Fiscal Decentralization and Macroeconomic Management in Ethiopia

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I. Introduction

The recent moves towards the establishment of regional governments in Ethiopia, with corresponding decentralization of fiscal powers, constitute substantial institutional changes in the fiscal and monetary management of the country, with profound implications for the exercise of macroeconomic policies by the central government. The decentralization of fiscal powers has been sought as part of the general trend away from central government control of economic activities and as part of the effort to meet demands for democratization and local political autonomy. Some of the other reasons for the decentralization of fiscal authority include the desire to mobilize regional resources for accelerated development, promote effective regional participation in development, balance interregional differences in development, and ensure the effective provision of goods and services .in the regions.

In general, and especially in the Ethiopian context, where the country has gone through a long tradition of centralization, decentralization should bring some flexibility into an otherwise rigidly centralized bureaucracy by weakening undue central government interference in regional affairs and laying the basis for greater involvement of regional governments in economic management. A larger degree of decentralization may also be called for on the grounds of administrative and allocation efficiency.

The decentralization of fiscal powers to the regions, however, involves the transfer to them of taxing, spending and borrowing instruments which are important means of the central government in the conduct of fiscal and monetary policies for the attainment of stabilization, growth and distribution objectives. Since fiscal and monetary policies constitute the two pillars of macroeconomic management, the central government's ability to control these key macroeconomic variables, namely taxes, public expenditures and the money supply, should not be hindered by the process of decentralization. In the distribution of fiscal powers between centre and region, this ability can be potentially undermined, crucially affecting the success of macroeconomic policies.

Thus, a careful examination of the mechanisms of the proposed fiscal relations and their impact on macroeconomic management is needed. This is even more so since the moves are taking place at a time when the government is taking major steps to facilitate economic adjustment and recovery, which, inter alia, call for the design and implementation of an appropriate system of region/centre fiscal relations to ensure the achievement of the major macro-goals of stabilization and growth.

This paper attempts to evaluate the recent moves to decentralize fiscal powers to the regions to see to what extent they can affect the conditions for macroeconomic management in the country, given the ongoing economic reform programme that emphasises the correction of past macroeconomic mismanagement as the basis for stabilization and growth. The focus is on how central government control of the policy variables can be affected by the proposed changes in fiscal management. The rest of the paper is organized as follows. The first section attempts to develop a theoretical framework for analysis. This is followed in section two by a brief discussion of the Ethiopian institutional setting and the proposed changes in section two. Section three uses the framework to evaluate the proposed system. The final section presents a summary of the paper and some recommendations.

II. Analytical Framework

The respective fiscal roles of central and regional governments should be clearly defined if efficient macroeconomic management is to be ensured, especially where a federal type of administration is sought. There is now a very wide volume of literature on fiscal federalism that devotes a lot of space to this issue.

In the literature, the discussion of the distribution of responsibilities between different levels of government usually starts with the assertion that the government has an important role to play in resource allocation, the redistribution of income and in the stabilization of both output and prices, and in overall macroeconomic management (Musgrave 1959).

Although it is usually assumed that in a market economy the private sector undertakes much of the allocation of resources, the presence of externalities and public goods means that the government could still be required to perform important allocative functions. Likewise, while the market, through its allocation of resources, generates a certain distribution of income, the government plays a role in ensuring a more equitable distribution of income, for example by taxing the rich to provide a higher standard of living for the poor. Above all, the government has to come in, in periods of economic instability, to promote policies aimed at stabilization, and to provide conditions for growth. Thus, while macroeconomic management by the government is desirable and unavoidable, the question remains as to which level of government should be primarily responsible for such functions.

The approach of traditional public finance theory (Masgrave and Musgrave 1973) to macroeconomic management is that output and price stabilization has a public good nature, i.e., when provided it will be available to all regardless of who bears the cost of financing it; hence no single individual or region might have the incentive or even the ability to exert any effort towards macroeconomic stabilization. There is no question therefore that this is a role that must be played by the central government.

There is, however, general agreement that excessive centralization can be accompanied by significant costs:

- Rigid centralization usually results in little experimentation and innovation, especially in situations where it perpetuates itself and becomes rigid and anachronistic.

- It may result in inefficiency if different regions with different tastes and attitudes have to conform with the same mixture of taxes and spending imposed by the national government.

- Taxes and spending programmes may experience diseconomies of scale when carried at the national level because they become inefficiently large, with the prevalence of organizational problems, bureaucratic inefficiencies and rent-seeking activities.

- Central governments may have less direct information on local needs and preferences than local jurisdictions.

Thus, fiscal decentralization is sought to bring efficiency to fiscal management, attend to local needs, bring a higher rate of resource mobilization, promote economic development, etc. However, the decentralization of fiscal authority should be carefully thought out to ensure that:

- the pursuit of stabilization policies is not compromised: for example, with extreme decentralization countries are known to have lost their ability to pursue efficient stabilization policies - Brazil, Argentina, Nigeria, Yugoslavia (Shah 1991);

- the ability of the government to pursue redistributive policy is not reduced; and

- the production of national public goods is not ignored.

