

Bevan, David L.

Working Paper

The fiscal dimensions of Ethiopia's transition and reconstruction

WIDER Discussion Paper, No. 2001/56

Provided in Cooperation with:

United Nations University (UNU), World Institute for Development Economics Research (WIDER)

Suggested Citation: Bevan, David L. (2001) : The fiscal dimensions of Ethiopia's transition and reconstruction, WIDER Discussion Paper, No. 2001/56, The United Nations University World Institute for Development Economics Research (UNU-WIDER), Helsinki

This Version is available at:

<https://hdl.handle.net/10419/52939>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.



United Nations
University

WIDER

World Institute for Development Economics Research

Discussion Paper No. 2001/56

The Fiscal Dimensions of Ethiopia's Transition and Reconstruction

David L. Bevan*

August 2001

Abstract

In 1991, the new Government of Ethiopia faced a triple fiscal challenge. First, a major effort was required to overhaul and modernize the tax system. Second, the need to switch expenditure from military to civilian uses had to take place within a potentially severely reduced resource total. The severity of the general financing problem was however ameliorated by a rise in aid flows. Third, there was the political imperative to press on with the process of fiscal decentralization that was the necessary accompaniment to political decentralization. .../...

Keywords: sub-Saharan Africa, Ethiopia, conflict, economic reform

JEL classification: O10, O55

Copyright © UNU/WIDER 2001

* University of Oxford, UK

This study has been prepared within the UNU/WIDER project on Underdevelopment, Transition, and Reconstruction in sub-Saharan Africa which is directed by Dr Tony Addison

UNU/WIDER gratefully acknowledges the financial contribution to the project by the Government of Italy (Directorate General for Development Cooperation), the Government of Sweden (Swedish International Development Cooperation Agency), and the Government of the United Kingdom (Department for International Development). These agencies are not responsible for any information provided or views expressed, which remain those of the authors alone.

The present government has, for the most part, been quite impressive in macroeconomic policy, fiscal reform and public expenditure management. It has embarked on a radical decentralization programme and an ambitious civil service reform. Its record on privatization has been mixed, and privatization has proceeded at a much slower pace than elsewhere in sub-Saharan Africa.

1 Introduction

Ethiopia clearly qualifies as an underdeveloped country undergoing a transition from state socialism while reconstructing a war-damaged economy. The country is one of the world's poorest and considerable pro-poor growth as well as pro-poor public spending will be needed to achieve significant poverty reduction. Extensive economic reform has been required to overcome the legacy of the Derg, including exchange rate reform and financial reform. Finally, substantial numbers of combatants had to be demobilized and reintegrated after the fall of the Derg in 1991. In these ways, Ethiopia shares some of the fundamental problems of the other countries discussed in the study. Moreover, the new war with Eritrea adds a new set of problems to the conduct of economic policy.

However, a number of special features characterize and differentiate the Ethiopian experience over 1991-98, and these have significant consequences, not least for fiscal developments which are the focus of this paper. These are discussed in section 2. Section 3 discusses their fiscal implications, particularly in the context of the shift from war to peace. Section 4 discusses fiscal choices from a macroeconomic perspective, given the need for reconstruction and the availability of large aid flows. Section 5 looks more closely at the move to fiscal federalism as a counterpart to political federalism, and discusses potential problems in the chosen design. Section 6 turns briefly to the political and managerial dimensions of these changes, and section 7 concludes by assessing the overall record since the Derg's fall.

2 Defining characteristics

Apart from being a large, complex and very poor country, Ethiopia has a number of special features. Although some of these individually have counterparts elsewhere, taken together they constitute a unique and characteristic combination. In this section, five of these features are highlighted.

The first feature is that, for many years prior to the coup in 1974 that led to the rule of the military (the Derg), Ethiopia had been governed by a series of emperors from the core territory of historic Abyssinia. The functioning of the state involved a powerful centre which controlled a set of peripheral territories that had little in common with each other, either economically or ethnically.¹ Equally significant, this feature was maintained following the coup. Therefore although there was a major shift toward state socialism, there was continuity in the high degree to which power was centralized.

