Federal Finance: What can South Sudan and Somalia Learn from their Neighbor Ethiopia?

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Abstract

The paper examines the Ethiopian experience with fiscal federalism which can be used as a lesson by South Sudan and Somalia, the two countries which are struggling to have a stable and viable nation. Ethiopia adopted federal system in 1995 which creates nine states based on ethnic grounds. Of the nine states, six of them have single ethnic group representing more than 80 percent of state's population while remaining three are multi-ethnic states. The fiscal relationships between the federal and state governments are provided in the Constitution addressing the four major components of federal finance. The expenditure assignments among tiers of government appears to be in line with the general principles while taxing power is over concentrated in the hands of federal government which resulted in high level of vertical fiscal imbalance. To correct this imbalance the federal government makes transfers to state governments in the form of formula-based budget subsidy which covers much of their budget. While political forces known to influence division of powers in federal structure, the existing federal finance arrangement in Ethiopia does not face serious challenges. The country, both at federal and state levels, has been ruled by the same political party since the adoption of the federal constitution. The existing fiscal arrangement may face challenge if another political party takes power in some states or the federal government.

Keywords: Federalism, Finance, South Sudan, Somalia, Ethiopia

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1. Introduction

The last ten years have witnessed promising developments in the Horn of Africa- a place characterized as one of the most politically fragile regions in the World. South Sudan has gained independence from the Sudan in 2011 ending the longest-running civil war in Africa and has become the youngest nation of the World. Somalia, on the other hand, has started state building process to end two decades of conflict and statelessness which followed the deposition of Siad Barre regime in 1991. Both countries have followed different paths to address their political problems and start state building. The political arrangements in South Sudan provide for decentralization by dividing power between the central, state and local governments. Even if the country comprises of various ethnic groups and the arrangement seems to have some elements of federal structure, the transitional constitution of the country doesn't declare that the country is a federal country. However, following the eruption of the 2013 infighting and civil war between political factions which displaced millions and killed thousands, some states in the country have started to demand federal system as a solution to its ethnic-based violence and protracted conflicts (Sudan Tribune, 2015).

In contrast, even if Somalia is a relatively homogeneous society, in recognition of the clan-based infighting and mistrust the country adopted a federal structure, also dubbed clan federalism, which distributes power and resources between states and the central government. However, the transitional constitution, which was adopted in 2012 and expected to be replaced by the final constitution in 2016, has not addressed the allocation of power to two levels of government. Rather it provides that the allocation of powers and resources will be negotiated and agreed upon by the federal government and the would-be federal member states upon completion of their creation. Creation of states appears to be challenging task. Somaliland, a northern Somalia region which claimed independence from Somalia in 1991 and has operated as a *de facto* nation state without formal recognition by the international community, is not willing to be part of the federation. On the other hand, Puntland, a north-eastern Somali region which was established as a federal state in 1998, expressed its willingness to be part of a federation retaining the right to govern its own people while allocating some powers to a Federal Government.

Despite their difference in socio-political landscape, both South Sudan and Somalia are facing similar problem- addressing the long standing political interests of different groups of the society to save their country from disintegration and another protracted war. It is apparent that these countries have a lot to learn from the federal experience of their neighbor Ethiopia which passed through years of civil war and later adopted ethnic-based federal system in a bid to address political issues of different ethnic groups.

This paper examines the experience of Ethiopia in the implementation of federal finance which defines the fiscal relationship between the central and state governments. This experience could be used by both South Sudan and Somalia, taking into account their specific political, social, institutional and economic realities, as a lesson in the design of their intergovernmental fiscal relations to address the existing contentious political issues of different ethnic groups.

The remaining sections of the paper are organized as follows. Section 2 provides the theoretical issues in federal finance. Section 3 presents the political setting of South Sudan and Somalia. Section 4 explains the federal structure of Ethiopia and fiscal relationship between the federal and state governments. Section 5concludes.

2. Literature on federal finance

Federal system is a form of government where power and responsibilities are divided between a central government, also called federal government, and a set of unit governments, also called state or regional governments (Buchanan, 1950; Smith, 1985; Alesina, et al., 1995; Musgrave, 1971; Horowitz, 2006; Oates, 1977; Mackintosh & Roy, 1999). There are roughly 24 federal countries in the World today, which together represent nearly 40 per cent of the World's population[1].The federal structures of these countries differ tremendously in terms of the relation between the governments at different levels, the degree to which state governments are represented within central government and the allocation of powers and responsibilities between the two levels of government. The forms of federalism range from central-centered (more power to central government) to state-centered (more power to state governments) and no single model of federalism fits for all.

[1]Countries which follow federal system are Argentina, Australia, Austria, Belgium, Bosnia and Herzegovina, Brazil, Canada, Ethiopia, Germany, India, Iraq, Malaysia, Mexico, Nepal, Nigeria, Pakistan, Russia, South Africa, Spain, Sudan, Switzerland, United Arab Emirates, United States of America, and Venezuela (Forum of Federations, 2017).

One important aspect of federalism is the division of fiscal powers and responsibilities among different levels of government. Fiscal federalism gives sub-national governments (all government tiers below the Centre, i.e., states and local governments) some taxing power and expenditure responsibility, and allows them to decide on the level and structure of their expenditure budgets (Boadway& Shah, 2009; Musgrave, 1971; Oates, 1999). The main goal of such division of fiscal powers and responsibilities is to move governance closer to the people and to allow local governments have some autonomy to make independent fiscal decisions.

