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Fiscal Decentralization and Subnational Revenue: Experience of the Emerging Region of Ethiopia

Tadewos Mentta (Corresponding Author)
Ethiopian Civil Service University

Professor D.K. Mishra
Ethiopian Civil Service University

Melesse Asfaw, Ph.D., PMP
Ethiopian Civil Service University

Abstract
This study focuses on the subnational governments' revenues, their productivity and contribution to the total budget of the region. In Ethiopia, the regions get significant amount of revenue from the central government's block grant and their revenue sources generate very small amount of revenues and their tax bases are also very narrow. The study describes the revenue contribution of tax and non-tax bases separately and their trends throughout the periods. Moreover, it distinguishes specific revenue sources and their productivity, consistency of revenues from specific sources to finance local needs, and challenges in administration of their own revenue sources.
Keywords: Fiscal federalism, block grant, tax revenues, non-tax revenues, government budget.

I. Introduction

Ethiopia differs from other African countries in history in that it has never been under colonial power, which has happened in Africa and the rest of the world. It was the only African country to defeat the colonial power of a European country (Berhanu, 2008), and the first independent member of African League of Nations as well as the United Nations. Ethiopia is the second most heavily populated country in Africa with a population of more than eighty million.

Ethiopia has passed through various government structures and political ideologies, which left multiple scars on its political and economic conditions to date. Governments of Ethiopia, prior to 1991, were characterized by highly centralized ideology aimed at achieving national growth taking subnational development as a national project (Tegegne, 2000). The centralized ideology perceived that government's investments, which were considered promising from the view point of the national perspective, were thought to bring changes such as industrialization, water resources development, rapid growth and development and exports of agricultural products, which were not ultimately achieved in many instances and due to various factors (ibid).

After the downfall of the emperor regime, Ethiopia adopted the socialist ideology aiming to curtail the inequalities of the development process by the middle of 1970. This ideology hijacked the revolution against the previous monarchical regime and took advantage to come to the power. The main aim of this ideology was to nurture equitable distribution of benefits and ensure socio-economic development in the country (Tadesse, 1985, Tegegne, 2000). However, these policy directions were aimed to be achieved through a centralized ideology, which in practice didn't consider the diverse preferences of localities that could have been addressed through devolution of functions and powers at various tiers of government. Among other things, this system might have collapsed because of the central command that didn't represent the preferences of localities.

A decentralized system has been put into practice after the current government has taken power. As said earlier, prior to 1991, the governments of Ethiopia were known in highly centralized, top-down structure of political, economic, administrative, and fiscal responsibilities. The transition from the centralized structure to the decentralized one started in the early 1990s and all the decentralized system of governance was ratified in the constitution of the country in 1995. The centralized structure, inherited from the preceding government, had to be revolutionized and transformed to a structure that fits a new system at the earlier stages of the current government. To shift from the one centralized edge to the other opposite edge, it had to start from the scratch and bring an end to the central dictate over local decisions. This pushed the responsibilities from the hands of the center to the subnational and then local tiers of government (Bulti, 1994). The new government started macroeconomic and structural reforms and transformed the command economy into a market-oriented economy (African Development Fund and African Development Bank, 2009).

A shift from centralized system to decentralized governance has resulted in the constitutional right of subnational governments to share powers and responsibilities. The current practice at subnational governments tells us that subnational governments are exercising their powers in their territories. This manifests in regional budgeting, revenue raising capacity of emerging region from own sources and subnational dependence on central government transfers.

II. Theories of Fiscal Federalism

Fiscal federalism is known in distribution of government responsibilities and decision-making powers to the lower level governments. Unlike the centralized model of government structure, it is a way of addressing diverse needs of various groups of people through sharing responsibilities with subnational and local governments. From legal perspective, federalism can be seen from two indispensable elements: autonomy and coordination (Sacchetto, 2008, cited in Bizioli and Sacchetto, 2011). Autonomy can be considered from the perspective of having the power of decision-making responsibilities as an independent body. It exists when subnational governments exercise their political power and make decisions on their affairs (Kraan, 1996, p.28) and tax structures of their entities. Coordination, on the other hand, is related to a linkage between the direction of the center and peripherals. The Federalist Papers (New York, 1788, cited in Bizioli and Sacchetto, 2011) states that "*federalist theory was not born to divide but to merge what before was divided*."

Sacchetto (2008) quotes the common elements of all states and common denominators and institutions present in all federal states identified by the famous author G. De. Vergottini (1990) and these are considered as the general principles. The first principle is known as an autonomy, which is related with the proper competences among states, and the second principle is associated with the existence of enforcement of the central body's competence in accomplishing various functions existing in all the territories of subnational governments, i.e., principle of overlapping. The third principle is related to the active participation of states/subnational governments in achieving the political will of the government.

Although different countries have various experiences of decentralization (Ter-Minassian,1997, Petrei, 1998), it is very difficult to draw the best out of these experiences because of the fact that it depends on the political, economic, social and implementation capacities of public institutions of a given country (Abrar Suleiman, 1994).