The second feature is that the civil war which culminated in the overthrow of the Derg in 1991 was not a war between parties holding fundamentally different ideologies. Both the Derg itself and the insurrectionist parties in the North shared much the same ideological vision, and subscribed to a state-socialist perspective on the role of the state. Consequently, the end of the war did not in itself signal a switch away from Marxist-

¹ There are a number of excellent texts which cover the imperial and revolutionary periods, and the link between the two: these include Clapham (1988), Keller (1988), Bahru Zewde (1991), and Shiferaw Bekele (1995).

Leninist precepts. In fact, in 1990 the Derg had accepted the inevitability of increasing the role of market mechanisms and had moved some way to liberalize the economy (World Bank 1990); following its overthrow, there appeared to be a real possibility that these reforms would be aborted by the new regime. In the event, they were taken over more or less intact, and for much the same reasons. Therefore paradoxically, the process of economic reform pre-dated the change of regime, and its initial path was probably little affected by the change. Furthermore, the basic rationale for the reform probably remained one of practicality rather than any major intellectual conversion. The present government's view of land ownership (broadly that it should remain with the state) is a particularly acute illustration of this point (on the implications of state land ownership in Ethiopia see Daniel Ayalew, *et al.* 1999).

The third feature is that although the victors of 1991 may have differed from their predecessors relatively little in their economic ideology, they did represent a major change all the same, namely the victory of the periphery over the centre. In the case of the Eritreans, they had been fighting a war of secession for thirty years, or perhaps more properly a war of independence (see Hansson 2001). With the acquiescence of their principal partners from Tigray, this was indeed the outcome for them. For the Tigrayans, the position was radically different. During the civil war, they had been fighting to rid themselves of an oppressive regime, but had continued to see their future as lying within the larger Ethiopian State. In the short term, their victory over the Derg, coupled with the departure of the Eritreans and the disarray of political organization elsewhere in Ethiopia, enabled them to take over the centre and hence to govern Ethiopia as a whole. However, given their small numbers, and the very limited resource base of their region, it was unlikely that they could retain control indefinitely. One interpretation of the push towards ethnic regionalism is that it was conceived as a means of preserving the Ethiopian State while reducing the risk that the periphery would again in future become dominated by an over-mighty centre (on the alternative political trajectories of over-centralized states in Africa, see Addison 1998).

The fourth feature concerns the government's view of the political process. The recent experience of China has made it very clear that it is possible for a socialist regime to embrace far-reaching economic liberalization and to encourage market development without subscribing to a participatory democratic view of the political process. Similarly, regimes such as that governing Uganda have argued forcefully that attempting to develop multi-party democratic institutions is not only unnecessary as an accompaniment to economic reform in the style of the 'Washington Consensus' but may actually retard it (for further discussion of this issue see Addison 2001). In the case of Ethiopia, the government is controlled by the Ethiopian Peoples' Revolutionary Democratic Front (EPRDF), which had its origins as the command structure of a guerilla organization, not as a conventional peacetime political movement (also the case in Eritrea). This party now dominates the political process, and it is often difficult to see where the government ends and the party begins. This blurred edge is also increasingly apparent in the economic sphere, with the proliferation of businesses which are non-governmental, but which are controlled by or associated with party political organizations.²

² See the introductory paper by Addison 1998 on the implications of such 'straddling' for policy-making in Ethiopia and elsewhere in post-socialist Africa

The fifth feature is one that Ethiopia probably shares with most countries that have fought a protracted and damaging civil war. This relates to the scale and nature of any 'peace dividend' that it may be hoped will materialize upon the cessation of hostilities (Bevan and Pradhan 1994). The familiar argument is that if a substantial flow of resources (foreign exchange for munitions, manpower etc) is being devoted to fighting a war, then the end of the war will make these available for peaceful uses, and hence there will be a peace dividend. To the extent that wars are financed through the public purse, a substantial part of this dividend will be a fiscal dividend to government (on fiscal issues see Addison and Ndikumana 2001). However, civil wars may come to an end precisely because they have become unsustainable: they stop (or the incumbent loses) because there is no longer a sufficient flow of resources to permit them to continue. In the case of Ethiopia, this seems to have been largely the case, for at least three reasons. First, there was a sharp reduction in the flow of Russian munitions to the Derg as the cold war wound down. Second, the Derg found it increasingly difficult to maintain the very high rate of expropriation of resources through taxation of the population. Third, the government had run a very large domestic budget deficit throughout the 1980s and this also seemed unsustainable. In so far as there was any peace dividend, this was the greatly increased flow of civil aid that became available following the end of the war.

