thereby addressing the expectations of stakeholders.

The New Budget Formula

- **Variables Used in the New Formula**
- The variables used in the new formula centers on four aspects:-
 - (i) population;
 - (ii) differences in relative revenue raising capacity;
 - (iii) differences in relative expenditure needs; and
 - (iv) performance incentives.

Summary Of Differences In Revenue Capacity And Expenditure Needs Assessment

Region	Average Population	Average per Capita Transfer	Difference in Per Capita Revenue Capacity	Difference in Per Capita Expenditure Needs	Sum of (2), (3) and (4)	(5) multiplied by (1)	Percentage Share
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Tigray	4.10	88.95	-5.04	10.25	94.16	385.59	6.38
Afar	1.33	88.95	3.33	21.95	114.23	151.57	2.51
Amhara	18.06	88.95	4.26	-4.57	88.63	1600.84	26.49
Oromia	24.97	88.95	-3.92	-3.44	81.59	2037.62	33.72
Somale	4.09	88.95	6.14	3.58	98.67	403.68	6.68
B,S Gumuz	0.59	88.95	-4.42	60.54	145.07	86.03	1.42
SNNPR	14.01	88.95	3.06	-2.67	89.34	1252.10	20.72
Gambela	0.23	88.95	-22.59	172.80	239.15	55.87	0.92
Hareri	0.18	88.95	-56.91	133.38	165.41	30.40	0.50
Dire Dawa	0.37	88.95	-34.02	52.43	107.36	39.64	0.66
Total	67.94	88.95	0.00	0.00	88.95	6043.34	100.00

Working of the Grant formula

- For illustration purpose the five year (2002 - 2006) average budget transfer, Birr 6,043.34 million is taken to indicate the percentage share of each region from the annual pool of budgetary transfer.
- Accordingly, assuming an equal per capita amount of transfer, Birr 88.95, and adjusting this with respect to the total results of revenue capacity and expenditure needs, the per capita share of each region is arrived at (column 5).
- The amount and percentage share of each region (column (6) and (7)) is, thus, calculated from the five year average transfer, Birr 6,043.34 million.
- The percentage share in column (7) indicates the annual share of each region from the Federal budgetary grant irrespective of the size of the pool.

Relationship Between Percentage Shares of Regional Population and the New Federal Budget Transfer

Region	Percentage Share of Population	Percentage Share of Budget Transfer	Ratio of (2) to (1)
	1	2	3
Tigray	6.04	6.38	1.056
Afar	1.96	2.51	1.281
Amhara	26.59	26.49	0.996
Oromiya	36.76	33.72	0.917
Somale	6.02	6.68	1.110
Benishangul Gumuz	0.87	1.42	1.632
SNNP	20.62	20.72	1.005
Gambella	0.34	0.92	2.706
Hareri	0.26	0.50	1.923
Dire Dawa	0.54	0.66	1.222
Total	100	100	1.000

Reasons for Variations on the share of Regions

- The budget transfer shares of the populous regions are less or about equal to their population shares.
- On the other hand the transfer shares of the less populous regions are higher than their population share with wide variations.
- The differences in the less populous regions arise mainly because:-
 - 1. Cost differences arising from economies of scale especially in the regions with less than a million population i.e. Harari, Gambela, Dire Dawa and Benishangul Gumuz.
 - 2. cost differences arising from dispersion/distance in Afar, Somale, Benishangul Gumuz and Gambella.

Reasons for Variations on the share of Regions

- 3. Higher expenditure needs of rural roads for Afar, Somale, Benishangul Gumuz and Gambella.
- 4. The impact of spillover effects in Hareri and Dire Dawa.
- 5. Higher than average capacity to raise revenue with the exception of Afar and Somale.

Institutional Setup for Revenue Transfer

- Although the FDRE Constitution provides for the sharing of concurrent taxes between the federal government and the states and the transfer of grants from the center to the states, it refrains from laying down any rigid formulas or specific amount payable to the state in the form of shared taxes and grants.
- The drafter of the constitution seems to have learnt from the experience of other federal countries or have realized the problems of determining permanent formulas in the effort to meet the changing socio-economic conditions of a country.
- Federal experiences have demonstrated several options in using different institutions dealing with the issue of revenue.