The decentralization concept has become a controversial ideology especially in least developed countries because of the market system and existence of inefficiencies at lower tiers of government. Thus, instead of full decentralization of political, economic, and fiscal functions, the intervention of the center is accepted as a controlling tool for minimizing inefficiencies and addressing the national problems (ibid).

Federalism and Taxation

The idea of federalism is seen from taxing power of subnational governments from at least three perspectives:

1. Taxing power attributed to only subnational governments;
2. Management and assessment of taxes at subnational levels (which shows the relationship between taxpayers and the active party of tax obligation); and
3. The destination of the revenue of taxation (i.e., revenue destination – to states and local entities) (Sacchetto, 2008).

Local governments can shift costs of production to non-residents through the central government transfer funding their expenditures, and this shifting is considered as inefficiency from economic point of view. In order to control this inefficiency, the federal subsidy or grant has to be equal to zero and the local tax must be responsible for all marginal costs of their services to the residents (Rodden, Eskeland, and Litvack, 2003, p. 37). If governments at subnational tiers are not allowed to raise at least some amount of revenue from their own sources, they have little incentive to provide public services in an efficient and effective ways (Watts and Chattopadhyay, 2008). In practice, however, this is very difficult to implement as the central government plays significant roles in narrowing the gap between economic operators through redistribution of economic resources.

Hollerstein, the professor of University of Georgia School of Law, states that in United States of America, although there are no explicit constitutional restraints that limit the spending power of states, the constitutions of states limit expenditures to public purposes (cited in Biziolli and Sacchetto, 2011, p. 35). This clearly indicates the importance of limiting public expenditures for public purposes and the role of legal framework that oversees public spending against public purpose.

Government Budget and Expenditure

A budget that doesn't include the bulk of revenues and expenditures cannot reflect the choices of society as it is impossible to compare programs and no assurance that scarce resources would be allocated to the local preferences (Shah, 2007).

Fiscal decentralization transfers revenue and expenditure responsibilities by allowing subnational governments taking forms such as self-financing or cost recovery through user charges, co-financing with private sectors through public-private-partnership, generating revenues from tax and non-tax sources, or financing expenditures by local borrowing (Schiavo-Campo and Sundaram, 2001).

The past two decades have shown that citizens would be empowered to hold their governments accountable for the performance of their services (Shah, 2007). In principle, voters use election to hold their government accountable for their past achievement (Persson & Tabellini, 2000, cited in Shah, 2007). Meaning, where the government has unsatisfactory performance, the voters penalize their existing government and vote for competing candidates. In order to achieve this benefit, there should be fierce competition, which limits rent creating strict accountability.

Budget transparency is an essential requirement in political accountability as it enables politicians to understand fiscal plans of the government. In government operations, comparing the actual performance against predetermined plans would enable decision makers to locate variances and deficiencies of operation and hence take corrective measures (Shah, 2007).

There should be principles governing responsibilities of the central and subnational governments. These principles should govern:

- Clearly set responsibilities for each level of government,
- Arrangement of stable and predictable revenue sharing,
- Provision of incentives for efficiencies of local governments,
- Accounting and budgeting rules of subnational governments and their uniformity (Schiavo-Campo and Sundaram, 2001).

If these principles are not respected in fiscal relations, upheavals will occur in government expenditures, and the entire system will collapse as a result of weak assignment of responsibilities, problems resulting from revenue sources and productivities, and weak control over government budget and expenditure. Moreover, the absence of incentives for local efficiencies will discourage local commitment. A uniform accounting and budgeting system would help government to take measures on variances and hence achieve stated objectives as much as possible.

Schiavo-Campo and Sundaram (2001) state that strategic allocation of expenditure and control would be achieved through:

- Making fiscal targets cover the general government,
- Making revenue assignment consistent with expenditure assignment, and allocating sufficient revenues to subnational governments to finance their expenditures,
- Prohibiting subnational governments from dumping the fiscal deficit,
- Setting special mechanisms to control expenditures of subnational governments' borrowings,
- Sanctions over budget arrears or overruns and taking measures,
- Ensuring sound reporting and accounting systems, and
- Making analysis of policy consolidating expenditures of various levels of government.

According to Allen and Tommasi (2001), the three objectives that have to be achieved in the budget system are:

- To maintain the aggregate fiscal discipline relating to the effective control over the budget total controlling the budget ceiling and individual spending;
- To allocate resources in accordance with public priorities to ensure the allocative efficiencies[1];
- To promote the efficient delivery of service in ensuring technical and operational efficiencies at the lowest cost.

These three objectives are interdependent[2] and if one of them is violated, the budget objective will not be achieved.

Should subnational governments be allowed to finance their deficit through borrowing? This question needs detailed discussions and scholars have different stands on this. Different countries have various experiences in deficit financing and central subnational fiscal relations. For example, in Argentina, provinces may contract debt both internally and externally whereas the Central Bank oversees the impact on the financial system. On the other hand, in Brazil, the Federal Senate limits the maximum amount of borrowings to be made at states, federal district, and municipalities. In Canada, there is no restriction of debt and market regulates the financial system. On the contrary, in Mexico, states are not allowed to contract loans or obligations directly or indirectly that may be repaid in foreign currency. States and municipalities are allowed to borrow money only for productive capital investments of the public. Furthermore, in Venezuela, subnational governments and municipalities may not contract debts without the approval of the central government (Ter-Minassian,1997, pp. 158-162; Schiavo-Campo and Sundaram, 2001; Petrei, 1998).