3 Initial conditions and fiscal implications

The initial condition and the evolution of the state in Ethiopia during the 1990s reflect this mixture of inheritances in respect of the economy, the structure of government, and the EPRDF itself. We may summarize the main characteristics of the situation as follows. The economy had a very low per capita income, and an infrastructure that had always been inadequate but had been further damaged by the war and by the depredations of state socialism. This damage certainly included physical infrastructure such as roads, bridges and the like, but it also involved institutional structures such as markets and regular economic migration. Private as well as public investment had been very low, so the overall productive capacity of the economy was probably deteriorating, even leaving explicit damage aside (Bevan 1994).

Ethiopia has also had a remarkably varied fiscal history, culminating in the later years of the Derg in a very high rate of resource extraction by the government, and a still higher rate of government spending (Bevan and Pradhan 1994). Explicit tax revenue had not been unusually high by the standards of SSA, but non-tax revenue had been very substantial and rising. This consisted largely of the residual surplus of public enterprises, unlike those in many countries on the continent (Mozambique, for example), where these organizations were more typically a serious fiscal drain on government. The true burden of government operations on the private sector was considerably higher than appears from the explicit budgetary figures, as there was also very substantial implicit taxation through various forced contributions (with very negative consequences for agriculture). Since many of these arrangements collapsed with the fall of the Derg, there was a sharp drop in both explicit and implicit revenues.

In consequence, the new government faced a triple fiscal challenge. First, a major effort was required to overhaul and modernize the tax system: however, it would have been inappropriate to try to rebuild revenue to its previous level, which had been excessive.

Nor was it appropriate to continue domestic deficit financing on anything like the previous scale.

Hence, second, the need to switch expenditure from military to civilian uses had to take place within a potentially severely reduced resource total. Compounding this, the new government was also faced with a major, and potentially expensive and disruptive demobilization requirement, involving both its own victorious guerilla forces and the defeated and largely conscript army of the Derg (see Daniel Ayalew, *et al.* 1999). The severity of the general financing problem was however ameliorated by a rise in aid flows.

The third component of the challenge was to some extent self-inflicted. This was the political imperative to press on with the process of fiscal decentralization that was the necessary accompaniment to political decentralization (Eshetu Chole 1994). The problem here is that the components of spending that have been devolved to the regional governments (notably education, health, agricultural roads and extension) are precisely those that need to be expanded relative to the rest. Therefore the devolution does not simply involve the transfer of known operations, but a simultaneous shift of what the responsibility is as well as a shift in who is responsible for it. This may all sit uncomfortably with the adoption of national sectoral programmes for education and health (see Bigsten 1999). However, since the vertical imbalance in the new fiscal federal structure (i.e. the shortfall between the extent to which spending has been devolved and the extent to which revenue has been devolved) is very high, the federal government can clearly enforce its view in the case of disagreement.

4 The macroeconomic perspective

In many SSA countries the macroeconomic perspective on fiscal issues has tended to divide naturally between a stabilization and a post-stabilization phase. The first phase is characterized by excessive fiscal deficits, a wide gap between official and parallel exchange rates, high inflation and flight from domestic currency. The required response has been a sharp reduction in the deficit, which has usually involved equally sharp reductions in government spending. Stabilization may or may not be difficult as a matter of practical policy, but it is at least conceptually straightforward. The post-stabilization phase may be less challenging politically, but it raises subtler questions concerning the appropriate scope and scale of government, as well as the best means of financing it.

Since the end of the war in 1991, Ethiopia has also been through a first phase and embarked on a second. However, although the second is somewhat similar to that sketched above, the first definitely was not. During the war, the Derg government had certainly run a very high fiscal deficit, and had financed this by all available means, which included substantial recourse to monetization. However, inflation was modest and there was little sign of the sort of flight from domestic currency that this might have produced elsewhere. Since private savings were low, this suggests a surprising willingness of Ethiopians to hold their restricted financial assets in cash. There was a large gap between the official exchange rate (2.07 birr/US\$) and the parallel market rate (over 7 birr/US\$) but this was a consequence of modest differential inflation over a quarter of a century, not of a recent history of high inflation (see also Addison and Alemayehu Geda 2001).

