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## A Review of Fiscal Decentralization Practices in Ethiopia

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### Abstract

Ethiopia attempted to introduce federalism in general, and fiscal decentralization in particular back as far as the transition period (1991-994). Later, a clearer federal system was established with the adoption of the 1995 Constitution of the Federal Democratic Republic of Ethiopia. The constitution shared political power between federal and regional governments. Accordingly, the federated units exercised this constitutional right. The main objective of this study was to assess the practices and problems of fiscal decentralization in Ethiopia. The study employed a review of relevant empirical studies, discussion with experts and the researcher's own observation. In Ethiopia, the practices of fiscal decentralization show that there is high vertical fiscal imbalance and regional disparities, problem of effectiveness and efficiency in resource utilization, problems of administrative malpractice and tight political influence mainly at local levels, and problems of spillover effect. The current study suggests that: civil service institutions should be divorced from party politics to allow a build-up of professional, committed and honest civil servants to serve the interest of the general public; assigning appropriate revenue sources for regional units so that subnational units could provide adequate public service to the local people; promoting transparency, and encouraging wider participation of the general public and civil society institutions so that they can play constructive roles.

**Keywords:** fiscal federalism, fiscal decentralization practices.



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## Introduction

Federalism is a form of state structure by which political power is constitutionally shared between the federal government and respected regional units. There are different political, economic and social factors that necessitated federalism. The political factor is justified by the aim to promote collective security, to protect individuals' liberty and to promote regional and local interests. The economic factor that necessitated federalism is a belief in its optimization of resource utilization. Additionally, the social factors are mainly to promote freedom of cultures, and to preserve history (Endawke, 2009).

The federal system involves at least two tiers of government (federal [central and regional], and state government) and a written constitution that defines the different powers and functions of the central and regional governments, and their interstate relations.

Fiscal federalism is one aspect of federalism that involves fiscal decision-making power among the different tiers of government (Moges, 2005). It refers to the allocation of expenditure responsibilities, allocation of revenue raising power, the fiscal imbalance between the tiers of government and intergovernmental financial transfer (Moges, 2005). It is also concerned with the allocation of government resources and spending to the various tiers of government (Ewetan, 2012). It requires each tier of government to balance resources in the undertaking of their activities (Wheare, 1963, as cited in Ewetan, 2012).

Fiscal decentralization exists when subnational governments have the power to raise taxes and undertake spending activities provided by the constitution (Tanzi, 1996). According to Prud'homme, fiscal decentralization "not only transfers power from central to local governments, but also from central to local bureaucracies. And central government bureaucracies are likely to attract more qualified people...because they offer better careers...more possibilities of promotion (and better salaries)" (1994, p. 9, as cited in Tanzi, 1996).

The objective of this paper is to discuss fiscal decentralization practices and problems in Ethiopia. This study is produced, basing empirical evidences discussed by several scholars, the researcher's own observations and discussion with subject matter experts. This study is organized in four parts: the subsequent part discusses the advantages and disadvantages of fiscal federalism. Then, part three discusses fiscal federalism practices in Ethiopia: benefits and problems, and part four presents the concluding remarks of the study.

### *Fiscal Decentralization: Advantages and Disadvantages*

Fiscal federalism as a response to improve the performance of the public sector has its own advantages and disadvantages.

#### *Advantages of Fiscal Decentralization*

Fiscal federalism has political, economic and social advantages that enables democratic institutions and enhances the quality, quantity and provides different public service activities that reflect the priorities of local populations. Accordingly, it enables the addressing of people's most urgent needs. The following discussions are the seen as the major benefits of fiscal federalism:

*Optimum utilization of resources and development growth* – this means that it is the federal constitution that assigns federal and state governments to determine their own revenues and to spend them (Endawke, 2009). In so doing, it must do so effectively in

accordance with the proper system to design and implement the methods of financial operations. Therefore, it also enables control of the people's developmental burden expeditiously in a manner that satisfies the beneficiaries. This in turn, results in the overall development of the country.

*Employment opportunity to professionals and workers* – as a result of the decentralization of fiscal power to the different levels of government and changing needs of the local people with the dynamics of time and technology, large numbers of professional and skilled workers are required. That means considerable public employment is required in order to cope with the local needs (Endawke 2009).