Ter-Minassian((1997) discusses that increase of debt financing in relation to GDP is an inappropriate design of fiscal relations in the country in which large vertical (fiscal gap) or horizontal imbalance (fiscal inequity) is prevalent, or in a system of intergovernmental transfer in which transparent and conducive criteria

[1] Schiavo-Campo and Sundaram (2001) state that allocative efficiency can be ensured if expenditure decisions are made at responsible lower levels of government.

[2] The three objectives are interdependent. Allen and Tommasi (2001) state that without fiscal discipline, it is impossible to achieve government priorities and without fiscal control it is not possible to ensure the allocative efficiency.

are not available (p. 156).

Watts and Chattopadhyay (2008) state that there should be principles that guide governments at different tiers in their expenditure responsibilities. Some of the principles are as follows:

i. *Efficient provision*: Services would be more efficient if costs and benefits of small geographic areas are internalized.
ii. *Correcting fiscal inefficiency*: Differential net fiscal benefits[1] have to be corrected by the central government (i.e., fiscal inefficiency existing at subnational governments).
iii. *Dealing with regional (horizontal) inequity*: When identical incomes are not equally treated as a result of residential differences, the central government has to deal with fiscal inequities.
iv. *Redistributive role*: Vertical inequity is dominantly addressed by the central government although subnational governments are required to involve in implementing specific programs in their territories.
v. *Provision of quasi-private goods*: Subnational governments have to provide quasi-private goods (education, health services, etc.) if justified on the ground of equity.
vi. *Spending power*: There should be a distinguished power of spending at both governments (central and subnational governments).

Intergovernmental Transfer

Canada is the most decentralized country in the world with no restraints of tax rates and collections and no requirement of harmony of the system horizontally with other provinces or vertically with the federal government. Furthermore, it doesn't require the approval or control of the central government to borrow money (Rodden, Eskeland, and Litvack, 2003, p. 86). This experience shows that Canada is the most decentralized country and its redistributive role is significantly minimized due to high independence of subnational governments in their tax and related decisions. Furthermore, subnational governments' adequate capacity of financing their expenditure needs allowed them to take substantial responsibilities of their localities. However, this cannot happen in countries in which high economic disparities exist and capacity of subnational governments to generate adequate revenues from their own sources is weak. The Canadian experience would demand tax bases that would generate adequate revenue to their local needs and capacities of economic operators to manage revenues and expenditures of their territories.

In the Czech Republic, before 1992, municipal budgets were primarily dependent on the state's transfer, and the entire capital budgets (investments) were financed by the grants of the central government (subsidies of the center). Later, in 1993, the government introduced a system of a new tax and municipal financing, which allow municipalities to generate own revenues from shared sources and local taxes. This resulted in greater capacity of municipalities in financial and fiscal autonomy. However, this newly introduced policy resulted in budget deficits and forced municipalities to finance their expenditure requirements by debt from commercial and state sources (pp. 54 -59).

Government of Czech Republic controls local governments using tax sharing as an instrument and transfers are used as an automatic mechanism to correct fiscal disparities. In order to decrease the dependence of the municipalities on the central government transfer, tax bases which are desirable and flexible to generate high income for their expenditure needs were assigned. These tax sources adjust themselves when there is economic upturn or downturn creating automatic stabilization (p. 64).

Fiscal decentralization, however, has to consider the country's context including political, economic, social and policy directions. In financing their expenditures, some countries allow subnational government to borrow funds for their deficit (e.g. Australia) and some other countries do not allow their subnational governments to finance their deficit through borrowing (e.g. Chinese government disallowed its subnational governments from issuance of bonds or borrowing from banks and they are required to run a balanced budget, or use the accumulated budgetary surpluses or extra-budgetary funds[2] to finance their deficit) (Schiavo-Campo and Sundaram, 2001). In ethnically diverse countries like Ethiopia, South Africa, Nigeria, etc., the ethnic pressures and conflicts would push the central government to take the responsibility of redistribution to finance inequalities existing among subnational governments. Bakke and Wibbels (2006) argue that fiscal decentralization in high inter-regional inequality facilitates central redistribution of resources to mediate the impact of regional inequities.

In decentralization of revenue sources (especially taxes), it is good to think of which taxes are assigned

[1] Imputed benefits from public services minus tax burden (Watts and Chattopadhyay, 2008).