Fiscal federalism has four major components: expenditure assignment, revenue assignment, intergovernmental transfer, and borrowing (Keen, 1998; Musgrave, 1983; Oates, 1996; Tanzi & Zee, 2000) which are discussed hereunder.

2.1. Expenditure assignment

Expenditure assignment involves a clear assignment of functional responsibilities among different levels of government which requires expenditure. In most federal countries the constitution addresses the functional responsibility of the central and sub-national governments. In general, even if the expenditure assignment is not the same in all countries, there are some principles in the assignment of functional responsibility.

The assignment of service responsibility considers the geographical dimension of benefits from the service. Hence, the functions allocated to the central government have a national dimension and services which meet the needs and preferences of people residing in small areas are provided by sub-national governments (Musgrave & Musgrave, 1989). National defense, national policies, currency, immigration, and foreign relations are usually the responsibility of the central government while such services as fire protection, police, street lighting, sanitation and water supply are the responsibility of sub-national governments (Shah, 1991). There are also many other economic and non-economic principles applied in assignment of responsibilities among different levels of government such as economies of scale, cost of decision making, spillover effect, macroeconomic management, institutional capacity, and the like (Oates, 1972; Dafflon, 2006).

2.2. Revenue assignment

Revenue assignment deals with which level of government tax what and how. In federalism it is presumed that state governments without independent sources of revenue would lose their autonomy and become under the financial influence of the central government. The central government also needs to have its own source of revenue to effectively discharge its allocation, distribution, and macroeconomic stabilization functions that benefit the nation as a whole. The issue of tax assignments is closely related to the expenditure assignment because of the need to assure that governments have revenues that are adequate enough to finance the expenditures assigned to them (Liberati, 2010; McLure, 2001; Musgrave, 1983; Norregaard, 1997).

Literature in fiscal federalism defines some general principles by which to allocate taxes between central and state governments. Accordingly, taxes to be collected by the federal government are those taxes that contribute to macroeconomic stability, taxes that minimize locational distortions of economic activities; taxes on mobile factors of production in order to prevent distortions in location of economic activity; and tax on natural resources which are very unevenly distributed throughout the national territory (Shah, 1991; Bird, 1999; Liberati, 2010). Taxes which are commonly assigned to state governments are taxes on immobile factors such as tax on low-income workers and property and excise and user fees and charges. Assignment of such taxes to state governments allows local authorities some freedom to vary tax rates without the tax base vanishing and avoid harmful tax competition among state governments (Shah, 1991; Bird, 1999; Norregaard, 1997).

2.3. Intergovernmental transfer

The third component of federal finance is mechanism of the transfer of money from central government to regional governments (Bahl, 2002; Bird, 2001; Schroeder & Smoke, 2003). Intergovernmental transfers are intended mainly to correct fiscal imbalances (vertical imbalance and horizontal imbalance), to correct inter-jurisdictional spillovers (Bahl, 2002; Bird, 2001, Ebel &Taliercio, 2005), and to achieve minimum national standard of public services (Boadway and Shah, 2009).

Vertical fiscal imbalance occurs when the difference between expenditures and revenues of state governments is different from that of the central government. Horizontal fiscal imbalance, on the other hand, occurs when there is variation among state governments in the gap between own revenues and expenditure (Bird, 2001; Dahlby & Wilson, 1994; Schroeder &Smoke, 2003; Martinez-Vazquez & Boex, 2001).Inter-jurisdictional spillover arises when services of a state targeting the local community extend beyond the borders of the locality and benefit the community of other state governments (Dahlby, 1996; Martinez-Vazquez &Boex, 2001).

2.4. Borrowing

The fourth component of fiscal federalism is the division of borrowing power. In some federal countries state governments are allowed to borrow domestically but are not allowed to borrow from abroad. In some other federal countries borrowing by state governments is not permitted altogether. In such countries it is the central government which has the power to borrow from domestic and external sources. In some federations such as in Canada, the USA, Brazil, all levels of government have autonomy to borrow from abroad and domestic financing institutions as long as they respect budget discipline rule and macroeconomic policies are not undermined. There are arguments for and against borrowing by state governments. The main argument against borrowing by state governments is the possible macroeconomic implications both at state and national level of borrowing powers decentralization without control and regulation. It is claimed that if a state government defaults on loan, the debt problem will not be limited to that state government as the state is one part of the federal system and the central government may be required to rescue the debt-riddled state (Tanzi, 1996; Ter-Minasian, 1996; Von Hagen &Eichengreen, 1996).

Since central government has the responsibility for stabilization policies, it is required to support the troubled state government in solving the debt crisis. This may create unplanned fiscal liabilities for central government. Therefore, in the absence of strong and tight control over the borrowing activities of the state governments, it is argued that state governments should not be allowed to borrow and the central government should have full control over public debt (Jin and Zou, 2003; Rodden, 2006). Besides, if state governments feel that the central government provides guarantees to their borrowing, they may engage in excessive borrowing creating moral hazard problem (Ter-Minassian, 1997).

3. Setting of South Sudan and Somalia

3.1. South Sudan

South Sudan gained independence from the Sudan in July 2011 as a result of the 2005 Comprehensive Peace Agreement (CPA) signed between the Sudanese government and the Sudan People's Liberation Army that ended Africa's longest-running civil war. The country is bordered by the Sudan to the north, Ethiopia to the east, Kenya to the southeast, Uganda to the south, the Democratic Republic of the Congo to the southwest, and the Central African Republic to the west. The country has estimated population of 11.9 million people with nearly 83% of them residing in rural areas. Even if the country is endowed with natural resources, the economy heavily relies on oil production and subsistence agriculture. The government derives nearly 95% of its revenues and 50% of its GDP from oil. South Sudan is believed to have the largest oil reserves in sub-Saharan Africa after Nigeria and Angola (IMF, 2015).