The general opinion is, therefore, for the central government to take over nation-wide responsibilities such as stabilization, redistribution of income and the generation of national public goods but to leave to local jurisdictions the freedom to carry out government functions of particular interest to the individuals who live in those jurisdictions. The less the spillover the policies generate outside the jurisdiction, the more they should be the responsibility of the jurisdiction (Oates 1972; Shah 1991). In developing countries like Ethiopia, where economic structures are less diversified, and thus more prone to international fluctuations in commodity prices, natural disasters, wars, world-wide recession and the like, the stimulation of stable economic growth and the attainment of distribution goals would be a major preoccupation of the central government.

If the theoretical considerations warrant that macroeconomic management be carried out by the central government, the conditions for an effective implementation of such functions crucially depend on the central authorities' ability to exert control over key policy instruments of fiscal and monetary policy, i.e., taxes, public spending, borrowing and the aggregate money supply. Since taxes, public spending and the money supply are important determinants of economic activity, the central government should have flexibility to be able to alter any of these variables as the state of the economy requires. That is to say, it should have some degree of control over taxes, public spending and borrowing to effectively implement fiscal and monetary policies.

Decentralization involves the whole spectrum of expenditure powers to be transferred to local authorities, tax assignment from the centre and transfers from the centre to the regions. The efficiency of the government's fiscal policy, on the other hand, depends on how much of the taxes and public spending is commanded by the central government. The central government's control on these depends on whether regions support themselves or require deficit financing, with effects on the overall government budget. The essential requirement is that the correspondence between regional expenditure responsibilities and overall regional resources be ensured. The experiences of other transition countries have shown that, with fiscal decentralization, the expenditures of regional governments increase relative to those of the centre, because benefit considerations dictate that many expenditures are made by the regions (Bird and Wallich 1993). Typically, expenditures such as those on schools, hospitals, urban infrastructure, etc. are usually assigned to the regional level. Thus, governments should determine the actual costs of providing these services and design a system of tax assignments, shared taxes or transfers that provide for sufficient revenues to meet the assigned expenditures while at the same time meeting macroeconomic objectives.

The macroeconomic management policies of the central government may be compromised if the regional expenditure needs and revenue flows (including transfers) are not well matched. Since the regional government would be left with inadequate resources to provide needed services, it might resort to 'coping mechanisms' to permit services to be delivered where otherwise they could not be provided.

These may include shifting public budgetary outlays to enterprises owned by the regions, resisting privatization of enterprises that provide social services, and encouraging government enterprises to borrow or accumulate arrears in order to be able to continue providing services, establishing extra budgetary funds that make the budget less transparent.

These coping mechanisms surely threaten macroeconomic stability, since they limit the central monetary authorities' control over the public debt and deficit. Macroeconomic stabilization and the containment of inflation are major objectives of economic policy. Expenditure/revenue mismatch, if allowed to persist, can lead to the accumulation of expenditure arrears, delayed tax remittance, borrowing from banks and enterprises, and development of extra-budgetary resources by the regions. In particular, if regions and enterprises succeed in obtaining bank credit, the control of inflation and monetary management will be seriously undermined.

To sum up, there are clear advantages to be reaped from fiscal decentralization in terms of efficiency gains and promotion of economic development so that there should be a sharing of fiscal powers. Further, in the division of powers between the central government and the regions, macroeconomic management should be primarily the function of the former. However, for the effective implementation of macroeconomic management the central government requires some degree of control over the tax system, the allocation of spending and monetary variables. The pattern of taxes and spending and other monetary variables should be designed in such a way that it will not only meet local needs but also be consistent with efficient macroeconomic management. An examination of the new move towards fiscal decentralization in Ethiopia will be made below to see how it can affect the conditions for macroeconomic management by the central government. Before this is done, however, the next section will outline the proposed institutional changes with a view to offering an insight into the way the two levels of government can interact on issues of macroeconomic management.

III. The Institutional Setting for Fiscal Decentralization

A series of proclamations (TGE 1991, 1992b, 1992c, 1992d) put out by the government lay the basis for a new fiscal relationship between the central government and the regions. The first, the charter of the transitional government of Ethiopia, which affirmed "the rights of nations, nationalities and peoples to self determination and to determine their own affairs by themselves", provides the legal umbrella for the decentralization of power in the country. The next proclamation, No. 7/1992, provides for the setting up of regional self-governments with extensive powers in the areas of finance, taxation and borrowing, which have been traditionally the domain of the central government. Proclamation No.33/92 further elaborates on the nature of the envisaged decentralization, the framework for revenue sharing, and arrangements for grants to, and borrowing by, the regions. Finally, Proclamation. No.41/1993, dealing with the allocation of powers and duties between the executive organs of the central government and the regions, defines the regions' authority with regard to the preparation of budgets and the collection of revenue.

The new arrangements implied by these proclamations call for two layers of autonomous governments, the central government and the regional governments. Although, according to the proclamations, there are to be zonal and woreda governments, pending the establishment of these tiers, this description of centre-region relationships is only with respect to the above two. The attempt is to offer some insights into the way the two levels of government can interact on issues of macroeconomic management.