Institutional Setup for Revenue Transfer

- Some have opted for independent commissions mandated with advisory role, while others use the federal legislature or some form of intergovernmental councils.
- After the adoption of the Federal Constitution, the power to determine the sharing of revenue collected from joint tax sources and of grants that the federal government provides to the states is vested in the House of Federation, HOF (Art. 62(7) of the Constitution).
- **Why is the power conferred on the HOF? Why the Constitution does not adhere the transitional government system?** For two reasons:

Institutional Setup for Revenue Transfer

- **First**, the Constitution follows the principle that non-political or majoritarian institutions should not deal with all major political issues. Accordingly, constitutional adjunction, secession issues and the transfer of revenue are the major political issues that have to be decided by the representatives of 'nations, nationalities and people' at the HOF.
- **Second**, the HOF is designed as an institution that can play a role similar to that of intergovernmental council. So, by having authority over revenue sharing and the transfer of grants, the HOF promotes intergovernmental relations.

Powers and Function of HOF on Revenue Transfer

- As enshrined in Article 62(7) of the Constitution, the function of the HOF are :
- 1. Determining the division of revenues derived from joint federal and state tax sources and its distribution among the states.
- 2. Determining the subsidies that the federal government may provide to the states'.
i.e. 'determining the grant formula' for distributing the grant to each member states.
- The House will deliberate on the disbursement of the revenue pool made by the federal government from the sources assigned to it.

Limitations of the HOF as Institution of IG Fiscal Transfer

- **1. It is not a full time institution**
- Even though the job requires full time attention in practice it meets only twice a year for a few days.
- **2. It does not have the necessary expertise to do the Job**
- Its task requires the gathering of relevant data from appropriate governmental bodies, analyzing and deciding on the adoption of grant types and revenue-sharing formula.
- Above all, the impact of revenue transferred to the states needs a series of studies.
- However, the HOF is dependent on recommendation of the Ministry of Federal Affairs (MOFA) and Ministry of Economic Development and Cooperation (MEDAC).
- It had no experts of its own; most of the members hardly understand the complexity of the grant system.

Limitations of the HOF

- 3. Even though it is **supposed to be counter majoritarian** by nature to protect minorities and to ensure regional interests in federal decision making its composition and lack of legislative authority limit its function.
- Now the relatively populated states are pushing the House to increase the weight of population size (and it has increased over the years from 30 per cent to 65 per cent) in the allocation of shared revenues and grants.
- The less populated states are consistently becoming the losers and it seems it is hardly possible to reverse this trend.
- As a result, while the HoF might have been envisaged as the most legitimate political body to decide on fiscal transfers, it is becoming less relevant to the less populated states.

Remedies Suggested

- Dr. Solomon argues the use of Ministries on the fiscal transfer is not advisable because:
 - They are not independent and they could be acting at the discretion of the federal government which makes the decision less objective and
 - employees of the ministry could not have authority to discuss sensitive issues.
- **Recommendation**
- This role can be better performed if an extra professional advisory body assists the House.
- Alternatively it would be even more effective if the power is reassigned to a permanent independent institution which has the necessary expertise and autonomy to conduct the ongoing complexity of data gathering and analysis.

Chapter Ten

Intergovernmental Relations In Federations(IGR)

WHAT ARE INTERGOVERNMENTAL RELATIONS (IGR)?

- Inter Governmental Relations(IGR) are those relations that arise between different orders of governments and their organs in the conduct of their affairs.
- IGR (Interactions) are the various ways in which institutions of government work with each other and with others across jurisdictional boundaries.
- IGR is about how different orders of government in federal countries communicate and collaborate with each other.