South Sudan is one of the most diverse countries in Africa. It is home to over 60 different ethnic groups. The Dinka are the largest ethnic group in the country constituting around 36% of the total population followed by Nuer representing 16% of the population. Other prominent ethnic groups include Shilluk, Azande, Bari, Kakwa, Kuku, Murle, Mandari, Didinga, Ndogo, Bviri, Lndi, Anuak, Bongo, Lango, Dungotona, Acholi. (CIA Factbook, 2015). English is the official working language of South Sudan even though Dinka, Nuer, Bari, Zande, and Shilluk are widely spoken languages (CIA Factbook, 2015). Regarding religion, around 60% of the population is follower of some form of Christianity. There are also small portion of the population who are Muslims. The remainder follows traditional religions.

The Transitional Constitution of South Sudan, which was enacted in 2011, prescribes a decentralized system of governance with three levels of government: the national level, the state level, and local level government within the state. Accordingly, the Transitional Constitution divides the country into 10 states, with the capital being Juba. The states are Northern Bahr el Ghazal, Western Bahr el Ghazal, Warrap, Lakes, Unity, Upper Nile, Jonglei, Western Equatoria, Central Equatorial (which contains Juba, the national capital), and Eastern Equatoria (see Figure 1 for administrative map). In 2014, the Greater Pibor Administrative Area was created as a semi-autonomous area within Jonglei State following request by the Anyuak, Jie, Kachepo, and Murle people in Jonglei who sought greater autonomy from the Jonglei State government which is dominated by Nuer and Dinka. The South Sudan government is dominated by the Sudan People's Liberation Movement (SPLM), a group which waged over five decades of civil wars against Sudan to gain independence.

Figure 1: Administrative map of South Sudan

Two and half years after independence, South Sudan has witnessed civil war between ethnic groups of the country with Dinka and Nuer, the two major ethnic groups, taking different sides. The 2013 conflict has resulted in a horrific humanitarian crisis and exposed the fragility of its political arrangement. Some states and political elites have called for the country to be organized as a federation to address some of key political issues of different ethnic groups.

3.2. Somalia

Somalia is a nation under state rebuilding after two decades of disintegration. It is bounded by the Indian Ocean and the Gulf of Aden to the east, by Kenya to the southwest, by Ethiopia to the northwest, and by Djibouti to the north. It is estimated that Somalia has a population of around 10.5 million. About 80% of the population represents nomadic or semi-nomadic pastoralists. Agriculture is the most important economic sector accounting for about 65% of the GDP and employing 65% of the workforce. Livestock contributes about 40% to GDP and more than 50% of export earnings (CIA Factbook, 2015).

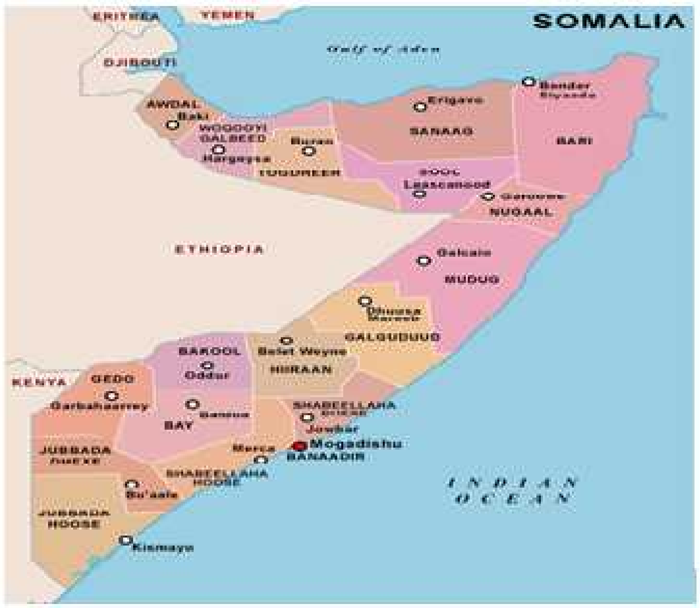
Around 85% of residents of Somalia are ethnic Somalis with more or less similar culture, same religion (Muslim) and same language (Somali). Despite high level of homogeneity, Somalis are divided into clans. The four main clans are Darood, Dir, Hawiye and Digil-Rahanweyn, which are further divided into hundreds, and at times, thousands of sub-clans and sub-subclans. There are also minority clans in Somalia such as Bantu, Tuni, Jiito and Bajun. The Daroods reside predominantly in the northeast and southern Somalia. The Hawiye predominantly inhabit central Somalia and around the Mogadishu. The Digil tribes inhabit Southern Somalia. Dir tribe predominantly inhabits the Northwest of Somalia. The small tribes of Jiito, Buntu, Tuni and Bajuni are spread from central to southern Somalia.

Following its independence from Italian and British colonies in 1960, Somalia had been ruled by a civilian government before it was deposed by military forces in 1969. The military government has been in power for more than twenty years and was overthrown in 1991 by a coalition of militia groups. The overthrow of the military government has ushered in two decades of protracted and terrible civil war, retaliations, warlordism, clan-based politics, and fragmentation of the country into several autonomous regions and territories each of which having its own government, army, and, in some cases, own currency.