A. Fiscal Relationships

The most significant outcome of the decentralization measures shown in the legal arrangements is in the area of fiscal relationships between the two levels of government. These relate to the distribution of taxing power, the distribution of expenditure responsibility and transfers between the two levels of government, and are treated separately below.

1. The Distribution of Taxing Power

Under the new system there is to be a remarkable transfer of tax assignments from the central government to the regional governments. Proclamation No.7/1992, which provides for the establishment of national/regional governments, involves a drastic change in the allocation of taxing power from the centre to the regions since it confers on these governments the authority to levy dues and taxes, and to issue laws relating to sources of revenue (TGE 1992b).

The transfer of taxing responsibilities is perhaps best shown by the changes indicated in the proclamation on revenue sharing (TGE 1992c), which gave the regions the right to collect certain taxes and to share others with the central government. The revenues that are to be collected by the regions include: agricultural income tax on unincorporated farmers; rural land use fees; profit and sales taxes on individual traders; taxes on income from inland water transport; taxes from rents on region-owned and private properties; profit and sales taxes on enterprises owned by regions; income taxes on regional government employees and on most private enterprises and enterprises owned by regions; income taxes, royalties, and land rents from small-scale mining operations; and charges and fees for their licenses and services.

In the old system the central government levied all taxes on personal income, which have now partially been transferred to the regions and are expected to be a major source of regional revenues (IMF 1993). Other changes characterizing the new division of taxing powers include the right of regions to share with the centre the following joint revenues: profit, sales and personal income taxes from enterprises owned jointly with the centre; profit, dividend and sales taxes from private incorporated enterprises; profit taxes, royalties and land rents from large-scale mining, petroleum and gas operations; and forest royalties.

Revenues from these sources would be collected by the central government, though responsibility for collection can be passed to the regions. Modalities of apportionment of these joint revenues are still to be worked out.

Revenues to be specifically collected by the central government include the following: taxes on imports and exports; personal income tax on employees of the central government and international organizations; taxes on profit, personal incomes and sales originating from central-government-owned enterprises; taxes on lotteries; taxes on certain types of transportation; taxes on rents on houses owned by the central government; and fees and charges on services provided by the central government.

The laws clearly set the principles for regional devolution of tax collection authority. The categorization of tax sources into those to be collected by the regions, those to be collected jointly and those to be collected by the centre, appears to be standard. However, certain problems remain.

The regions' powers of collection of revenues appear to be limited. The determination of tax bases and rates both for taxes reserved for joint use by the central government and the regions and those exclusively reserved for the regions is to be made by the central government. Regions have not only been denied powers in the determination of rates but are also not allowed either to introduce new taxes or raise rates on existing ones. The proclamation refers to the need for the tax systems to have "unified policy base" and that the Ministry of Finance will ensure that tax laws issued at both levels adhere to this (TGE 1992b).

Although the proclamation implies that there will be tax sharing between the two levels of government, the criteria and means of sharing are not specified. As the experiences of other countries show, these are quite complex, and usually impose conditions on the use of the funds, and attempt to address multiple objectives beyond tax sharing, for example, fiscal equalization, regional development, etc.

The implementation of revenue sharing can thus be problematic, pending the elaboration of modalities and the determination of a formula. The proclamation refers to the establishment of a "committee" for the purpose and does not refer to the intricacies involved in the sharing formula. Therefore, allocations may not result in immediate yields, pending the institutional arrangements for the collection of taxes, especially for joint taxes. At any rate, the revenue sources reserved for the regions appear to be inadequate, given the structure of the Ethiopian revenue system. Although income taxes and agricultural income can be new sources of significance, the more productive taxes still remain with the central government.

By requiring central government approval of regional budgets, and the regulation of tax administration, and the general absence of a mechanism through which local governments share in revenues, the law also implies continuation of central government control in tax administration. Under the circumstances, where the allocation of revenue sources is not accompanied by a relaxation of central government control over tax collection and administration, there is little to be gained in terms of higher revenue for regions.

As Table 1 below shows, no immediate change in revenue shares is expected. The share of regional revenues in total revenue budgeted for Ethiopian Fiscal Year 1993/94 at 21% does not show increases from its historical levels. In fact, the central government's share of government taxes remains high, showing that the most productive sources of revenue still remain under central government control.

Table 1: Tax Revenue Collection by Level of Government (million birr)

Year	Central Gov't	Share [%]	Regions	Share[%]	Total	Percent
1985/86	1855.9	73.9	655.5	26.1	2511.4	100
1986/87	2299.7	81.5	515.2	18.3	2815.0	100
1987/88	2407.7	71.3	971.8	28.7	3379.5	100
1988/89	2363.0	71.8	968.1	28.2	3331.1	100
1989/90	2051.8	68.3	952.3	31.7	3004.1	100
1990/91	N.A.	N.A.	N.A.	N.A.	2703.7	100
1991/92	N.A.	N.A.	N.A.	N.A.	2370.0	100
1992/93	2719.2	85.9	444.8	14.1	3164.0	100
1993/94	3129.9	79.5	806.3	20.5	3936.2	100

Source: Ministry of Finance

N.B. Figures for 1985/86 to 1989/90 are adopted from Tesfaye Andarge "Study on Likely Revenue Sharing Under Federal Administration in Ethiopia", Amharic, Tir 21, 1984.