Table 1 provides summary statistics for the main fiscal magnitudes in per cent of GDP. To put the fiscal situation towards the end of the war in perspective, it is instructive to compare averages for five years before the end (1986/87-1990/91) with those for five years after (1991/92-1995/96). As a share of GDP, total revenue fell from 23.1 per cent to 17.7 per cent, with the domestic revenue component accounting for almost all of this decline, down from 19.7 per cent to 14.9 per cent. Total expenditure was cut from 30.2 per cent to 22.6 per cent, with the brunt of this being borne by recurrent spending (21.2 per cent down to 14.5 per cent). The fiscal deficit after grants fell from 7.1 per cent to 5.0 per cent. Although it is useful to summarize in this way, the averaging process conceals the fact that the initial drop in domestic revenue was much sharper—to only 10.6 per cent of GDP in 1991/92, and followed by a protracted recovery (12.0 per cent, 13.9 per cent, 17.2 per cent and 18.0 per cent) over the next four years. This type of rapid reversal of a revenue collapse is most unusual, and may be contrasted with the very slow rate of revenue recovery achieved in Uganda, for example. It may partly reflect the speed with which reforms were initiated, and the fact that the archaic existing revenue structure gave these reforms substantial leverage: it is a remarkable achievement nonetheless.

Table 1
Fiscal accounts (per cent of GDP)

	<i>Average</i> 1986/87- 1990/91	<i>Average</i> 1991/92- 1995/96	91/92	92/93	93/94	94/95	95/96	96/97
Total Revenue	23.1	17.7	13.2	13.7	17.4	20.3	20.7	22.3
Domestic Revenue	19.7	14.9	10.6	12.0	13.9	17.2	18.0	18.8
External Grants	3.4	2.7	2.6	1.7	3.5	3.1	2.7	3.5
Total Expenditure	30.2	22.6	20.2	19.6	25.0	24.7	22.5	22.8
Recurrent Expenditure	21.2	14.5	15.7	12.9	15.5	15.4	13.6	12.9
Capital Expenditure	9.0	8.1	4.6	6.7	9.5	9.3	8.9	9.9
Deficit before Grants	10.5	7.7	9.6	7.6	11.0	7.4	4.2	3.9
Deficit after Grants	7.1	5.0	7.0	5.9	7.5	4.3	1.5	0.3

Note: Averages are weighted, so do not correspond to simple average of annual figures.

Source: World Bank (1998).

Therefore there was a major fiscal adjustment, but unlike the usual stabilization story (where expenditure cuts, mainly of capital spending, reduce the deficit, given fairly stable revenue), what happened was a sharp reduction in domestic revenue, accommodated largely by reduced current spending, with the deficit cut only modestly. The composition of spending underwent equally dramatic shifts. Table 2 provides summary statistics for the shares of the main spending categories in the total. Again comparing five year averages, the share of defence fell from 30.8 per cent of the total to 10.8 per cent, the major beneficiaries being social services, which increased from 15.9 per cent to 23.6 per cent, and economic infrastructure (notably roads), up from 5.6 per cent to 10.8 per cent. The other major increase was in debt service, which rose from 4.8

per cent to 10.4 per cent, partly reflecting the devaluation of the birr. These changes were achieved remarkably rapidly, within a year or two of the war's end.

Table 2
Composition of total spending (per cent of total)

	<i>Average</i> <i>1986/87-</i> <i>1990/91</i>	<i>Average</i> <i>1991/92-</i> <i>1995/96</i>	91/92	92/93	93/94	94/95	95/96	96/97
General Administration	7.2	10.5	9.1	9.2	9.7	11.0	11.9	10.8
Defence	30.8	10.8	17.9	13.0	9.3	8.8	8.9	8.3
Economic infrastructure	5.6	10.8	4.9	8.5	11.9	13.1	11.9	13.7
o/w Roads	1.9	4.6	1.6	3.1	5.3	6.8	4.3	9.5
Economic services	24.4	22.9	20.2	26.7	22.3	22.9	22.4	24.3
o/w Agriculture	7.9	7.5	6.4	9.1	8.0	6.3	7.7	5.8
Social services	15.9	23.6	19.2	23.3	25.8	22.8	24.9	25.0
o/w Education	9.5	14.3	12.6	14.3	14.1	13.5	16.0	15.3
Health	3.3	5.2	4.5	4.9	5.3	5.1	5.5	6.2
Other	16.1	21.5	28.7	19.2	21.0	21.4	19.9	17.9
o/w Debt service	4.8	10.4	7.3	10.2	13.5	10.0	9.9	9.3

Note: Averages are weighted, so do not correspond to simple average of annual figures.