Importance of IGR

- **No real watertight compartments** : Powers and responsibilities in modern federations cannot be cleanly divided between the two orders of governments, or are concurrent or shared in various ways. This inevitability of overlaps and interdependence requires that they work together avoiding conflicts – IGR
- **For adaption to Changing circumstances:** Federal constitutions are usually difficult to amend, fairly rigid. IGR constitute one of the most important instruments of flexibility to adapt to changing circumstances in a federal political system.
- A federal constitution establishes the structure of government; **IGR bring the structure to life**. The constitution is the structure; IGR are the process – the way in which the necessary business of the federation gets done.

Forms and Institutions for IGR Process

- In relation to the orders of government IGR could be **vertical or horizontal**.
 - Vertical IGR between the Federal Government and the Regional States.
 - Horizontal: Between and among the Regional states.
- In relation to form, IGR could be **formal or informal**.
- **Formal**: when the IGR is conducted in formal interactions between the concerned bodies.
 - Formal scheduled conferences, meetings involving legislatures, ministers, sector offices.

- Formal interaction through established IG councils or committees with or without legal framework.
- **Informal interaction** ,Information exchange and informal consultation.
 - Telephone communications, informal meetings
Informal norms, practices and meetings etc.
- **In relation to institutionalisation:** it could be Institutionalised or adhoc.
- It could be institutionalised with constitutional or legal framework establishing various institutions for facilitating IGR.

Forms and Institutions for IGR

- More modern (or recently revised) constitutions give greater recognition to IGR and IG institutions
- Federal and state councils, Ministerial Councils, Second Chambers etc, In which various government organs are represented.
- It could be adhoc interaction evolved through practice.
- In all cases, institutions have emerged in response to practical needs with either limited or no guidance from the constitution

Forms and Institutions for IGR

- Constitutional provisions nonetheless influence the kind of IG practices that emerge by virtue of:
 - **Whether or not the legislative and executive powers are fused or separate**
 - **Nature of the upper chamber at the federal level**
 - **Nature and distribution of legislative and administrative powers between orders of government**
 - **The political party system and particularly the character of the linkages between national and provincial branches of political parties.**
 - **Extent of the dependence of regional and local governments on financing from the federal level.**

Competitive and Cooperative Federalism

- **Nature of IGR could vary based on nature of the Federal system.**
- **Competitive federalism also called Dual federalism** is, where the allocation of executive authority is in principle considered co-extensive with the distribution of legislative responsibilities.
- This stems from the fact that, if the federal and state governments are to remain autonomous, then each must act directly towards the people in the process of enforcing its laws.

Competitive & Cooperative ctd.

- As a result, it follows that not only legislative but also executive, financial and judicial powers should be divided between the federal government and the states so that each will act autonomously.
- There is rather a competition between the two levels of government as each legislates, executes and adjudicates its laws.
- Eg. The USA at the formative. years
- IGR in such federations develop and a function of necessity through practice with little guidance from the constitution.

Competitive and Cooperative Federalism

- Cooperative Federalism also called Executive Federalism. Exists in federations where administrative responsibility has not coincided with legislative authority.
- Administration for many areas of federal legislative authority is constitutionally assigned to the governments of the units.
- Both the federal and regional governments required to cooperate for implementation of laws.
- Accordingly there is a constitutionally mandated IGR in federations with cooperative federalism.

Concerns in relation to IGR

- **1. Democratic deficit in IGR.**
- IGR is basically carried out by the executive. The role of the legislative is very restricted. Here issue of accountability arises.
- **2. Common decisional trap.**
- If the system of IGR is interlocking all actions must be done in consultation and this reduces the decisional autonomy of both orders of government.

THE SYSTEM OF INTERGOVERNMENTAL RELATIONS IN ETHIOPIA

- The Ethiopian Constitution offers little guidance on managing federal-state relations relative to roles and tasks.
- There is neither a comprehensive dual structure nor executive federalism at work. The institution of cooperative federalism, too, is not well-known.
- However there is a huge constitutionally created interdependence between the federal and state governments that warrants IGR.