Figures since 1990/91 are budget figures.
N.A. = not available

Thus, although the move could no doubt contribute to strengthening regional authority, the extent of revenue collecting authority has to be clearly defined. There appears to be further need to expand tax sources for the regions and rationalize the revenue sharing arrangement.

Given this state of affairs, maximum gains from a decentralized regional fiscal government structure can only be made if there is some local discretion in shaping the budget and setting tax rates. This would allow for the expansion of services in regions and the building of an efficient tax administration with taxing powers adequate to capture a significant portion of income growth in the regions.

2. Expenditure Responsibility

The old system featured a rigidly centralized system of public spending authority in the hands of the central government. Even functions of a purely local nature such as rural infrastructure and education were financed and carried out from the centre. In marked contrast to this, the new arrangement calls for the transfer of expenditure responsibility to the regional governments in a way consistent with the decentralization trend noted earlier.

The basic devolution law (TGE 1992b) provides for the transfer of extensive responsibilities to the regional governments, including the power to prepare, approve and implement their own budgets, both operating and capital. This responsibility is further elaborated by another law on the functions of ministries and bureaus (TGE 1992d), which states that each regional finance bureau is charged with preparing a consolidated annual budget for its region. Other responsibilities transferred to regions by this proclamation include establishing, directing and supervising social and economic development; establishing enterprises; administering, developing and protecting their natural resources; establishing and directing regional security and police forces; owning properties of the regions; owning property and transfer of property; and performing all other matters not reserved for the central government.

The responsibilities reserved for the central government are conventional and comprise defense, foreign affairs, economic policy, conferring of citizenship, declaration of state of emergency, development of the army, printing of currency and undertaking major development establishments such as communication networks. As shown in Table 2, the budgets for 1992/93 and 1993/94 indicate the government's determined move to decentralize expenditure responsibility to regions. Although the central government still claims the lion's share of expenditures, regional shares in expenditure are planned to rise from less than 26% a few years back to 37 %.

However, the effective transfer of expenditure responsibilities, and subsequent efficiency gains from this depend on a number of factors. In particular the arrangements for revenue sharing and transfers should address the issue of how to effectively carry out the proposed transfers of spending assignments to regional governments. The regions should have sufficient revenues under their control and be free from undue central government control, with flexibility in the allocation of resources. These controls come in the form of central government approval of budgets, and regulation of tax administration. The previous section indicated the inadequacy of revenues allotted to regions and the lack of detailed mechanisms for transfer. Through ad hoc administrative decisions, moves were made to pass operational responsibility for capital expenditure to regions during the last quarter of fiscal year 1992/93. This was followed by the transfer of the recurrent budget in the current fiscal year 1993/94 (Melaku 1994). Current indications are that the process is slow, pending elaboration of detailed arrangements and the readiness of the various

Table 2: Expenditure by level of Government (million birr)

Year	Central Govern-ment	Share [%]	Region	Share [%]	Total	Percent
1985/86	1765.1	74.4	6070	25.6	2372.0	100
1989/90	3023.0	78.9	808.5	21.1	3831.5	100
1991/92	N.A.	-	N.A.	-	4651.7	100
1992/93	N.A.	-	N.A.	-	5931.9	100
*Recurrent	2088.5	66.0	1075.5	34.0	3164.0	100
*Capital	N.A.	-	N.A.	-	N.A.	100
1993/94	5302.6	62.8	3144.5	37.2	8447.1	100
*Recurrent	2889.6	62.8	1710.4	37.2	4600.0	100
*Capital	2413.1	62.7	1434.0	37.3	3847.1	100

Source: Ministry of Finance and Tesfaye Andarge, *op-cit.*
N.A = Not Available

regions to assume such responsibilities. In fact, the general perception is that it will be some time before the decentralization of expenditure assignments will result in corresponding improvements in services and development in the regions.

3. Fiscal Transfers

If the revenues from the assigned and shared taxes, and the financial outlays associated with the expenditure responsibilities, are not likely to be compatible for the different levels of government, inter-governmental transfers will have to play an important role in the arrangement. As Shah has elaborated (Shah 1992), properly designed transfer systems can support important macroeconomic management objectives. They can be used to bridge fiscal gaps, ensure minimum standard of public service across the nation, create a common internal market and achieve stabilization objectives.

There can be different mechanisms of transfers such as tax transfers and grants (which can be general or specific) which can be applied depending on the objectives sought (Eshetu 1993). The important requirement for our purposes is that they be tailored in such a way that they give the central government enough leverage to control regional spending for macroeconomic management purposes, while at the same time giving due regard to regional needs and priorities.

According to the proclamation on revenue sharing (TGE 1992b), the objectives of transfers include the prômotion of regional social services and economic development, developing formerly neglected regions narrowing regional income disparities, fostering interregional cooperation, and promoting projects earning foreign currency.