After more than two decades of civil conflict and lawlessness, the historic adoption of the Transitional Federal Charter for the Somalia Republic at the beginning of 2004 has opened a new chapter in the political history of the country. The charter resulted in the creation of transitional government at the end of 2004 and the adoption of provisional constitution and formation of internationally-recognized federal government in 2012. The constitution provides for a decentralized system of administration based on federalism which creates two levels of government: the national federal government and federal member state with the later further divided into local governments.

The provisional constitution doesn't mention the federal member state. However, it requires the federal member states to be established from among the 18 regions that existed prior to start of 1991 civil war (see Figure 2 for the old administrative map).

Figure 2: Administrative map of Somalia (1991)



It also offers the option for two or more of these regions to merge to form a federal member state. The public finance issues are not included in the provisional constitution pending the creation of federal member states. Even though the creation of federal member state is expected to be finalized in 2016, the progress so far is very slow due to increased disputes between clans and between potential federal member states on the geographical boundaries of these states.

Table 1 presents a socio-economic comparison of Ethiopia, South Sudan and Ethiopia using some key indicators.

Table 1: Socio-Economic Indicators Comparison

	Ethiopia	South Sudan	Somalia
GDP (2014)	USD 55.6 billion	USD 13.3 billion	USD 5.7 billion
GDP per capita (2014)	574	1,115	542
Life expectancy (2013)	63	55	55
Mortality rate, infant (per 1,000 live births) (2015)	41	60	85
Access to electricity (% of population) (2012)	26.6	5.1	32.7
Death rate, crude (per 1,000 people) (2013)	7.6	11.8	12.3

Source: World Bank's World Development Indicators

4. Federal finance in Ethiopia

4.1. Country Setting

Ethiopia, home for more than 80 ethnic groups, is one of the three Africa countries which follow federal system[2]. It shifted from unitary to ethnic-based federal system in 1995 after undertaking constitutional reforms. The country is divided into a central government, nine state governments, and two federally-administered chartered state-cities (Addis Ababa, the capital city of the Federal Government, and Dire Dawa). Dire Dawa is not mentioned in the constitution of the FDRE. It is established by a Federal Proclamation No416/2004 and its existence seems temporary until the territorial claims by Oromia and Somali gets solution. Six states (namely, Tigray, Afar, Amhara, Oromiya, Harari, and Somali) have single ethnic group representing more than 80 percent of state's population while the remaining three are multi-ethnic states (namely Benishangul-Gumuz, Southern Nations, Nationalities and Peoples (SNNP), and

[2]The other two are Nigeria and South Africa. In fact, the constitution of South Africa does not mention if the governance system is a federal one, although in practice the political setting is typically a federal one. Somalia will become the fourth African federal country if a new constitution is adopted. South Sudan will also join the club if the current political upheavals lead to the adoption of federal system as demanded by some states.

Gambella). Figure 3 presents the administrative map of Ethiopia and Table 2 presents the population and land area share of each state in the national total.

Figure 3: Administrative map of Ethiopia

The federal government has two houses: House of Peoples Representative and House of Federation. The House of Peoples Representative is the highest authority of the federal government whose members, not exceeding 550, are directly elected by the people for a term of five years. The House of the Federation is composed of representatives of nations, nationalities and peoples. Each nation, nationality and people is represented in the House of the Federation by at least one member and each ethnicity is represented by one additional representative for each one million of its population. The House of Federation is tasked mainly with interpretation of the constitution and deciding on issues related to national self-determination (Constitution of FDRE, 1995). The House of Federation doesn't have legislative role. It is the House of Peoples Representative which has legislative role making the country to have a unicameral legislative structure.

Table 2: Regional distribution of population and land area size

States	Population	Population Share (%)	Land Area Share (%)
Afar	1,678,000	1.9	7.07
Amhara	20,018,988	22.8	17.34
Benishangul-Gumuz	975,998	1.1	4.3
Gambella	396,000	0.5	2.4
Harari	226,000	0.3	0.03
Oromia	32,815,995	37.3	33.05
SNNP	17,837,005	20.3	10.28
Somali	5,307,002	6.0	19.82
Tigray	4,960,003	5.6	5.53
Addis Ababa	3,194,999	3.6	0.04
Dire Dawa	427,000	0.5	0.15

Source: Central Statistics Agency Population Projection of Ethiopia, 2014

Since the adoption of the new constitution, the country has been ruled by a single political party called the Ethiopian People's Revolutionary Democratic Front (EPRDF) which is an alliance of four ethnic-based political parties representing major states which constitute about 85 % of the total national population. The parties are the Oromo Peoples' Democratic Organization (operating in Oromiya), the Amhara National Democratic Movement (operating in Amhara), the South Ethiopian Peoples' Democratic Front (operating in SNNP) and the Tigrayan Peoples' Liberation Front (operating in Tigray). Parties which rule the other regions also have affiliation with EPRDF.

Decentralization is the essence of Ethiopian federalism as it devolves powers, functions, authority and finances to different territorial levels of government. In the following sections the four major component of Ethiopian federal finance, namely, expenditure assignments, revenue assignments, inter-governmental transfers, and borrowing, are discussed.

4.2. Expenditure Assignment

Article 51 and 52 of the Constitution list the respective powers and functions of the federal government and regional governments. Article 51 lists 21 powers and functions of the federal government which include setting national economic and social policies; formulating and implementing monetary policy and policies relating to inter-regional state transportation and commerce; establishing national standards; setting foreign policies; and ensuring national defense. The Constitution follows the principle of residuality regarding the powers and functions of regional governments. Accordingly, Article 52 indicates that "all powers not given expressly to the Federal Government alone, or concurrently to the Federal Government and the States are reserved to the States". Generally speaking, most government functions and services which have direct impact on the daily lives of the people including provisions of social services (education, health, and policing) are the main responsibility of state governments.