Interdependence between federal and Regional Governments in Ethiopia

- They are interdependent in wide range of matters:
- **First**, in economic ,social and development matters, the federal government is authorised to formulate and implement the overall policies of the country while states have power on specific policies and strategies in their region.(Art.51(2),52(2)(c))
- **Second**, in matters of education, health, science, technology, protection of cultural and historical legacies, federal government sets national standards and states are the conduits for protection and promotion of the languages , cultures and histories of their respective constituent ethnic groups.Art.51(3),

Interdependence continued...

- **Third**, while the federal government is responsible to enact laws for utilisation and conservation of land and other natural resources, the administration of such resources within the boundaries of federal laws is left for the regions. Art.52(2)(d)
- **Fourth**, the judicial authority of the Federal High Court and Federal First instance court is delegated to the state Supreme courts and state high courts respectively. Art.80(4)
- **Fifth**, although each order of government is, in principle assigned executive authority in the same matters for which it has legislative authority, federal laws in practice are largely executed through institutions of regional states.
- Therefore, in all the above matters, interdependence of the governments require IGR cooperation.

The system of IGR Cooperation in Ethiopia

- In Ethiopia the political relationship between the federal government and the states is regulated by both formal structures weakly defined in the constitution and various proclamations as well as practice outside the legal framework.
- As the current practice shows there are some ways of IGR cooperation in Ethiopia. These are:
 - 1.Co-operation through executive institutions;
 - 2.Co-operation through party structure; and
 - 3.Co-operation in the process of policy making.
 - 4.Co- operation through the HOF

The system of IGR Cooperation in Ethiopia

- **1. Co-operation through Executive Institutions**
- One such mechanism is the Ministry of Federal Affairs.
- The activity of the Ministry of Federal Affairs (MOFA) in the states is one of the semi-formalized practices that has an impact on federal-state relations.
- **The powers and duties of this Ministry stated under Procl.No.471/2005 Art. 21 are rather briefly outlined as follows:**
- A) In co-operation with the regions, ensure that public peace and order is maintained;

The system of IGR Cooperation in Ethiopia

- B) without prejudice to the provisions of Articles 48 and 62(6) of the federal constitution, facilitate the resolution of misunderstandings arising between regions;
- C) *Give assistance to the regions with particular emphasis on the less developed ones;*
- D) supervise and co-ordinate the executive organs, mainly, Federal Police Commission, Federal Prison Administration, National Urban Planning Institute, Addis Ababa and Dire Dawa city administrations.

The system of IGR Cooperation in Ethiopia

- E) serve as a focal point in creating good federal-regional relationship and cooperation based on mutual understanding and partnership and thereby strengthen the federal system;
- F) coordinate and integrate supports of other federal organs to the emerging Regional States
- In this connection we need to remember the bad legacy of the now defunct 'Yekilil Gudayoch Zerf' (Office for Regional Affairs) under the Prime Minister that come before MOFA.

The system of IGR Cooperation in Ethiopia

- **2.Co-operation through Party Channels**
- In the absence of formal institutional mechanisms, Implementation of federal law in regions is facilitated by *party channels*.
- *This is perhaps the most pervasive scheme used by the federal government to influence state governments as well as to guarantee uniformity of policies.*
- The EPRDF a coalition of ethnic parties is controlling all the regional state governments in the Ethiopian federation; either directly through the member parties or indirectly through affiliated parties.
- This largely centralized party structure appears to contradict the division of power that is expected to exist in a federation and subordinates the regional governments to the federal government.
- It is this factor along with its impact on the process of policy making that explains the centralizing trend in the federal system.
- It is also this factor that appears to explain the fact that intergovernmental conflicts are rare.

The system of IGR Cooperation in Ethiopia

- A central committee leads the ruling coalition. The central committee, often through the chairman, generates specific plans of action which are the basis for the EPRDF's five-year plans that are implemented nationwide.
- The five-year plans to be implemented are adopted at federal level and become the basis for state government plans and policies.
- Consequently, the constitutional right of the states to formulate and implement plans and policies are severely diminished by the fact that the state governments are in one way or another forced to follow the centrally designed policies and plans, resulting from the party structure.