These objectives are broad. It is also not yet clear whether grants are to be provided for specific purposes and projects or whether general subsidies are to be provided on the basis of overall budgetary requirements. As Table 3 below shows, regions are expected to face a huge fiscal gap. This imbalance is due to the expenditure-revenue assignments described earlier.

Although transfers are expected to play a major role in the decentralization process and in the effort to meet the government objectives of ensuring a common minimum standard of public service, promote regional development and narrow interregional differences in growth, the arrangements provided for in the proclamations, particularly with respect to grant design and the choice of grant instruments, are severely deficient.

However, because of the effects of transfers on policy objectives such as allocation efficiency, distributional equity and macroeconomic stability, the design of an appropriate system of transfers is essential to any decentralization strategy.

Table 3: Revenue, Expenditure and Surplus/Deficit/ of Regions (million birr)

YEAR	REVENUE	EXPENDITURE	Surplus/Deficit
1985/86	655.5	607.0	48.5
1989/90	968.1	808.5	159.6
1991/92	N.A.	N.A.	N.A.
1992/93	444.8	-	-
1993/94	806.3	3144.5	(2338.2)

Source: Tables 1 and 2
N.A. = Not Available

B. Monetary Policy Aspects

Another area in which the two levels of government may interact is in the area of monetary management and banking. In the examination of the macroeconomic implications of the new intergovernmental relations, issues of monetary arrangement and banking should be considered. This is because, even with generous transfers, regions may still require additional financial resources to meet their expenditure requirements, so that they may need to borrow. However, borrowing, both domestic and foreign, by regions can have serious implications for stabilization and macroeconomic management policies of the central government. It is important, for example, to ensure that foreign borrowing by regions, if allowed, is consistent with balance of payments and stabilization objectives. Likewise, regional credit requirements should be consistent with overall credit expansion and stabilization objectives. In short, the central government's control over credit expansion and monetary management should not be compromised by the move towards regional autonomy.

The central government should develop appropriate policies to ensure that financial discipline of regions, particularly as concerns borrowing by regions, does not negatively influence the overall financial condition of the country.

As indicated earlier, the heavy responsibility for expenditure entrusted upon regions, in relation to the revenue they collect will make them heavily dependent on transfers from the central treasury, foreign loans and grants and/or domestic borrowing, as shown in Table 4 below.

Table 4: Central & Regional Governments: Revenue and Expenditure Allocation, F.Y. 1993/94 (million birr)

	INCOME		EXPENDITURE		DEFICIT
	REVENUE	Loan & Assistance	Recurrent	Total	
Grand Total	4742.4	4833.9	4600.0	8447.1	+1129.2
Central Gov't.	3936.1	4270.9	2889.6	5302.6	+2904.4
Regional Gov't. Total	806.3	563.0	1710.4	3144.5	1775.2
Tigray	57.4	51.9	122.4	279.9	180.6
Region 2	7.7	19.0	39.5	113.7	87.0
Region 3	113.4	163.8	360.4	697.0	419.8
Oromiya	185.7	140.3	562.6	882.1	556.0
Region 5	31.1	25.8	63.9	137.3	80.4
Region 6	4.6	12.1	38.2	85.6	68.9
Southern Eth.	82.9	54.3	279.0	471.7	334.5
Region 12	2.6	10.1	27.9	65.1	52.4
Region 13	18.9	0.6	22.4	25.4	5.9
Region 14	278.3	82.4	169.4	357.2	+3.5
Dire Dawa	23.8	2.7	24.8	29.6	3.1

Source: Transitional Government of Ethiopia, *1986 Fiscal Year Budget Proclamation* (Draft), Hamle 1985, Addis Ababa.

It is clear from Table 4 that not even the relatively well endowed regions can generate a current budget surplus. Provision for deficit financing will therefore be crucial for regional autonomy and macroeconomic management.

The deficit requirements of the regions can be met from external sources or from domestic borrowing. Since the central government maintains control over the negotiations and disbursement of external loans and grants, regions have not been given the power to contract loans and grants. These are to be channelled to the regions through the central government. The revenue sharing law also reserves the right to hold and administer foreign currency in the hands of the central government. There exists an elaborate budgetary process through which resources from external loans and grants and foreign exchange are allocated and approved. The central government thus maintains firm control over external borrowing and foreign exchange management.

With respect to domestic borrowing, however, the situation is less clear and requires caution if potential adverse effects of excessive regional domestic borrowing for monetary and inflation control are to be avoided. Again, as part of the budgetary process, regions are expected to submit their borrowing requirements to the central authorities, presumably to be made consistent with the national borrowing limit and other macro targets. Both proclamations 7/1992 and 33/1992 recognize monetary policy to be the exclusive domain of the central government, allowing it to retain the power of coinage and currency and the overall regulation of the banking and financial system. They also empower the regions with the authority to borrow. The latter law also elaborates on the procedures for domestic borrowing, viz:

- Regions apply to the ministries of Finance (MOF) or Planning and Economic Development (MOPED), as appropriate, with justifications and proof of ability to pay.

- The relevant ministry studies the application in relation to general economic indicators and the overall budget.