Source: World Bank (1998).

As noted earlier, it is common to talk about the existence of a 'peace dividend' and it may seem that this reallocation of resources from military to civilian uses is only what should be expected. However transfers on this scale are remarkably hard to achieve. To take Uganda as an example once again, the defence budget continued to increase its share of spending for five years after the end of the civil war before it eventually began to fall.

To summarize, the incoming Ethiopian government did not face a conventional stabilization problem, but it did face a major fiscal challenge both in terms of a short run revenue collapse and in the need to achieve a major shift in the composition of spending. It seems fair to say that it met both challenges in a most impressive manner. More recently, the fiscal deficit after grants has also been reduced to within 2 per cent of GDP.

Once the government had achieved the analogue, in the then Ethiopian circumstances, of stabilization, that left the question of what should the post-stabilization plan be? Apart from the government's fiscal activities, there had also been a programme of liberalization, privatization and the like. Partly in consequence of this, partly as a response to the new circumstances more generally, and partly because of benign climatic conditions, agricultural growth recovered from three decades of poor performance to grow through the 1990s at an average 5 per cent per annum. Growth in the economy as a whole reached 7-8 per cent before 1998. The question remains as to how much of this growth was simply taking up the slack left by the previous policy

regime (which had clearly been inimical to productive activity) and to what extent it is sustainable into the longer term.

There is evidently enormous scope for higher government spending in Ethiopia (see for example World Bank 1997, 1998). Consider the three key sectors of education, health, and roads. Education indicators are among the lowest in the world, with the primary enrolment rate for example averaging only 26 per cent. There is also huge variation between regions, with Afar achieving only 8 per cent relative to the 70 per cent of Addis Ababa. The same is true for health, with for example only one third as many primary health-care facilities as the SSA average, and for roads, whose density is only about half the (very low) regional average. Bigsten (1999) discusses sectoral spending priorities in more detail, and therefore we confine ourselves here to discussing the macro-economic dimensions of the fiscal issue.

Since the need is so high, there are then three considerations governing the level of expenditure that is prudent. The first concerns absorptive capacity. There have been concerns that the capital expenditure programme has been limited more by the capacity to use funds than by their availability. The second concerns the size of the actual and prospective 'resource envelope'. There is a case for saying that in a country as poor as Ethiopia, a domestic revenue yield of 17 per cent of GDP is as high as should be targeted: currently, it may be possible to sustain external grants at better than 5 per cent, making a total of 22 per cent.

The third consideration is the level of deficit financing which can be sustained (see the Addison and Ndikumana 2001 for a review of the issues). This has two components, domestic and foreign. Ethiopia is a highly indebted country, with external debt at about 70 per cent of GDP, and domestic debt at around 20 per cent. In normal circumstances, the appropriate level of deficit financing depends inter alia on the likely growth of the economy and on the inherited debt position. For a very poor, highly indebted country which is in line for debt relief (Ethiopia has qualified for debt relief under the HIPC initiative), the backward-looking stock position for external debt ceases to be relevant. Creditors reduce external debt service to a level which is deemed sustainable, and further debt may be incurred provided it is on sufficiently concessional terms. There is however no comparable mechanism for relief of domestic debt. Unless a government explicitly repudiates it, or does so implicitly via accelerated inflation, excessive domestic debt can only be reduced via a domestic budget surplus. If this domestic surplus is coupled with an external budget deficit, the government is effectively borrowing from the rest of the world to repay its domestic creditors. To summarize: as regards stocks, we are typically interested not only in aggregate government debt, but in how it is distributed between external and domestic creditors; and similarly, as regards flows, we are typically interested not only in the overall budget deficit, but in how it is distributed between external and domestic deficits.

On a forward-looking basis, an overall deficit of 2 per cent of GDP or so for a strongly growing country seems reasonably prudent. For Ethiopia, the Policy Framework Paper for 1996/97-1998/99 set a target external financing deficit of around 2 per cent of GDP, but saw this as being used to retire domestic debt. In other words, the overall target was fiscal balance, with the government's capacity to increase its external concessional borrowing being used entirely to reduce its domestic debt. The objective of reducing the government's dominance over domestic borrowing was certainly desirable, but restricting expenditures to the level at which all external borrowing would be deployed

for this purpose was probably excessively restrictive. In the event, the pressure to increase expenditures on sectors such as education, health, and roads threatened to derail this very prudent fiscal regime.