The system of IGR Cooperation in Ethiopia

- In Ethiopia, except the party channel, there is hardly any institutionalized intergovernmental mechanism comparable to those in the European federations.
- Until recently there are no formal meetings on governmental level between federal ministers and state governments.
- Nor are there any such meetings among representatives of legislative bodies of the two governments.
- But recently, there are some consultative meetings between sector offices are started.
- There are some horizontal IGR relations that are begun between neighboring regions.
- All these however need formalization & institutionalization.

The system of IGR Cooperation in Ethiopia

- **3. Co-operation through the Process of Policy-Making**
- The federal government has currently issued several policy documents.
- These documents outline sometimes areas covering even elementary education that are according to the Constitution within the competence of the states.
- The documents mainly originated as party documents but were then published as federal documents and published by the Ministry of Information.
- Party members at federal and state level discuss them and decide to implement them in their capacity as government officers.
- In general the states accept the economic, social and development plans issued by the federal government.

The system of IGR Cooperation in Ethiopia

- **4. House of Federation as IGR Institution**
- The HOF has important roles in deciding the revenue transfer from the federal to regions and based on some agreed up on criterion. The regional and federal governments agree upon these criteria through negotiation.
- The HOF is also an institution for dispute resolution for conflicts between states.
- In conclusion the system of IGR in Ethiopia is yet to evolve.
- And a lot of informalism and centralism dominates.

Additional Material On IGR In Comparative Perspective

Seven Federations: Six models

Seven federations: Six models

- Australia
- Canada
- Switzerland
- Germany
- India
- South Africa

IGR in Australia

- Relatively homogeneous, lightly populated
- It is a dual federation, each sphere has a full set of governing institutions; cooperation between governments is commonplace affecting all institutions and all programs. (Cooperative federalism)
- Six states, two territories, and several administered territories
- Relatively centralized, even though constitution (1901) written to minimize this

Australia context

- Westminster system with fused executive and legislature with concentration of power in executive; upper chamber elected by proportional representation with equal representation from each state
- Component units, representing the states in the Senate, have a role in central institutions.
- Each level of government with legislative authority administers its own laws
- Lots of concurrency in legislative powers.
- IGR processes provide vehicles for inter-jurisdictional dialogue, development of national approaches to policy issues and conflict resolution

Australia (cont'd) Institutions and processes

Council of Australia Governments (COAG)

- It is made up of First Ministers (includes all State Premiers and Chief Ministers and the President of the Australian Local Government Association), and is chaired by the PM
- One of its main purposes: to increase cooperation among governments in the national interest.
- **The Treaties Council**
- The membership is the same as for COAG.
- Deals with significant treaty negotiations that may have a particular impact on states and territories

Australia (cont'd)

- **Ministerial Councils**
- In contrast to COAG, they are less formal arrangements for ministers to discuss current agreements and working arrangements.
- Some have voting rules with qualified majorities
- Well-developed system of executive federalism
- In each jurisdiction, overall responsibility for IGR lies with the heads of government: the PM of the Commonwealth, the State Premiers and Territory Chief Ministers.
- Each jurisdictional leader has respective agency that manages and oversees IGRs.
- Commonwealth and state governments have separate IG ministries

Australia (cont'd)

- **Fiscal institutions**
- Commonwealth government raises much more revenue than required for own-purpose expenditures
- Extensive sub-system of unconditional transfers
- Commonwealth decisions rely on independent commonwealth grants commission
- IG agreements also used to pursue national policies via “special purpose” (conditional) grants
- Commonwealth government creates framework policy with state governments designing and delivering within framework.
- Coordination of IGR takes place at two levels: between the Australian jurisdictions and within each jurisdiction

- Formal meetings of officials, informal discussion between the commonwealth and the states and territories and between jurisdictions are common and frequent.
- **Conflict resolution**
- No formal legislative mechanism for resolving such conflicts
- Regarding disputes of constitutional matter, the courts are the only formal mechanism for conflict resolution
- Inter-jurisdictional conflicts are dealt with on ad hoc basis bilaterally through correspondences or meetings.
- **Conclusion**
- with homogeneous people, extensive legislative concurrency, and substantial vertical fiscal gap, Australian system heavily centralized and well coordinated.