[2] Extra-budgetary funds are created where government wants to protect priorities from budget cut, to avoid problems in budget implementation, to use in the cases of powerful political lobbies, etc. However, the extra-budgetary funds sometimes may be related to the desire to hide transactions from scrutiny by some legislators such as parliaments or the public (Allen and Tommasi (2001).

to which government, and in sharing revenue and hence expenditure responsibilities. It is common that mobile tax bases are assigned to the central government and immovable taxes are assigned to subnational and local governments. It is because of the fact that mobile tax bases are characterized by creating economic distortions by changing tax rates if assigned to the subnational and local governments. Instead it is good to assign tax bases that are immovable in nature and stable in generating revenues for their own expenditures (Schiavo-Campo and Sundaram, 2001).

In fiscal relation, it is good to know the characteristics of tax bases and their impact on economy and revenue on subnational financing. This revenue sharing remedy would correct vertical imbalances existing across the hierarchy of the government. On the other hand, government corrects the horizontal imbalances through conditioned or unconditioned intergovernmental fiscal transfers (Schiavo-Campo and Sundaram, 2001). Empirical studies indicate that intergovernmental fiscal transfers have impact on local government fiscal policies, including the flypaper effect[1] (Dollery and Worthington, 1998). The discussion on flypaper effect states that grants are one of the potential sources of fiscal illusion.

III. The Experience of Subnational Government of Ethiopia Federalism and State-Center Relations

In Ethiopia, fiscal decentralization is aimed at ensuring fiscal equalization objective and considers capacities and revenue sources available to the regional governments. This is shown from the yearly budget allocation in the form of block grant to subnational governments in relation to their share of revenue from their own sources.

The Federal Government of Ethiopia is empowered to protect and defend the constitution of the country and formulate and implement the country's policies, strategies and plans of economic, social, and developmental matters taking all these as a role of the center. The constitution of the country's Article 51clearly delineates the functions of the federal government on economic, social, and developmental matters and its power to set the national standards and basic policy criteria for economic activities such as public health, education, science and technology, and protection and preservation of cultural and historical legacies.

In addition to the above functions, the federal government is empowered to perform tasks such as devising policies and strategies in relation to financial (including printing of money by the National Bank of Ethiopia), monetary, and foreign investment.

Furthermore, the constitution continues to explore functions of the regional governments stating that powers not given to the federal government alone, or powers not concurrently enjoyed by both the federal government and the regional governments are considered to be the power of the regional governments. The powers given to the regional governments are proclaiming state constitution and other laws, formulating social, economic, and developmental policies and plans of the state, administering land and other natural resources within their territory in accordance with federal laws, levying and collecting taxes and duties to raise revenues from their own sources (see Article 97), and enacting and enforcing laws on civil services of their territory.

The Ethiopian Constitution clearly indicates the Federal and Regional Governments' taxing powers and responsibilities, and tax bases that are assigned to both governments (Article 96 and 97 of the Constitution). Although there are some tax bases concurrently assigned to both governments, the implementation and administration of these tax bases have become tedious and revenues from these sources have become unpredictable.

Afar Regional State, as an emerging region, gets a considerable block grant from the federal government to finance its expenditure needs. As other regions do, the share of block grant on Afar Regional State's annual revenue is very substantial, which indicates that it depends heavily on the central government transfer to finance its larger share of expenditures. The following table shows the share of the central block grant on the total subnational revenue of the region.

Table 1: Share of Block Grant on Total Actual Revenues of Afar Regional State

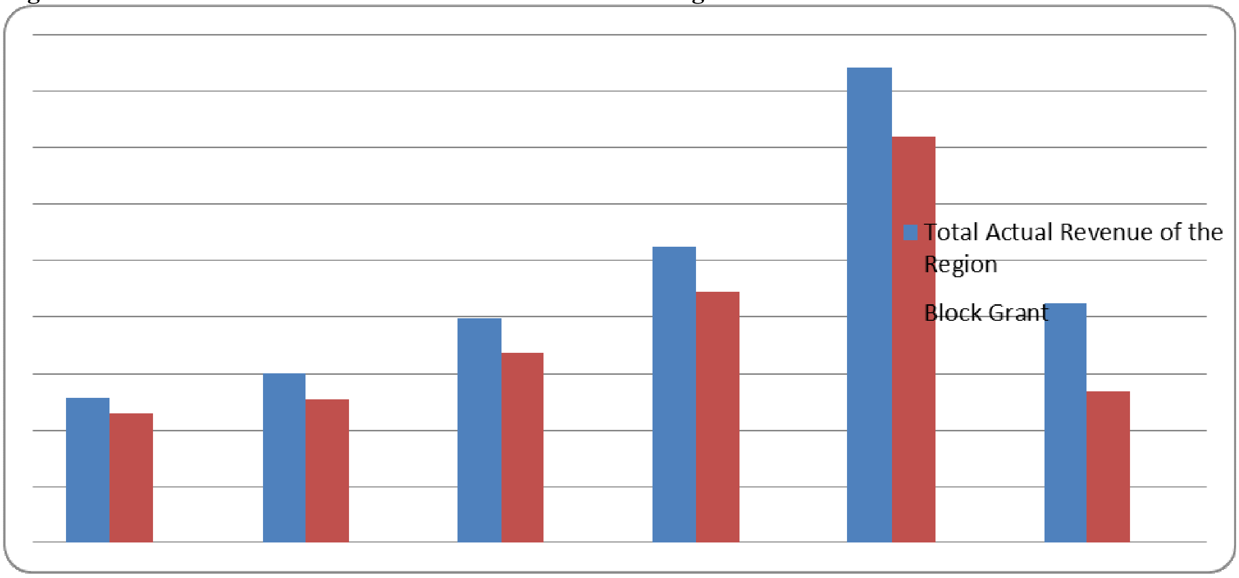
Year	Total Actual Revenue of the Region	Block Grant	Share of Block Grant on Total Revenue
2007/08	514,004,493.83	460,734,725.34	89.64%
2008/09	601,852,269.86	509,928,553.00	84.73%
2009/10	796,817,413.68	675,509,287.54	84.77%
2010/11	1,048,192,835.49	891,795,235.30	85.08%
2011/12	1,684,232,295.48	1,438,067,270.51	85.38%
2012/13	850,964,981.05	535,372,003.10	62.91%