There is also the massive uncertainty arising out of the 1998-2000 war with Eritrea. Earlier hopes that this could be restricted to the level of skirmishes quickly evaporated. Apart from the wider damage, there is also a specific fiscal threat. The scale of the re-mobilization of the Ethiopian military is clearly very large and will be costly, though hard figures are currently unavailable. What is more, this increased fiscal burden may prove difficult to reverse within a reasonable time-scale, with a heavy cost to the evolving social programme.

5 Fiscal federalism

One possible rationale for the switch of the Ethiopian governance structure to a federal system was given earlier. Whatever the reason, the change was made very rapidly, and this may partly—but only partly—account for a number of peculiar features in the chosen structure which need to be underlined (see for example, World Bank 1999).

The first of these features is that the regional units created by the switch are overtly ethnic in character. It is sometimes the case that federal structures lead to ethnic polarization in ways that can become dysfunctional. But the boundaries were drawn in the Ethiopian case in ways that were intended to codify and express ethnic differentiation from the outset.

Second, and partly as a consequence, the scale—whether of area or population—of the different regions varies substantially, as does their economic and political strength and sophistication. All federal systems involve questions of potential imbalance between their regions: in Ethiopia these reach an extreme form. Since, as it appears, decisions on the geography of the regional structure pre-dated any systematic consideration of how the system should operate, the challenge of designing an operational federal system was unusually acute. Since, again, it was accomplished at very high speed, it has a number of features which are potentially problematic.

Third, there is a wide, and widely perceived, gap between the formal devolution of powers to the regions and the de facto continuation of central control. This is hard to interpret at the present relatively early stage in the process. It is certainly something on which Ethiopians themselves take very different views. It has both an economic and a political dimension (considered in the following section). Formally, the devolution is very extensive, with the wide range of powers not explicitly reserved to the federal government being vested in the regions. Regions also have the explicit right, given certain checks and balances, to secede from the federation or to re-configure themselves in various ways. They also have, as is fairly common, very extensive expenditure responsibilities, particularly for the social sectors and for much of the economic infrastructure.

However, they have been given relatively restricted powers to raise revenue. It is commonplace in decentralized government for there to be a discrepancy between the devolution of spending responsibilities and revenue powers respectively: the extent of

this so-called vertical imbalance varies widely. In Ethiopia, it is unusually large, with the regions being responsible for over 40 per cent of spending but raising less than 20 per cent of the domestic revenue. Since aid flows are such a significant source of government finance, and these are overwhelmingly routed through the federal government, the extent of local self-reliance is lower still. Within these averages, there are also wide inter-regional differences, with the larger and more developed regions financing 20-30 per cent of their expenditure, and the least developed ones financing less than 10 per cent.

It might appear straightforward to change the assignment of taxes (which are currently grouped into federal, regional and joint categories, with the rules for allocation of the last being somewhat obscure). This is likely to prove difficult however, since the existing assignment is constitutionally entrenched (unlike the expenditure assignment, where the details are embedded in proclamations which are easier to alter). This is a shame since the existing assignment is highly unusual, and probably dysfunctional. Revenues are assigned to the three categories not by type of tax, but by the nature of the tax-paying entity. For example, profits tax accrues to the federal government if it is levied on a federal enterprise or a partnership; it accrues to the regional government if it is levied on a regional enterprise, a sole proprietorship or farmers' co-operative; and it is treated as joint if it is levied on a private company.

Given the size of these vertical imbalances, the design of the system of intergovernmental transfers becomes central. The details of this have been in continual evolution, but (with limited exceptions such as the Road Fund) it has always taken the form of a block grant. There appears to be little enthusiasm for introducing conditional grants which permit the federal government to influence the composition of regional spending by altering the effective relative prices. The inter-regional allocation is currently based on a weighted average of relative population, a development index, and an index of revenue effort. Unlike the block/conditional grant issue, there seems to be considerable willingness to experiment with these formulae, even if the resultant allocations are in consequence rather volatile.

There is a potential difficulty, particularly under a block grant system, of how to combine considerable regional autonomy in the organization of health, education, and roads, with the ambitious and co-ordinated perspective for these sectors embedded in the sectoral development programmes. There is a wider issue here, which is taken up in the following section.