The Ethiopian Constitution does not have provisions regarding the assignment of functions to local governments called *Zones*, *woredas (*districts*)* and *kebeles (*counties*)*. Such issues are addressed in the constitutions of state governments. In many states *woredas* are responsible for delivery of primary services such as primary and secondary education; basic health care; agricultural extension programs; construction and maintenance of *woreda* roads and access roads to *kebeles*; veterinary clinics; water supply; land use administration; water development, wells construction and maintenance; local police; and the like. *Woredas* further delegate some of such responsibilities, especially basic social services, down to *kebeles*.

4.3. Revenue Assignment

Article 94 of the Ethiopian Constitution requires both the federal government and the regional governments to bear all financial expenditures necessary to carry out all their respective responsibilities and functions assigned to them. Constitution Articles from 96 to 99 divide the taxation power into four categories, namely 'the federal power of taxation', 'the state power taxation', 'the concurrent power of taxation', and "undesignated power of taxation".

The central government has ownership over such taxes as taxes and other charges on imports and exports; income tax on employees of the federal government and international organizations; income, profit, sales and excise taxes on enterprises owned by the federal government; tax on the income and winnings of games of chance; taxes on the income of air, rail and sea transport services; taxes on income of houses and properties owned by the federal government; taxes on monopolies; and federal stamp duties.

State governments have the power to levy and collect such taxes as income taxes on employees of the state and of private enterprises; taxes on the incomes of private farmers and farmers' cooperatives; profit and sales taxes on individual traders carrying out a business within state territory; taxes on income from transport services rendered on waters within state territory; taxes on income derived from private houses and other properties within the state; profit, sales, excise and personal income taxes on income of enterprises owned by the state; taxes on income derived from small and medium scale mining operations, and royalties and land rentals on such operations.

Both the central and state governments have joint ownership over profit, sales, excise and personal income taxes on enterprises they jointly establish; taxes on the profits of companies and on dividends due to shareholders, and taxes on incomes derived from large-scale mining and all petroleum and gas operations. The federal government has the obligation to levy and collect the joint taxes and share them with the state government using the allocation scheme approved by the House of federation. Currently, 40% of royalty on mineral and petroleum operations are allocated to the state government while the central government takes the remaining 60%. Profit tax of enterprises jointly owned by the federal government and state government is allocated in proportion to their respective capital contribution. It is also provided that direct taxes (income and profit taxes) of companies and jointly owned enterprises are shared equally while state governments take 30% indirect taxes (value-added tax, turnover tax, and excise taxes) with the central government taking the remaining 70%.

The Constitution has provided that taxes not designated as federal, regional, or joint will be referred to the joint session of the House of the Federation and the House of Peoples' Representatives, which should determine by a two-thirds majority vote which government has the power of taxation. There are many instances in which the two Houses decided to designate taxes included in the income tax and other tax proclamations but not explicitly designated in the Constitution. For example, excise taxes on companies, income taxes on royalties from copyrights and patents, capital gain tax, and income tax on interest from bank deposits are not designated in the Constitution. The Joint Houses designated excise taxes on companies as joint taxes, income tax on interest from bank deposits as federal tax, income taxes on royalties derived by individuals as regional taxes, and income taxes on royalties derived by companies as joint taxes. Currently, capital gain tax which is levied on the gain obtained from the transfer of company shares and business buildings is not designated and requires the decision of the joint houses. Some argue that value-added tax requires designation as it is not mentioned in the Constitution. Others, on the other hand, argue that value-added tax is a form of sales tax and hence both value-added tax and turnover tax are implicitly designated in the Constitution.

One of the major issues in federal finance is the issue of tax harmonization across states. Even if the Ethiopian constitution assigns tax power to the two levels of government, both levels of government are required to harmonize their taxes in terms of tax rates and tax base[3]. Currently, most of the tax laws of state government are copied from the tax laws of the federal government. The only tax laws that regions enact independently are agricultural income tax because of absence of such taxes at federal level. Such harmonization prevents tax competition among states and avoids a “race to the bottom”.

4.4. Intergovernmental Transfer

It is evident from the revenue and expenditure assignments stipulated in the Constitution that expenditure responsibility of state governments is greater than that of the federal government. In terms of revenue assignment, however, the federal government takes much of the tax revenues generated by the economy. As a result, state governments do not cover their budgetary expenditures from their own revenue sources whereas the federal government is in a better financial position. This resulted in significant vertical fiscal imbalance between the federal and state governments.

The extent of vertical fiscal imbalances in Ethiopia is measured using the following formula:

$$VFI = 1-[(R_R/R)/(E_R/E)]$$

Where VFI is vertical fiscal imbalance, R_R is combined revenue of all states, R is the total (federal plus state governments) revenue of the government, E_R measures the amount of combined expenditure of states, and E measures the total (federal plus state governments) expenditure. The coefficient of the vertical fiscal imbalance ranges between zero and one. Coefficient of zero indicates that there is no vertical fiscal imbalance and hence states have fiscal autonomy. This occurs when the revenue and expenditure share of the states is the same as that of the federal government. On the other hand, a coefficient of one indicates that

[3] See Article 100 of the Constitution, Article 64 of Financial Administration Proclamation No. 648/2009, and Article 53 of Financial Administration Regulation No. 190/2010

the federal government has absolute control over states. This takes place when the states do not have their own revenue. As shown in Table 3, over the past eleven years, the vertical fiscal imbalance in Ethiopia had a coefficient of 49%.