Source: Compiled from the Financial Report of the Region, 2014

[1] According to Drollery and Worthington (1995), the flypaper effect occurs when the lump-sum grants increase public expenditure by more than an equivalent increase in income from other sources.

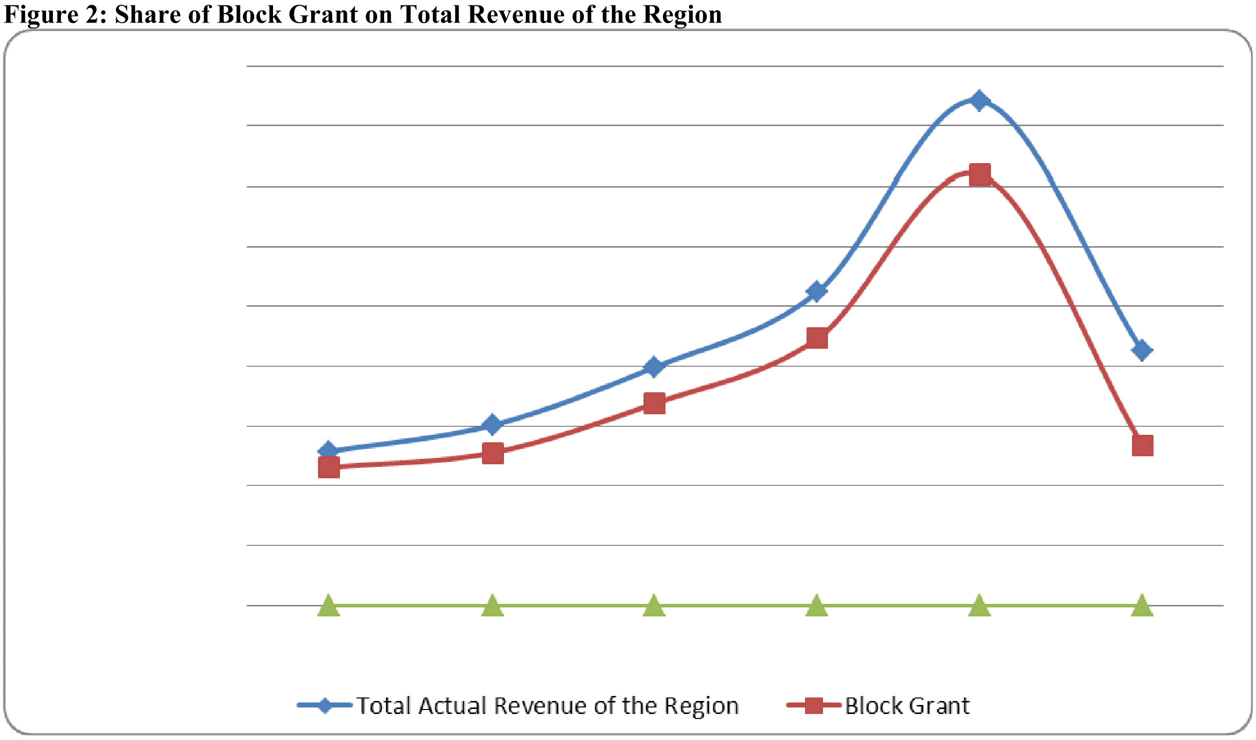
The above table indicates that more than 85 percent of the subnational government's budget was financed by the central government transfers. In 2012/13 budget year, however, it has shown decrease on total budget of the region.
The following graph indicates the trends of share of block grants on total revenue of the region.

Figure 1: Share of Block Grant on Total Revenue of Afar Regional State



Source: Compiled from the Financial Report of the Region, 2014

Figure 2: Share of Block Grant on Total Revenue of the Region



Source: Compiled from the Financial Report of the Region, 2014

The above graph shows the increasing trends of revenue up to 2011/12 budget year and later it has shown a significant decrease in both total revenue and block grant (in 2012/13). One can understand from this graph that the change in block grant significantly affects its entire budget and hence expenditures of the region. The financial information shows that in 2012/13 budget year, the central government entirely avoided the recurrent budget of the region although the region has planned a recurrent budget of about Birr 548,294,550.
When Afar Regional State's share of block grant on total annual budget is compared with that of the Southern

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Nations, Nationalities, and People's Regional State in the same periods, the former gets more disclosed share of block grant, which exceeds 85% of its annual total revenue on average (except for the special case of a budget year 2012/13) (see Table 1 and Table 2).