6 Political and managerial dimensions

Although this paper is primarily concerned with fiscal issues, these have to be considered within their political and organizational environment. This section examines two aspects of this. The first is the high coherence between the regions and the federal government that has so far marked the regionalization process. The second is the longer-run evolution of the system, particularly when the circumstances underpinning this coherence begin to decay.

Given the extremely far-reaching changes to the formal system of governance in Ethiopia since the early 1990s, there seems to have been surprisingly little dislocation or

evidence of divergence. The evolution of the economy, of economic policy, and the operation of government itself seems to have exhibited the sort of continuity which might more readily have been expected under a continuation of the old centralized system. There are a number of possible explanations for this, which appear more or less plausible to different observers.

The first explanation is simply that following the war, disputes over possible policy choices were dominated by the imperatives flowing from the extent of the damage to infrastructure, the poor state of social and other services, and the prevalence of poverty. Hence there were special (temporary) forces making for political coherence, and these postponed the diversifying impact of regionalization. On this argument divergences will begin to emerge once these crises have been handled, but this may be deferred for a long time, given their severity. A variation on this argument might be that, despite the great ethnic, cultural, and ecological diversity of the Ethiopian peoples, they have a rather coherent national view of the proper business of the state, and what its ends and means should be.

The second explanation is not unrelated to the first, and notes that political and managerial capacity is spread extremely thin in Ethiopia. Given the scale of the organizational changes which have had to be digested, most parts of the government system have been overloaded, and have had to struggle to keep functioning at all. In consequence, there has been little capacity to plan and implement divergent courses of action.

The third explanation relies on the extent of the vertical imbalance. As long as federal government is overwhelmingly in control of resources, the formal devolution of powers is compromised by the continued centralization of real power. This proposition is weakened by the enthusiasm with which the federal government has opted for explicit and transparent formulae for allocating intergovernmental transfers, as opposed to a more discretionary system.

The fourth explanation looks to the prevalence of the EPRDF as a unifying force. On this argument, the formal separation of the regions into autonomous units with different preferences and preoccupations is irrelevant as long as real power is exercised by the party, which appears to be a very coherent and focused entity. Ethiopia has a five-tier system of government: within the regions there are zones, which are divided into woredas of on average 100,000 people. The woredas are the key units of local government, central to the provision of public services: they are further divided into electoral units called kebeles where community grassroots participation takes place. The EPRDF and affiliated parties effectively manage this process across most of the country. In consequence, it is hardly surprising that a shift towards a more bottom-up system should put pressures on intermediate level politicians and civil servants that conform rather well with the views held at the federal level.

There is, however, argument about the nature and extent of the EPRDF's hegemony. In 1996 for example there were, according to the National Electoral Board, 63 legally recognized political parties active in Ethiopia, of which 56 were regional parties while the rest were national. The questions are over the extent to which these are positively affiliated with EPRDF in some way and, for the rest, the extent to which they exclude genuine opposition groups and the role of repression in achieving this. Members of the

EPRDF itself, on the other hand, sometimes bemoan the unwillingness of opposition groups to organize themselves to contest elections.

There may be some truth in all of these attempted explanations, or indeed the true explanation may lie elsewhere. In any event, it remains to speculate about the longer run prospects of the new Ethiopian arrangements. In doing so, no account is offered of the longer run implications of the recent war with Eritrea.

One possibility is that the EPRDF retains its effective hold on power without this requiring escalating repression. This would necessitate that it comes to be seen as truly capable of representing diverse constituencies. Experience with one-party states on the continent is not encouraging. On the other hand, simply installing the organizational forms of democracy does not create the institutional substance of democracy (see Addison 2001). Experience in Zambia for example would induce caution about the necessary superiority of multi-party structures. Lacking proper democratic foundations, these are as easy for interest groups to hijack as any other.

A second possibility is that the political processes within the different regions do progressively lead to considerable divergence between regions, and that the federal government, and whatever political process comes to control it, is content with this. A third possibility is that the centre objects to divergence, and that the devolution of power is reversed in some way, formally or informally, through due process or otherwise. The only thing that does seem clear at present is that the federal government has opened the door to great regional divergence, but has not yet had to confront the consequences of this.