- The relevant ministry decides on the amount each region may borrow, which is to be within the national limit.

- The relevant ministry transmits the decision to the National Bank of Ethiopia (NBE) and regions.

The loan requests to be submitted to the ministries of finance and planning should specify the required loan amount and must be supported by regional revenue forecasts and other relevant economic indicators, together with feasibility studies of projects to be undertaken. A decision is then made after evaluation of the applications, taking into consideration the debt repayment capacity of regions and the impact of the regions' borrowing on the overall national deficit.

For purposes of macro management, and in particular for ensuring the consistency of credit expansion with stabilization objectives, the stringent conditions imposed on domestic borrowing may be appropriate. Moreover, the mechanism should encourage regions to opt for self-initiated development projects while at the same time moving towards efficient economic management.

There are, however, many aspects of the new arrangement that would have implications for the conduct of monetary policy by the central government, and would need to be refined with further decentralization.

It is not clear from the proclamations whether the loans would be finally made available by the NBE or passed to other banks and other financial institutions. The arrangements as contained in the proclamations appear to preclude direct borrowing from the central bank by regions. Thus, the borrowing requirements of the regions can only be part of the central government's borrowing for deficit financing, indirectly transferred to regions as subsidies. Considering the legal ceilings to be enforced by the new banking proclamation (TGE, 1994) and the targets to be met under the stabilization program, the room for such borrowing is small.

In the same way, direct borrowing from regional branches of banks for the purposes of deficit financing is not allowed. In the case of enterprises operating in regions, however, it is expected that the same rules and regulations applying to other commercial entities are applied. Here again the capacities of regions in preparing and implementing viable projects would delay implementation. Stricter guidelines and supervision of banks by the central authorities are warranted.

Under the circumstances, the regions' access to borrowing, especially bank credit, does not appear to be immediately realizable so as to threaten macroeconomic stability. With further decentralization and a growing need to meet regional requirements for borrowing, there should be clearer mechanisms of borrowing.

Related to this is the need to clearly define the status of relationships between banks in the regions and financial operations of enterprises and governments in the regions. Although the budgetary process, which gives the central government authority to review regional budget submission and reporting requirements, can help to contain it, delayed action on this front can be a source of macro instability. This has been the experience of many other countries, especially economies in transition (Bird and Wallich 1993).

To sum up, although regions have been given extended responsibilities for the provision of essential services and socio-economic development in their respective regions, the arrangements for financing them (revenue sharing, transfers and borrowing) need further refinement if they are to provide them with sufficient revenues to allow regions meet expenditure responsibilities assigned to them. Meanwhile, as the system is evolving, it is important at the same time to ensure that the macroeconomic management policies of the central government are not compromised.

III. Implications of Fiscal Decentralization for Macroeconomic Management in Ethiopia

The attempt to decentralize fiscal authority, and fiscal reform in general, is taking place parallel with moves to strengthen the overall macroeconomic position and the central government's fiscal position as part of the on-going economic reform programme (TGE 1992a). For this reason, due regard should be given to the appropriateness of the proposed region/centre fiscal and monetary relationships. In particular, the implications of the evolving centre-region relationships in fiscal and monetary management for growth, income distribution, and stabilization should be considered.

The significance of the evolving centre-region fiscal relationships for macroeconomic management can be seen from three angles:

1. Effect on growth, i.e., whether the revenue sources assigned to the regions would be adequate to allow them to discharge their functions. In particular, it is important to know whether they would be able to meet their goals of regional development, the provision of goods and services, etc.

2. Effect on stabilization/distribution, i.e., whether the tax expenditure assignments are such that the central government's roles in redistribution and stabilization are not compromised.

3. Effect on inflation control, i.e., whether or not the decentralization of taxing/expenditure authority to regions results in significant reduction in the central government's grip on monetary and inflation control.

This section attempts to examine how the move towards a new system of interregional fiscal relations would be expected to affect the conditions for macroeconomic management in Ethiopia. Since fiscal and monetary policies are the cornerstones of macro economic management, the central authorities' control over key fiscal and monetary variables is considered to be crucial.

A. Implications for Growth

The implications of the new fiscal relationships for growth emanate from the responsibilities entrusted upon the regions by the decentralization legislation. The regions have been entrusted with responsibility for the provision of goods and services of particular interest to them and in which they had very little role in the past. They are to provide health and education services, build roads, establish and manage industries, provide housing and other amenities, and exploit indigenous resources. A pertinent question thus relates to the extent to which the evolving fiscal arrangement and institutional capacity could allow this.

The arrangements proposed show that regional expenditures are to be met through revenue sharing, central government transfers, external loans and grants channelled to regions through the budgetary process and/or domestic borrowing by the regions. With respect to revenue sharing, it was shown that although tax assignments have been made, the sources left to regions appear to be less productive, so that their overall share in total government revenue could be little changed from its historical level. Moreover, the extent of the regions' involvement in tax base and rate determination, and in tax collection has been restricted. The latter is further exacerbated by the lack of trained and experienced manpower in the regions to allow them reap maximum gains from decentralization by building an efficient tax administration capable of capturing tax potential in regions. Thus, anticipated revenue from the tax assignments falls far short of the heavy expenditure responsibilities of the regions.