*Decrease central bureaucracy and competition* – fiscal decentralization is believed to enhance the local people's participation in local decision making with regard to their financial matters in a manner that satisfies the need of the locality and prevents decision making from becoming an overload to central government. Accordingly, it prevents inefficiency and bureaucratic problems. Moreover, it deters financial mismanagement, corruption and lack of accountability. It is believed that budgetary auditing and reporting at different tiers of government enables the achievement of this objective. (Endawke, 2009).

*Sensitivity to diverse regional preferences* – fiscal decentralization brings regional units closer to the people, and thereby enables regional preferences to be entertained and addressed (Wellisch, 2000). Boex similarly discussed that fiscal federalism enabled government to meet the demands of the local people; made governments accountable to those who elect them to provide quality and timely services; and people at a local level become more willing to pay for public services and it is easier to raise revenue (Boex, 2001).

*Protecting the interests of the future generations* – fiscal decentralization allows federated units to take into consideration the needs of future generations living in the region (Wellisch, 2000).

#### *Disadvantages of Fiscal Decentralization*

There are different limitations associated with exercising fiscal decentralization, such as:

*Imbalance and competition* – In the federal system, there are variations among federated units in terms of population size, natural resource endowment etc. These differences can produce difficulties in designing the best formula to address financial gaps between federated units. As a result, there is imbalance and competition over resources that claim lives and ultimately leads to political instability, for example as seen in Nigeria (Endawke, 2009).

This also produces problems for the income redistribution role of the government. As a result, there exists vertical imbalance between the federal and state governments and horizontal imbalance among the different states of the federation.

*Mobility and Migration of Workers and Professionals* – Since federalism allows for the self-governance of regions, there is variation in the payment of professionals in different states and in between the federal or state governments. Financially richer states could more easily offer attractive salaries and provide wage increments according to the pace of their own development; whereas, the poorer states could struggle to satisfy public services and individual payments in their financial performance and development strategies (Endawke, 2009).

Therefore, variations in salary payment for the same professionals becomes inevitable and therefore may result in migration and accumulation of professionals and experts to a single state or federal government which is able to offer better salaries relative to other states.

*Spillover effect* – this meant that public goods produced by one subnational unit could be used by other regions which are not perceived as the intended beneficiaries of the budget (Wellisch, 2000).

#### *Fiscal Decentralization Practices in Ethiopia: Benefits and Problems*

Ethiopia attempted to introduce federalism in general, and fiscal decentralization in particular dating back to the transition period. Fiscal decentralization was enacted in proclamation Number 33 in 1992. According to this proclamation, sources of revenue of regional governments were: 1) taxes allocated to them; (2) grants to be given by the central government; (3) domestic borrowing; and (4) other sources of income (Befekadu, 1994). Likewise, fiscal federalism is clearly stipulated in the constitution by way of tax assignment for the federal government and for regional states (Federal Democratic Republic of Ethiopia, 1995, Articles 96, 97, 98).

The following are discussions on the benefits and limitations of fiscal decentralization in Ethiopia. Fiscal decentralization has brought about the following significances:

- Fiscal decentralization has enabled the Ethiopian government to come closer to the people and meet the competing needs of the local people;
- It has made subnational units assist the central government in the effort to bring about national economic development. In so doing, it has eased the burden of the central government;
- Allowed subnational units certain taxation powers that enables them to provide public services.

Despite these benefits of fiscal decentralization, the following limitations of exercising fiscal decentralization have been seen in Ethiopia:

*High vertical fiscal imbalance and regional disparities* – Ethiopian fiscal federalism is characterized by high vertical fiscal imbalance and regional disparities (Gebrehiwot, 2002). Several studies including Endrias (2003) have indicated that the federal government has controlled the richest sources of revenue. The federal government controls 80% of domestic revenue, 88% of indirect taxes, all international trade and foreign assistance that accounts for 90% of total revenue (Endrias, 2003). Endrias discussed also that in 1995-1996, the highest local contribution to state expenditure by Oromia was 24.4% of the total revenue; and the lowest by Afar at only 4.85%. Similarly, in the report of MoFED (Ministry of Finance & Economic Development, 2009) referring to the fiscal year of 2007-2008, it revealed that the federal subsidy accounted for 84% of Oromia's expenditure and 95.2% of Afar's regional state government expenditure.

Endrias asserted that regional states of Ethiopia were dependent on the federal states for their capital budget and more than half of their recurrent budget; but the revenue sources assigned to regions are inadequate for them to discharge their assigned responsibilities. With regard to horizontal imbalance, since there are regional variations in

Ethiopia in terms of revenue raising capability, developmental status, population size and the like, horizontal fiscal imbalance is a significant problem.