Table 2: Share of Block Grant on Total Revenue of Southern Nations, Nationalities and People's Regional State Budget

Year	Total Revenue of the Region	Block Grant	Tax Revenue from Own sources	Non-Tax Revenue	Other Revenues	Share of Block Grant %	Tax Revenue Share %	Non-Tax Revenue share %	Rev. from Other Sources %	Total %
2006/07	2,222,339.38	1,875,021.07	278,212.5131	60,515.8418	8,589.96	84.37	12.51	2.72	0.4	100
2007/08	3,170,979.05	2,672,454.359	406,223.8126	91,940.4421	360.44	84.27	12.81	2.89	0.01	100
2008/09	3,997,736.21	3,341,735.188	523,650.6828	131,676.7592	673.58	83.59	13.09	3.29	0.02	100
2009/10	4,872,331.10	3,989,448.488	627,107.4211	169,666.2122	86,108.12	81.88	12.87	3.48	1.77	100
2010/11	6,521,923.92	5,166,313.004	924,034.9774	245,218.0513	186,357.89	79.21	14.16	3.75	2.86	100
2011/12	10,390,476.33	8,412,958.663	1,407,386.063	326,710.4691	243,421.13	80.96	13.54	3.14	2.34	100
2012/13	13,566,054.98	10,677,192.78	2,196,402.121	406,497.0622	285,963.02	78.70	16.19	2.99	2.11	100

Source: Financial Report of the Southern, Nations, Nationalities, and People's Regional State

When the financial report of Afar Regional State is critically observed, however, there is an indication that revenue is observed in later years from miscellaneous sources, for which the revenue sources are not clearly specified. Moreover, the central government provides specific grants for regional states, which are not clearly indicated in financial information of the region. Thus, although the known share of block grant is very considerable in a regional budget, it also would have shown significant increase had the specific grant been tracked and included in financial report. It is apparent that emerging regions get the larger share of specific grants from the federal government when compared to other regions.

During 2012/13 budget year, the share of block grant on subnational total revenue was about 63 percent, which is the lowest share of the region in the stated periods whereas in this budget year the share of miscellaneous revenue of the region was about 5.5 percent of the total annual budget, which is very significant when compared to miscellaneous expenditures of other periods.

Table 3: Share of Miscellaneous Revenue on Total Actual Revenue of Afar Regional State

Year	Total Actual Revenue of the Region	Total actual Miscellaneous Revenue of the Region	Share on Total Revenue of the Region (%)
2007/08	514,004,493.83	1,498,832.23	0.29
2008/29	601,852,269.86	1,757,456.53	0.29
2009/10	796,817,413.68	6,186,049.04	0.78
2010/11	1,048,192,835.49	17,101,042.20	1.63
2011/12	1,684,232,295.48	14,736,152.85	0.88
2012/13	850,964,981.05	46,512,456.05	5.47

Source: Financial Report of Afar Regional State, 2014

When specific tax bases of the region are seen separately, the main source of the region's revenue highly depends on direct taxes. The following table shows the share of tax revenue of Afar Regional State.