Transfers from the central government are thus expected to have a prominent place in the arrangement. Here again much needs to be clarified - the sources of transfers, (taxes or others) and the nature of transfers (general grants or specific project-related grants).

Moreover, the transfers are to be obtained under tight financial conditions and rigorous appraisal by the central authorities. All said and done, the effectiveness of this source of regional revenue in meeting the objectives for which it is to be granted (i.e., in promoting regional social services and economic development, advancing previously neglected regions, etc.) is yet to be seen. In fact, the 1993/94 budget did not include provisions for such transfers.

B. Implications for Distribution and Stabilization

The government implements its goals of income distribution and stabilization through changes in tax rates and bases. Thus the implications of the proposed changes in fiscal relationships for income distribution and stabilization depend on the extent of central government control over tax rates and tax bases for the purposes of enforcement of fiscal policy.

Section II above has shown that important moves have been made towards a more decentralized system of tax assignments, with a substantial transfer of taxing powers to the regions than has been the case hitherto. It has given regions the power to levy new taxes and share others with the central government. The basic question that arises here is whether these assignments can be consistent with macroeconomic management objectives. Can they advance a national policy of redistributing income through the use of the tax system? Do they give due regard to the public sector's role of stabilizing the economy through the use of the tax system? Do they result in raising higher tax revenues? As noted earlier, the division of taxing responsibilities and bases appears to follow normally accepted criteria. Thus, duties and taxes on imports and exports, which are always collected by national governments to reduce the possibility that major distortions are introduced within the country by differential foreign trade taxes imposed by different regions, have been assigned to the central government.

Income taxes have been divided into two: those from central government employees and those from regions. Considering the stage of development of Ethiopia, and given that personal incomes taxes are schedular, the transfer to regions may be appropriate. However, as the country becomes more developed and people earn different incomes which may also be from different regions, there will be need to make this base global and apply it at the national level. However, for the time being the retention of personal income taxes and corporate income tax by the national government should also facilitate redistribution and stabilization policies of the government. Taxes on land and property are appropriately left to regional authorities.

Sales taxes have also been divided into two: those from central-government-owned enterprises and those from regional-government-owned enterprises. As long as highly differentiated rates are not in force, this is also an appropriate arrangement. Thus, in general, the new fiscal arrangement, though it may not result in significant taxing authority for regional authorities, leaves substantial discretionary power in the hands of the national government to enable it play its income redistribution and stabilization roles. The new arrangement does not involve a reduction in the effective use of changes in tax rates and bases as a means of implementing macroeconomic management.

On the other hand, the most important tax sources still remain in the hands of the central government, and this has raised the question of whether sufficient devolution has been undertaken (Melaku 1994). As the system is just evolving, detailed mechanisms and modalities of operationalizing the assignments are also lacking. However, as details are being worked out, there is a need to make them consistent with the overall macro objectives and policies. In particular, it will be useful, as stated in the proclamation, to ensure consistency within the tax system and to follow a unified policy in order to avoid cascading and permit harmonized implementation. The Ministry of Finance's reported (IMF 1993) distribution of "fiscal policy studies and directives" would be a useful move towards this end. Pending clarification of these issues, the partial undermining of national policies by regional governments, non-cooperation or even inaction by lower levels of government, which can be considered as possible outcomes, should not be allowed.

With respect to expenditures, it is noteworthy that the redistribution of responsibility from the national government to regions envisaged by the new arrangement is substantial. In the budgets for fiscal years 1992/93 and 1993/94, it was estimated that 34% and 37% respectively of public expenditures were to be handled by regional governments, with 66% and 62%, respectively, left under central government control. This is a marked reduction from the historical share of the central government (over 75%) in total expenditure (Table 2) in favour of regional governments. Nevertheless, to the extent government uses changes in expenditure as an instrument of stabilization, this is still a comfortable share for the purpose.

However, the share of total public expenditure under the control of the central government is just one factor to be considered when assessing the effectiveness of changes in government spending as an instrument of macroeconomic stabilization. Another relevant issue to be examined is the question of to what extent the lower levels of government are prepared and able to react to the changes that have placed the heavy burden of government expenditures on their shoulders. As indicated in the previous section, the effectiveness of the decentralization of fiscal responsibilities in meeting desired objectives depends on the preparedness of regions, in terms of skilled manpower and institutions, to be fully operational. Preliminary outcomes for the current year's budget indicate a much lower regional expenditure performance. Meanwhile, the new framework has not made it any difficult for fiscal stabilization and other macro policies based on changes in government expenditures to be an effective policy instrument of the central government.

IV. Implications for Monetary Policy and Inflation Control

In discussing fiscal decentralization, it is important to consider how such a move would affect the ability of monetary authorities to effectively control monetary aggregates, and hence its ability to conduct sound monetary policy. NBE's control over monetary management is not to be changed by the new arrangement. In fact, the new Monetary and Banking Proclamation (TGE 1994) is aimed at strengthening the autonomy of the bank in matters of monetary management. However, the new system has not ruled out problems in this area, especially in view of the anticipated dependence of regions on the central authorities for meeting their imbalances.