Germany

- Relatively homogeneous population, 16 Lander
- Federal and land governments: parliamentary with fused executives and legislatures
- Interlocking federalism with most federal laws administered by Lander
- Land governments directly involved in federal law-making through upper chamber (*Bundesrat*)
 - Made up of First Ministers and designated Land cabinet ministers
 - *Bundesrat* possesses veto on federal legislation affecting Lander

- Interlocking features lead to extensive government interaction
 - Extensive system of executive-to-executive IG councils
 - Each government has a ministry to coordinate IGR
 - Constitutional provision for federal government to enact framework legislation with which Lander can enact more detailed laws.
- *Bundesrat* made up of Land representatives, so IG bargaining more complex than Westminster systems
- Germany has the most-developed system of IGR of all federations

- Taxation powers concentrated at federal level, but constitutional provisions on revenue sharing
- Federal institutions emphasize equity and uniformity but at the cost of inflexibility and innovation (joint decision trap)
- **Conclusion**
 - Homogeneous people, extensive concurrency, Land administration of federal law, centralized fiscal system all combine to make decision process highly coordinated
 - Like Switzerland, a consensual model even though power more concentrated

Canada

- Lightly populated, vast area, ten provinces and three territories
- Population relatively heterogeneous with two official language groups, many small aboriginal nations, and an increasingly diversified population
- Although 1867 constitution written to encourage strong central government, in practice quite decentralized
- Westminster system with fused executive and legislature and power concentrated in executive
- Each level of government with legislative authority normally administers its own laws.

Canada (cont'd) Institutions of IGR

- Constitution silent on IGR, but extensive executive – to-executive institutions reflect fusion of power
- Federal provincial, and territorial **(FPT)** First Ministers meet informally, but weak institution in recent years
- New **Council of the Federation** made up of PT First Ministers and intended to strengthen provinces and territories in their relations with federal government
- Extensive system of FPT councils at ministerial, deputy ministerial, and working levels
- All governments have IG ministries to coordinate IG activities
- Decision rules of FPT councils usually unanimity makes national policy-making a challenge
- IG agreements usually not binding, leading to both flexibility and uncertainty

Canada (cont'd)

Fiscal arrangements

- Federal and provincial governments have extensive revenue raising authority and make use of it
- Provinces raise about 85% of own revenue, far more than in Australia
- But some income tax harmonization through FP agreements
- No independent institutions for revising allocation of federal transfers to provinces
- **Conclusion**
- Canada's IGR a mix of competitive and cooperative
- Policy coordination less tight than in Australia
- Larger provinces enjoy substantial autonomy

Switzerland

- Small population, considerable linguistic and religious diversity, 26 cantons
- Constitution specifies Separation of powers (unlike Canada and Australia)
- Many legislative powers assigned to federal government but cantons administer many federal laws, necessitating extensive IGR
- Executive is a collegial body of seven elected by federal legislature
- Upper chamber elected by people on a canton-by-canton basis
- Represents cantonal interests
- Has equal power with lower house
- 1/5 of federal legislators also sit in canton legislatures creates a connection between levels of government

Switzerland (cont'd)

- IGR more dispersed than in Australia and Canada
- Involves relations between executives, administrators, and legislatures in different governments, often in crisscrossing patterns
- Relationships not as highly coordinated as in Australia
- But IG arrangements often legally binding
- 1999 Swiss constitution specifies principles for collaboration between federal and cantonal governments
- Conference of Cantonal Governments often develops agreed positions for negotiations with federal government facilitating coordination.

Switzerland (cont'd)

- Fiscally quite decentralized; IG transfers play relatively small role
- **Conclusion**
- Heterogeneous population, exclusive legislative powers, decentralized finances, and cantons administering much federal law
- Result: decision process emphasizes inclusion, respect for minorities, and consensus
- Process slow: often entails lengthy deliberations, including referenda, but leads to widespread acceptance of decisions once taken.