Table 4: Share of Various Tax Bases on the Regional Government Tax Revenue

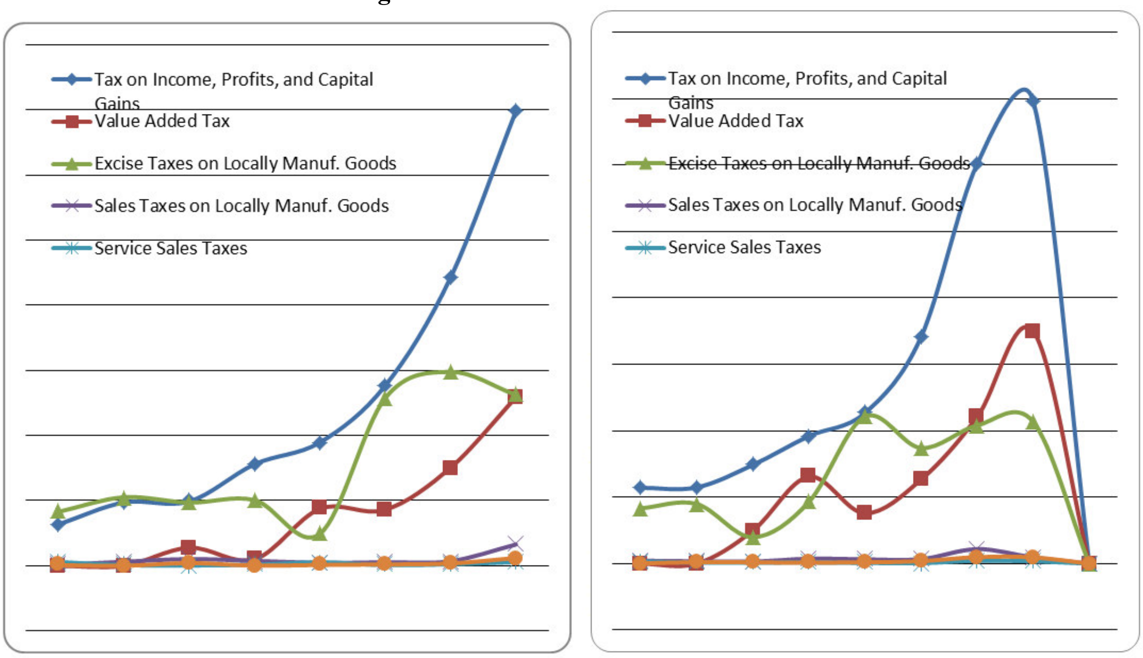
Year	Tax on Income, Profits and Capital Gains		Value Added Tax		Excise Taxes on Locally Manuf. Goods		Sales Taxes on Locally Manuf. Goods		Service Sales Taxes		Stamp Sales and Duties	
	Approved Budget	Actual Collection	Approved Budget	Actual Collection	Approved Budget	Actual Collection	Approved Budget	Actual Collection	Approved Budget	Actual Collection	Approved Budget	Actual Collection
2005/06	41.09	55.65	-	-	53.49	40.53	0.90	2.07	3.87	1.61	0.66	0.14
2006/07	46.34	54.17	-	-	50.20	42.45	3.00	1.65	0.43	0.70	0.04	1.04
2007/08	41.38	60.89	11.65	20.21	40.64	16.28	4.32	1.22	0.22	0.58	1.78	0.82
2008/09	56.47	45.07	3.62	30.72	36.50	21.77	2.74	1.73	0.57	0.43	0.10	0.29
2009/10	56.21	42.51	25.95	14.19	14.55	41.51	1.31	1.20	1.59	0.21	0.39	0.38
2010/11	44.00	52.25	13.68	19.37	40.96	26.68	0.87	1.02	0.16	0.12	0.34	0.55
2011/12	48.96	56.42	16.67	20.68	32.95	19.52	0.78	2.05	0.25	0.40	0.40	0.93
2012/13	54.96	54.33	20.36	27.29	20.68	16.65	2.58	0.73	0.46	0.27	0.95	0.73

As can be seen from the above table, the main source of revenue of the region is basically generated from direct taxes. Direct taxes are easy to collect from taxpayers and have low cost of administration. Actually collected revenue from these sources accounts for 52.66 percent on average during eight budget years. Moreover, 48.68 percent of the approved plan of revenue was from these direct taxes.

Similarly, excise taxes on locally manufactured goods take the next largest share of the total tax revenues of the region although excise tax on salt gets the total credit of this revenue.

When financial information is critically evaluated, actually collected revenue exceeds the approved plan of the regional state (except for 2008/09 budget year, in which actually collected amount is less than the approved plan). It seems that subnational government either couldn't estimate the revenue to be generated from tax and non-tax sources properly, or it has intentionally reduced it to obtain higher share of block grant from the center. In other words, the higher collection of actual revenue over the approved plan doesn't necessarily tell us that the region had fully invested its capacity in raising revenue from these sources. Underestimation of revenue and over estimation of expenditures are one of the challenges existing at lower levels of government.

Figure 3: Actual Vs Planned Tax Revenue



Source: Compiled from financial information of Afar Regional State

The trend indicates that direct tax shows a uniform increase through periods in both planning and actual collection of revenue. It also shows us that the contribution of other taxes is lower than direct taxes.

As said above, the main tax bases of the region that have a larger contribution to the total tax revenues are direct taxes. These tax bases are basically wages and salaries, profits from corporations and rental income, which are easy to collect and administer.

In 2005/06 budget year, the region was not even estimating the amount of revenues from direct sources such as profits to corporation, capital gains, agricultural income, royalties, interest income and tax on "Chat". Starting from 2006/07, the region has started to collect revenues from these sources although their contribution to the total tax revenue is the lowest. In this direct tax component, the larger share is taken by taxes on wages and salaries, which are stable sources of revenue to the region.

On the other hand, revenues from other bases such as excise taxes on locally manufactured goods (e.g. salt and petroleum and its products) also produce a significant share of tax revenues of the region. The region is known in salt production in Ethiopia and this mineral has become the main source of the region's excise tax on locally manufactured goods. Other tax bases such as taxes on mineral water, leather, and plastic goods, are almost close to zero. Later, from 2007/08 onwards, the region started to plan for collection of revenues from these and some more sources such as leather products and soft drinks.

Similarly, sales taxes on locally manufactured goods are not productive sources of revenue for the region. Sources of these revenues are salt, food, soft drinks, alcohol and alcoholic products, cotton and its products, leather and its products and farm products although the share of this revenue can be seen from Table 4. This table indicates that in all eight budget years the contribution of tax bases such as sales tax on locally manufactured goods[1], service sales taxes[2], and stamp duties[3] account for 1.46 percent, 0.54 percent, and 0.61 percent respectively on total tax revenue of the region.