Meheret discussed that regions in Ethiopia are varied in many respects such as population size, geographical area and level of socioeconomic development; hence, regions that have well established administrative and institutional capacity, including skilled manpower, a relatively developed infrastructure and sufficient local resource base, enjoy a relatively better degree of freedom and independence than those with serious shortages of trained manpower and finance. Amhara, Oromya, and Tigray are not subject to the same degree of interference by the Central Government as manpower deficient regions such as Gambella, Afar, Benishangul-Gumuz, and Somale (Meheret, 2000, as cited in Melkamu, 2004). This means that emerging regions in previous years have suffered from a shortage of skilled workforce, and as a result, the federal government had to fill this gap.

*Problem of effectiveness and efficiency in resource utilization* – In Ethiopia, the lack of skilled manpower in emerging regions has resulted in the inefficient utilization of resources. Accordingly, such regional states become less autonomous. Since the federal system requires vast economic resources to build up local capacity and adequate numbers of skilled manpower, in the absence of these resources inefficiency becomes a drawback (Tanzi, 1996). Today, all emerging regions have universities, which means that skilled manpower in some disciplines is no longer a serious problem compared to previous years.

Otherwise not only emerging regions but also “developed regions” in Ethiopia also suffer from skilled manpower migration to federal government institutions for the sake of better payment, work freedoms and future prospects. This has posed a challenge in providing efficient public service delivery. For instance, many academic staff of Jimma Teacher’s Education College (regional institution) leave after completing their Master’s education to work at Jimma University (federal institution). This has meaningfully affected the College’s service delivery into its expectancy. According to the Oromia Regional State Government Research Institute Bureau, in the past five years alone 150 qualified staff members have left the Bureau for federal organizations (Oromia Regional State Government Research Institute, 2013). This holds true in all regions of Ethiopia, with a high level of migration from regional institutions to federal organizations. This is merely because compared to regional institutions, federal institutions offer more attractive opportunities. In a study by Murphy, Shleifer, and Vishny (1991, as cited in Tanzi, 1996), it was stated that national level institutions provide more opportunities than local level institutions; hence, they attract more skilled human resources. This affects the quality of services offered by regional and local level institutions. In addition, Prud’homme argued that the quality of local bureaucracies could deter the importance of decentralization (Prud’homme, as cited in Tanzi, 1996).

*Problem of administrative malpractice and local level political influence* – Federalism aims to improve efficiency in the provision of public goods and services by taking into account the demands of the local people. In order to do so, this requires, according to Moges (2005), a professional, honest and politically independent bureaucracy in the course of improving the performance of public institutions and enhancing participatory decision making. However, as practice on the ground shows, there is a strong bond between party politics and public institutions in Ethiopia this has undermined the quality of service

provision in a very responsive manner that has also exacerbated corruption and other malpractices in Ethiopia.

*Problem of spillover effect* – Endawke discussed that in Ethiopia, spillover effects in the federal system is a problem observed mainly in Dire Dawa city administration and Harari People's regional state government. He also stated that 15% of the federal government budget is based on the expenditures of the two regions' health and education when considering non-residents or non-targeted recipients (Endawke, 2009).

## Conclusion

Fiscal decentralization aims to address the needs and preferences of the local people. Federalism in general, and fiscal federalism in particular, attracts the attention of states as it is difficult for the central government to entertain all the competing needs of those living in local and peripheral areas. It is therefore believed that national development as a whole could be ensured through the participation of local citizenship as this helps not only to assist the role of central government, but also to reflect local realities.

Ethiopia is exercising this form of decentralization in order to make public service efficient, transparent and accountable to those concerned. Despite the fact that there was a good start, as yet, the provision of public goods and services in an efficient, responsive and accountable way is still not being achieved.

Based on several studies including the researcher's own observations, the following actions are suggested as possible solutions:

- There is a discrepancy between revenue sources and functions in the Ethiopian fiscal federal system; this has detracted from the capacity and capability of the subnational units of government in terms of service provision. Hence, there should be reform with regard to the assignment of appropriate revenue to regional units in order that subnational units can provide adequate public service to the local people it serves;
- There should be a divorce between civil service institutions and party politics, as this could allow the building of a more professional, committed and honest civil service that better serves the interests of the general public;
- Promoting transparency and encouraging wider participation of the general public, political parties and civil society institutions so that they can play a more constructive role, and promote democracy through decentralization.

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