Table 3: Vertical fiscal imbalance in Ethiopia

Ethiopian Fiscal Year	Share of states revenue in general government revenue	Share of states expenditure in general government expenditure	Vertical fiscal imbalance
2012	22%	50%	0.56
2011	23%	43%	0.46
2010	18%	43%	0.58
2009	25%	47%	0.46
2008	26%	45%	0.43
2007	26%	41%	0.36
2006	25%	39%	0.35
2005	28%	46%	0.39
2004	18%	41%	0.56
2003	19%	42%	0.55
2002	19%	41%	0.55
Average	23%	45%	0.49

Source: Author's own calculation based on data from MOFEC

There is also high level of horizontal fiscal imbalance in the country which indicates the difference in financial position across states. Horizontal fiscal imbalance is commonly measured by calculating the percentage of total expenditure (i.e., recurrent plus capital expenditure) covered by own-revenue. Thus,

$$\text{Horizontal Fiscal Imbalance} = \text{Own Revenue} / \text{Total Expenditure}$$

However, due to lack of total capital expenditure data for regional governments, here the horizontal fiscal imbalance is measured using recurrent expenditure as a denominator which underestimates the true extent of horizontal fiscal imbalance.

Table 4: Horizontal fiscal imbalance in Ethiopia

States	2012		Average from 2005 to 2012	
	Ratio of own revenue to recurrent expenditure	Imbalance in Percent	Ratio of own revenue to recurrent expenditure	Imbalance in Percent
Afar	25%	75%	26%	74%
Amhara	29%	71%	28%	72%
Benishangul-Gumuz	20%	80%	25%	75%
Gambela	20%	80%	21%	79%
Harari	35%	65%	37%	63%
Oromia	28%	72%	32%	68%
SNNP	24%	76%	28%	72%
Somali	18%	82%	24%	76%
Tigray	50%	50%	41%	59%
Dire Dawa	43%	57%	39%	61%
Addis Ababa	255%	-155%	172%	-72%

Source: Author's own calculation based on data from MOFEC

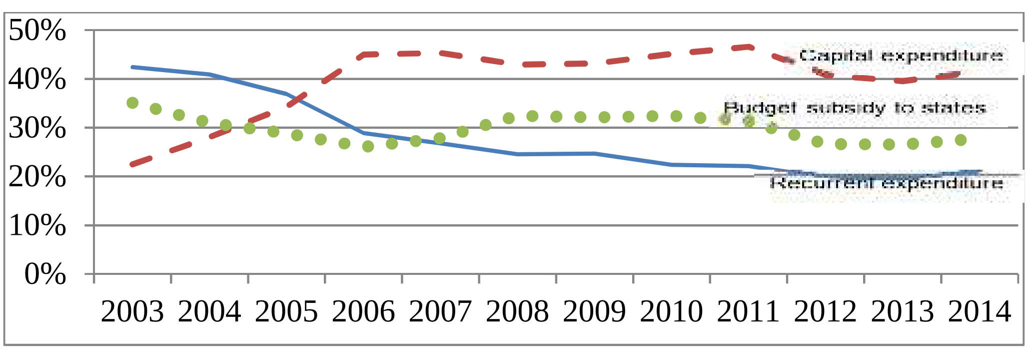
Table 4 shows the imbalance of each state for 2012 and for 2005-2012. As indicated in the table, Afar, Benishangul-Gumu z, Gambela, and Somali have the highest imbalance between own-revenue and recurrent expenditure which are needed to run the government administration machinery. These states could not cover more than 20% of their recurrent expenditure from their own revenue sources. A relatively better positioned state is Tigray which covered 50% of its recurrent expenditure from own revenue in 2012 and average of around 41% over the period between 2005 and 2012. Addis Ababa city administration is exceptional. Its own tax revenue for 2012 was 255% of its recurrent expenditure.

The Constitution provides for transfer of money from federal to state governments so as to address both vertical and horizontal fiscal imbalances and to ensure the proper functioning of state governments and to achieve minimum national standards of public services. There are two types of transfer from the federal government to state governments: specific-purpose grant and budget subsidy. Specific-purpose grant is made to fulfill the goals of national priorities and for implementation of federal program at sub-national level. For example, of during the final years of Millennium Development Goals (MDGs) the federal government has been making transfers to states to achieve such goals. The main form of transfer from the federal government is federal budget subsidy which is a formula-based unconditional transfer that constitutes the main component of both the federal and state government budget.

The budget subsidy allocation formula is developed by the House of federation while the total amount available for budget subsidy is approved by the House of Peoples Representatives. Designing a budget subsidy formula is a contentious undertaking as all state governments have strong desire to get favourable treatment in the formula. As a result, between 1994 and 2012 the House of Federation has revised the allocation formula seven times. In most cases the formula is developed by taking into account the population size, the revenue raising capacity, and level of development of states. From 1994/5 to 2006/2007, population size, revenue raising capacity and development index of the states were major indicators. From 2007/08 onwards, the Australian model, that tries to matches the states' revenue capacity with their expenditure needs, has been in practice.

In absolute terms, the amount of federal budget subsidy to regional governments has shown a continuous growth which increased with increase in the federal government revenue, foreign grants, and borrowing. Between 2003 and 2014, the amount of federal budget subsidy increased by 613%. Figure 4 shows, the pattern of the share of budget subsidy in the total federal budget. Between 2003 and 2014 the subsidy to the states averaged 29% of the federal government's annual budget.