The new arrangements imply higher expenditures by the regions than revenues to be collected. The conduct of monetary policy will thus be made difficult if the NBE is to be made the sole source of transfers to meet regional deficits. The situation will be exacerbated if there is to be direct borrowing from local branches of banks.

The borrowing of regions will be determined, as part of the budgetary review exercise, at the centre by MOF and MOPED, which will determine regional borrowing requirements, presumably after consideration of national borrowing limits. This may also mean that direct borrowing from local branches of the Commercial Bank of Ethiopia (CBE) will not be allowed. At any rate this needs to be clarified.

In many countries, local jurisdictions are not allowed to engage in deficit financing and are required to balance their budgets annually. In other words, they cover their expenditures out of their own current revenue and transfers from higher levels. The only exception is in the case of large and productive capital projects, where some borrowing might be allowed.

There must therefore be a hard budget constraint applied to regional governments so that their budgets are balanced. Recourse to coping mechanisms should also be discouraged. Central authorities should have mechanisms to monitor these for the effective conduct of monetary policy.

The law (TGE 1992c) requires regions to submit periodic reports on revenue and expenditure. Central accounting and auditing practices are also being transferred to regions to ensure against the overdrawing of revenue accounts or the running up of arrears.

V. Conclusions and Recommendations

This paper has attempted to analyze how the conditions for sound macro-economic management can be affected by the new fiscal management that seeks to devolve substantial fiscal powers to the regions. It showed that substantial changes have been put on the ground, though major moves at refinement are to come, especially with regards to modalities and mechanisms of implementation.

The legal basis for fiscal decentralization has been laid, involving the transfer of significant expenditure responsibilities and taxing powers to regions. The distribution of different taxes into centre, region and joint responsibilities appears appropriate and should not impair the central government's use of these for purposes of stabilization or income distribution goals. Likewise, to the extent the government uses changes in expenditure as instruments of macroeconomic policy, the transfer of expenditure responsibilities does not imply immediate loss of control by the central government for the purpose.

However, the regions' powers in the collection of taxes and in the determination and enforcement of rates for taxes allocated to them are heavily restricted. The mechanisms for sharing are also not known. At the same time, since most productive taxes may have remained with the central government, and the mechanisms for inter-governmental transfers and grants are yet to be elaborated, the regions' abilities to meet the heavy responsibilities entrusted to them become doubtful.

It appears that extended expenditure responsibilities have been assigned to regions without adequate arrangements for effectively carrying out the assignments through tax sharing and transfers. The room for domestic borrowing is also limited. As regions are strengthened and required to meet objectives set for them, their expenditures are expected to increase relative to those of the centre. Hence, the need to design a system of tax assignments, tax sharing, transfers and borrowing that takes into account the requirements of regions.

At the same time, note should be made of the fact that central government control of overall levels of expenditure, revenue and other monetary variables is an important element of successful macroeconomic policy. Although the ability of the central authorities to implement sound macro policies does not at the moment appear to be negatively affected by the changes, this cannot be ensured in the future. As the last section of this paper showed, inter-governmental fiscal relations have far-reaching implications for growth, stabilization and monetary management, the success of which can only be ensured with a degree of central government control. Thus, as the system develops, adequate mechanisms of control should be put in place.

This control should not be contingent on rigid centralization of fiscal activities as in the past, but rather on the adoption of appropriate policies that are consistent with macroeconomic goals as well as mechanisms of finance that provide appropriate incentives for control. The placement of an adequate system of inter-governmental relations to meet the major objectives of fiscal decentralization, resource mobilization, regional development, etc., while keeping consistency with macro objectives, is a difficult task . Meanwhile, the following recommendations seem to be warranted.

The assignment of expenditure responsibilities should be matched by adequate sources of revenue - tax shares, transfers and borrowing not only to avoid over-burdening regions with obligations beyond their means (thus limiting their abilities to meet the tasks assigned to them), but also to ensure the success of macroeconomic objectives. The regions' expenditure responsibilities should thus be determined in relation to revenues (tax shares, transfers, borrowing) that can be realized by them . This should also be related to the capacities of regions, in terms of manpower and institutions, to handle the expenditure assignments.

At the same time, the extent of the revenue-collecting authority of regions should be strengthened by allowing them to participate in the determination of rates and by giving them a greater role in budget preparation and tax collection and administration. An appropriate transfer system should be designed not only to fill part of the expenditure/revenue gap that would allow regions meet their objective but also ensure the achievement of macroeconomic goals.

Given that regional government and enterprise recourse to borrowing from the banking system, both for deficit financing or undertaking capital projects, is going to be inevitable, especially with further decentralization, there will be need to develop detailed criteria for borrowing by regions from the central government and the banking system through regulation and monitoring of lending by the banking system. Measures in this respect should take note of reforms in the financial sector and monetary management that ideally require hard budget constraints for region and enterprise borrowing, overall supervision of the banking and financial system and the periodic reporting of the revenue-expenditure and financial operations of regions.

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