India

- Densely populated, large, very diverse
- 28 states, 6 union territories, and national capital territory organized largely on ethno-linguistic lines
- Centralized federation in post colonial period becoming less so
- Westminster government with executive and legislature fused at both union and state levels
- Three highly-detailed lists of legislative powers (exclusive federal, exclusive state, concurrent)
- State governments administer much federal law
- Upper chamber elected mainly by state legislatures on weighted basis
- Upper chamber less extensive role in IGR than in Germany

India (cont'd)

- Substantial system of executive federalism with separate government ministries to coordinate Union and state governments IGR
- Greater emphasis on markets in recent period has helped to strengthen state roles
- Constitutionally-mandated interstate council active since 1990; also Zonal Councils and many extra-constitutional IG councils
- Major taxing powers largely Union but constitutional provision for sharing with states
 - Unconditional transfers: States share of centrally collected revenue determined by Union governments usually on advice of independent finance commission
 - Conditional transfers: On advice of planning commission

- **Conclusion**

- Heterogeneous population, legislative power exclusive, state administration of some Union law, and expansion of common market, combine to help make India, once highly centralized, less so
- Independent commissions reinforce this
- Union still has important emergency authority but gradual tilt to allow states more autonomy

South Africa

- Since 1996 a “quasi-federal” state with national, provincial (nine), and local spheres of government recognized constitutionally)
- Heterogeneous population of 44 million with diversity of racial and ethno-linguistic groups
- Provincial boundaries unlike India’s, purposively do not coincide with racial and ethno-linguistic communities
- National (federal) and provincial spheres mainly parliamentary in form with fused legislatures and executives
- Constitution sets out substantial area of concurrent jurisdiction and short list of exclusive provincial powers but division favors national government
- Constitution: governments work out differences through negotiation and consultation

- In upper chamber, National Council of Provinces, provincial representatives:
 - Vote as a block, have a veto on a range of federal legislation, and are chosen by legislatures or executives-mixed nature limits effectiveness
- Provinces depend highly on transfers from national government.
- National government raises 95% of revenue and distributes half to provincial and local government.
- Constitution provides for a Finance and Fiscal Commission that makes recommendations to national government on transfers to provincial and local government on “equitable” share basis
- **Conclusion:**
- Despite heterogeneity, concurrency and centralized fiscal system help support policy coordination
- dominated by national government--- reinforced by dominance of ANC in all three spheres of government.

Concluding observations

- The six federal and quasi-federal cases illustrate that the range of IG institutions varies widely
- In all cases, institutions have emerged in response to practical needs with either limited or no guidance from the constitution
- Constitutional provisions nonetheless influence the kind of IG practices that emerge by virtue of:
 - **Whether or not the legislative and executive powers are fused or separate**
 - **Nature of the upper chamber at the federal level**
 - **Nature and distribution of legislative and administrative powers between orders of government**
 - **Extent of the dependence of regional and local governments on financing from the federal level.**

Concluding observations (cont'd)

- More modern (or recently revised) constitutions give greater recognition to IGR and IG institutions
- The more homogeneous the population, the more centralizing the IG processes (as in Germany and Australia); and vice versa (as in Canada, India increasingly, and Switzerland)
- Exception is heterogeneous South Africa, where ANC is able to counter pressures to decentralize
- In all cases, extensive network of IG council and committees interacts on continuing and frequent basis
- Growth of IG institutions paralleled by growth of ministries to manage IGR

- Unique institutional developments in each federation facilitate IGR, but generality similar in all cases, especially among systems with fused executives and legislatures
- On IG fiscal relations:
- Constitutional provisions in Germany facilitate long-term government planning
- Role of independent commissions in Australia, India and South Africa appear to facilitate policy goals while helping to mitigate potential fiscal stresses in IGR
- With growth of joint or integrated programming, increase in ambiguity regarding accountability
- Legislative oversight of IGR has tended not to keep pace with the growth of IGR and related institutional developments, especially where executive and legislative functions are fused.