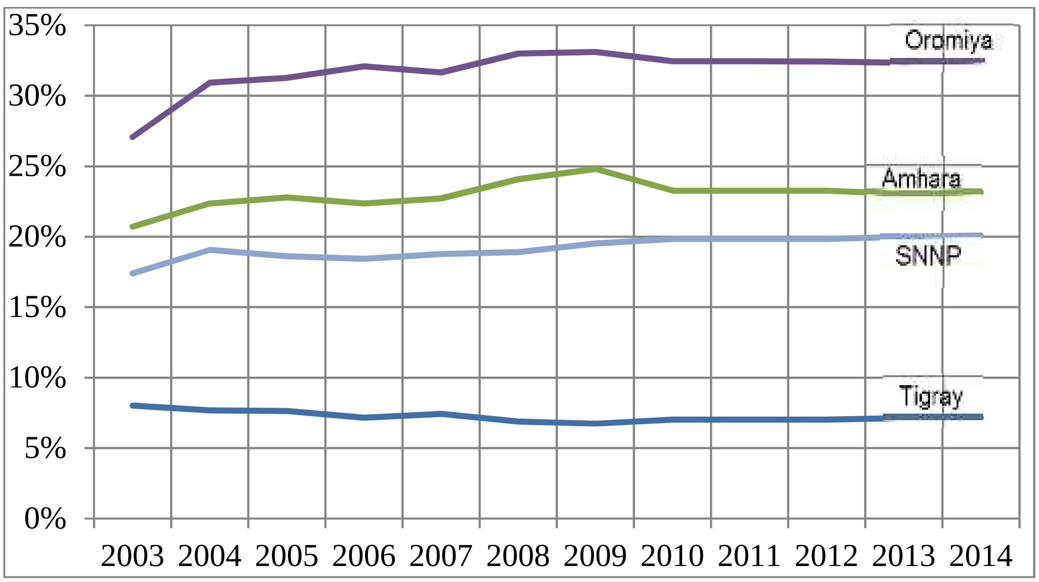
Figure 4: Percentage share in federal government budget



Source: Annual Federal Budget Proclamations

Figure 5 presents the percentage share of each state and the two city administrations in the annual budget subsidy of the federal government. The table clearly indicates that the annual share of each region and city administration in the federal budget subsidy has been slightly varying from year to year due to continuous changes in the variables used in the transfer formula. The recent transfer formulae do not include Addis Ababa as it has huge revenue raising capacity vis-à-vis other states. However, due to its strategic importance to the country, the federal government transfers small fraction of its subsidy to the City to finance various infrastructure development.

Figure 5: Percentage share of major states in the annual federal government budgeted subsidy



Source: Annual Federal Budget Proclamations

As far as local governments are concerned, even if most public services are provided at *woreda* and *kebele* levels, the revenue raising capacity of *Woreda* administrations in all regions is so limited that they can't fully cover their recurrent expenditures let alone financing capital outlays without the budget support from the regional governments. With the exception of land use fees and municipality revenues, no state has devolved any tax power to local governments. The states delegate many tax powers to *Weredas*. Table 5 presents the share of recurrent expenditures of *Woredas* covered by the revenue they collect.

As clearly indicated in the Table, with the exception of Addis Ababa City Administration, the revenues collected by *woredas* in all states cover very small portion of their recurrent expenditure requirement. As a result, in order to ensure the proper functioning of *woreda* administrations and proper provision of public services at grass root level, state governments allocate their share of federal budget subsidies and state revenues to the *woredas* and *kebeles*.

Table 5: Total *woreda* level revenue collection and recurrent expenditure from 2005 to 2012

States	Own Revenue to Recurrent Expenditure Ratio
Afar	20%
Amhara	28%
Benishangul-Gumuz	22%
Gambela	17%
Harari	10%
Oromia	26%
SNNP	22%
Somali	17%
Tigray	54%
Addis Ababa	342%
Dire Dawa	34%

Source: Author’s own calculation based on data from MOFEC

All states do not follow a uniform budget subsidy formula in the allocation of budgets to the lower government administration units. For instance, in Addis Ababa City Administration, Oromia Regional States, Amhara Regional State, and Benishangul-Gumuz Regional States the budget allocation classifies the expenditures into salary, non-salary recurrent expenditures, and capital expenditure. The budget allocated to each *woreda* and *kebele* covers their salary expenditures. However, for non-salary recurrent expenditures, different approaches are followed for allocation. The budget subsidy for main sectoral offices such as education, health, agriculture, water, roads and administrative costs are determined based on a unit cost approach. Under this approach the cost per student (for education), per patient (for health), per police officer (for peace and security), and the like are determined in advance based on the actual expenditures of the state for such sectors over the past few years. Once the standardized unit cost is determined, the budget for each sectoral office in each *woreda* and *kebele* is determined by multiplying the unit cost by the number of students, patients served, and the like of the *woreda* (Benshangul BOFED, 2013). For other sectoral offices the budget is based on past performance. Capital expenditures are allocated on the basis of the infrastructure development index of each *woreda* and *kebele*. The index may be stated in terms of pupil per classroom ratio, health centers per 25,000 people, schools per 1000 school age population, etc.

In contrast to these states, in the Southern Nations, Nationalities, and Peoples Regional State, which constitutes large number of ethnic groups, budget transfer to *woredas* is done following the budget subsidy formula used by the federal government. The Afar Regional State uses the Federal Government's budget subsidy formula to allocate budget to some *woredas* and urban administrations. For other *woredas* it uses the unit cost approach. In the Harari Regional State there is no *woreda* structure. Rather the region is divided into *kebele* administrations. Due to its small administration size, the state doesn't have a defined fiscal transfer formula to *kebele* administration offices. *Kebeles* essentially represent de-concentrated offices of the regional government.