Non-Tax Revenues

Afar Regional State collects some amount of non-tax revenues such as administrative fees and charges, sales of public goods and services, government investment income, and miscellaneous revenues. Moreover, administrative fees and charges include work permits, court fines and fees, forfeits, business and professional registration and license fees, and other fees and charges. Sales of public goods and service also includes sales revenue from sale of pubic newspapers and publications, advertising revenues, health service fees, sale of medicines and medical supplies, etc. Similarly, government investment income includes rural land use fees, interest income on loan to government employees, and capital charges.

When the above non-tax revenue bases are seen from the perspective of contribution to the regional financing, their share is very low and the sources are relatively not buoyant. The following table shows the share of revenue from tax and non-tax sources.

Table 5: Tax and Non-Tax Revenues of the Region

Year	Total Revenue		Total Tax Revenue		Total Non-Tax Revenue	
	Approved Revenue	Actual Revenue	Approved Revenue	Actual Revenue	Approved Revenue	Actual Revenue
2005/06	35,002,256.00	47,341,737.91	30,972,266.00	41,048,212.07	4,029,990.00	6,293,525.84
2006/07	45,000,000.00	46,414,505.46	41,962,500.00	42,323,107.86	3,037,500.00	4,091,397.60
2007/08	501,103,000.00	514,004,493.83	47,757,561.15	48,748,249.80	3,242,438.85	4,417,482.93
2008/09	609,478,446.00	601,852,269.86	55,250,366.97	85,150,303.01	5,676,354.03	6,601,554.15
2009/10	765,509,287.69	796,817,413.68	67,444,863.92	106,632,976.53	22,554,769.94	14,516,882.07
2010/11	1,011,725,976.00	1,048,192,835.49	125,747,226.46	130,446,767.53	14,252,773.54	25,434,801.08
2011/12	1,746,410,000.00	1,684,232,295.48	180,785,865.00	213,227,841.98	19,214,135.00	31,650,449.35
2012/13	1,960,260,000.00	850,964,981.05	254,001,973.13	256,382,884.91	36,952,626.87	54,581,472.67

[1] The highest share of actual revenue of sales tax on locally manufactured goods accounts for 2.07 percent of the total actual tax revenues and the lowest share accounts for 0.73 percent of the total tax revenues (2005/06 – 2012/13 budget years).

[2] The highest share of actual revenue of service sales tax on locally manufactured goods accounts for 1.61 percent (see 2006/07 budget year) and the lowest share accounts for 0.21 percent of the total tax revenues (see 2005/06 budget year).

[3] The highest share of the actual stamp duties is 1.04 percent of the total tax revenues (see 2006/07 budget year), whereas the lowest share accounts for 0.14 percent of the total tax revenues of the region (See 2006/07 budget year).

Table 6: Share of Actual Tax and Non-Tax Revenues on Total Actual Revenue of the Region

Year	Total Revenue (%)	Share of Total Tax Revenue on Total Revenue (%)	Share of Total Non-Tax Revenue on Total Revenue (%)
2005/06	100	86.71*	13.29*
2006/07	100	91.19*	8.81*
2007/08	10.34	9.48	0.86
2008/09	15.22	14.15	1.07
2009/10	15.20	13.38	1.82
2010/11	14.87	12.44	2.43
2011/12	14.54	12.66	1.88
2012/13	36.54	30.13**	6.41

*Block grants are not reported on the balance sheet. Thus, these values are calculated ignoring the block grant.
** During 2012/13 budget year, the block grant excluded recurrent revenues.

The above tables clearly indicate that the share of non-tax revenue on total tax is below 3 percent during 2007/08 -2011/12 budget years. In 2005/06 and 2006/07 budget years, block grant was not disclosed on the financial statement so that the values stated above cannot be compared with the share of other budget years. Similarly, in 2012/13, the recurrent block grant was zero so that the decrease in the total budget increased the share of total tax revenue significantly. During this period large amount of revenue was collected from non-tax bases.

Policy Implications

Governments at federal and national levels should have sufficient revenue to finance their expenditure needs. Regional revenue has to finance regional expenditure needs and thus it has to be generated from own sources sufficiently in addition to grants obtained from the center. The Ethiopian experiences indicate that the share of block grants covers more than 80 percent of their revenue needs.

There are arguments that subnational governments should get more revenue sources (tax bases) to raise and finance their expenditure needs and the central government revenue should be less in order to avoid the fiscal illusion. On the other hand, the central government's role is to ensure the redistributive justice narrowing the gap between the rich and the poor. Thus, government has to critically see revenue sources which would generate more revenues to subnational governments and help them finance their expenditure needs to the expected level.

It is also clearly observed that the horizontal imbalance is very significant among regional states in Ethiopia, and the central government should play pivotal role for the smooth operation of fiscal equalization and subnational decisions. The government should reconsider and revise the revenue sources that are convenient if managed by the subnational governments or the federal government to help subnational governments raise revenues as capacity allows and avoid unnecessary dependence, overestimation of expenditures and underestimation of revenues.

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