4.5. Borrowing

The need for borrowing arises when the expenditure exceeds the sum of revenues and grants. Even though the Ethiopian government is composed of the Federal Government, state governments, and chartered cities, the borrowing power of these three types of governments is not the same. Generally speaking, it is the federal government which has the power to borrow from external and domestic sources. State governments are not allowed to borrow from abroad. It is so to protect the country's macroeconomic stability and the state governments' financial capability to discharge their functions and obligations. The federal government borrows from external and domestic sources and channels part of the borrowed money to state governments and chartered cities through its annual budget subsidies.

In effect, the sources of finance for state governments are its own revenue, budget subsidy from the federal government, and specific-purpose grants from the federal government[4]. As a result, state governments are required to balance their budget without running budget deficit as the presence of budget deficit requires borrowing to cover the gap. In case where they experience budget shortfall in any fiscal year, the federal government may give them loan in the form of advance to be deducted from their budget subsidy of the following year. State governments are not prohibited from borrowing from the state-owned Commercial Bank of Ethiopia to address the cash flow mismatches[5]. However, such internal borrowing by the regional governments requires the permission of Federal Ministry of Finance and Economic Cooperation (MoFEC) to make sure that the borrowing is in line with the national fiscal policy and macro-economic policy. In addition to borrowing from banks, regional governments may borrow from MoFEC. Such loan provided to regional governments is deducted from their subsidy budget and hence cannot be over and above the subsidy budget approved to the respective states[6].

Unlike regional governments, the two chartered cities (Addis Ababa and Dire Dawa) have relatively relaxed borrowing power. These two cities have the power to borrow from domestic sources directly or by way of selling bonds, on short and long payment terms, after securing authorization from the Federal Government[7]. Regarding external loan, these cities can identify external sources of loan and request the Federal Government to borrow money on its behalf. However, the City administration is required to make sure that the exercise of this borrowing power does not endanger the country's macro-economic stability as well as the City Government's financial capability to discharge its functions and obligations both intermittently and perpetually[8]. Unlike Addis Ababa City which gets external loan only through the federal government, the Dire Dawa City administration can borrow directly from external sources (rather than through federal government) after securing authorization of the federal government[9].

[4] See Article 52 of the Federal Financial Administration Regulation No. 190/2010

[5] See Article 65 of Federal Financial Administration Proclamation No. 648/2009

[6] See Article 53 of Federal Financial Administration Proclamation No. 648/2009

[7] See Article 11 sub-article 2 (k) and Article 54 of the Addis Ababa City Government Revised Charter Proclamation No. 361/2003 and Article 9 sub-article 5 and Article 45 of the Diredawa City Government Charter Proclamation No. 416/2004

[8] See Article 54 sub-article 3 of the Addis Ababa City Government Revised Charter Proclamation No. 361/2003

[9] See Article 45 of the Diredawa City Government Charter Proclamation No. 416/2004

5. Conclusion

Both South Sudan and Somalia are at the turning point. The outbreak of the 2013 civil war in South Sudan in the aftermath of the 2011 independence has shattered the hopes of the youngest nation of the world. The civil war has created mistrust among various ethnic groups and endangered the existing provisional constitution which provides for decentralization than federal arrangement. Since 2013 many political groups in this ethnically diverse nation have started demanding for federal arrangement to ensure self-governance and keep the nation united. On the other hand, Somalia, which is home for relatively homogeneous people, has been engulfed by clan-based politics which has descended the country into disintegration and warlordism. The formation of internationally recognized federal government in 2012, which ushered in new beginning in the political history of the country, has faced various challenges to create a full-fledged federal country as envisioned in its transitional constitution.

This paper examines the experience of Ethiopian twenty years old federal finance which can be used by South Sudan and Somalia as a lesson to draw. The Ethiopian federal finance, as a main component of its federal system, deals with the division of fiscal power between central and state governments which are established on the basis of main ethnic groups.

The constitution of the country addresses various issues related to spending and service delivery responsibility, taxing power, intergovernmental transfers, and borrowing power. Many of the expenditure assignments in Ethiopia follow the generally accepted rules and principles of expenditure assignment. The federal government is responsible for the provision of public services with a benefit sphere and other economic and non-economic criteria that reaches the entire nation, such as foreign affairs, national economic policy, immigration, currency, and national defense. On the other hand, state governments are responsible for basic social services which benefit the local communities, such as sanitation, education, health services, policing, and regional roads.

The revenue assignment in the country divides the power to tax into federal, state and joint. The federal government has significant taxing power and collects more than 80% of the total public revenues generated from the economy. This high revenue generated by the federal government allows it to significantly influence state governments. Due to high degree of vertical fiscal imbalance, annually the federal government makes formula-based budget subsidy to state governments to finance their expenditures. External borrowing is the sole responsibility of central government. State governments are prohibited from borrowing by their own to finance budget deficits. They are required to balance their budget by taking into account their own revenues and the transfers they receive from the central government.

In general, the Ethiopian federal finance is characterized by high level of vertical imbalance which helps the central government to exercise control over state governments. The fact that the country has been ruled by the same party, EPRDF, since the adoption of federal system, has also helped the country to have a stable and unchallenged federal finance arrangement (Andreas Eshete, 2003). It is less than clear what will happen to the existing federal finance arrangement provided in the Constitution if the federal government or some state governments, if not all, are ruled by a political party other than EPRDF.

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