7 Conclusions

From the perspective of the 'developmental state', the current regime in Ethiopia would receive rather mixed reviews. It has for the most part been quite impressive in macroeconomic policy, fiscal reform and public expenditure management. It has embarked on a radical decentralization programme and an ambitious (possibly too ambitious) civil service reform: the latter is particularly important, not because the Ethiopian civil service is excessively large, but because it is—or is perceived to be—unusually rigid and bureaucratic. Its record on privatization has been mixed, and privatization has proceeded at a much slower pace than in Mozambique for example (see Castel-Branco, *et al.* 2001). It appears to be seriously concerned to maintain the country's rather good record on corruption. However its democratic credentials seem rather shaky, it has little concept of civil society unless that can be articulated through the party, and it is very sensitive to criticism. It is also perceived with distrust by many Ethiopians, though paradoxically, the otherwise very harmful outbreak of hostilities with Eritrea seems to have somewhat allayed at least those doubts which concerned its commitment to the future integrity of the Ethiopian State.

References

- Addison, T. (1998). 'Underdevelopment, transition and reconstruction in sub-Saharan Africa', *Research for Action* 45, Helsinki: UNU/WIDER.
- Addison, T. (2001). 'Reconstruction from war in Africa: communities, entrepreneurs, and states', *Discussion Paper* 18, Helsinki, UNU/WIDER.
- Addison, T. and Alemayehu Geda (2001). 'Ethiopia's new financial sector and its regulation', *Discussion Paper* 55, Helsinki, UNU/WIDER.
- Addison, T. and Leonce Ndikumana (2001). 'Overcoming the fiscal crisis of the African state', *Discussion Paper* 12, Helsinki, UNU/WIDER.
- Bahru Zewde (1991). *A History of Modern Ethiopia, 1855-1974*, James Currey, Ohio University Press and Addis Ababa University Press.
- Bevan, D. (1994). 'Economic aspects of the Ethiopian transition to peace', in J.-P. Azam, D. Bevan, P. Collier, S. Dercon, J. W. Gunning and S. Pradhan 'Some economic consequences of the transition from civil war to peace', *Policy Research Working Paper* 1392, Washington DC: World Bank.
- Bevan, D. and S. Pradhan (1994). 'Fiscal aspects of the transition from war to peace: with illustrations from Uganda and Ethiopia', in J.-P. Azam, D. Bevan, P. Collier, S. Dercon, J. W. Gunning and S. Pradhan 'Some economic consequences of the transition from civil war to peace', *Policy Research Working Paper* 1392, Washington DC: World Bank.
- Bigsten, Arne (1999). 'Selecting priorities for poverty reduction and human development: the case of Ethiopia', *Research in Progress* 22, Helsinki, UNU/WIDER (August).
- Castel-Branco, Carlos, Chris Cramer with Degol Hailu (2001). 'Privatization and economic strategy in Mozambique', *Discussion Paper* (forthcoming), Helsinki, UNU/WIDER.
- Clapham, C. (1988). *Transformation and Continuity in Revolutionary Ethiopia*, Cambridge: Cambridge University Press.
- Daniel Ayalew, Stefan Dercon and Pramila Krishnan (1999). 'Demobilization, land and household livelihoods: lessons from Ethiopia', *Research in Progress* 24, Helsinki, UNU/WIDER (December).
- Eshetu Chole (ed.) (1994). *Fiscal Decentralisation in Ethiopia*, Addis Ababa: Addis Ababa University Press.
- Hansson, Göte (2001). 'Building new states: lessons from Eritrea', *Discussion Paper* (forthcoming), Helsinki, UNU/WIDER.
- Keller, E. J. (1988). *Revolutionary Ethiopia: from Empire to People's Republic*, Indiana University Press.
- Shiferaw Bekele (ed.) (1995). *An Economic History of Ethiopia. Volume 1: The Imperial Era, 1941-74*, Dakar: CODESRIA.
- World Bank (1990). *Ethiopia's Economy in the 1980s and Framework for Accelerated Growth*, Washington DC: World Bank.

World Bank (1997). *Ethiopia: Public Expenditure Review*, Washington DC: World Bank.

World Bank (1998). *Ethiopia: Public Expenditure Review*, Washington DC: World Bank.

World Bank (1999). *Ethiopia: Regionalisation Study*, Washington DC: World Bank.

UNU World Institute for Development Economics Research (UNU/WIDER) was established by the United Nations University as its first research and training centre and started work in Helsinki, Finland in 1985. The purpose of the Institute is to undertake applied research and policy analysis on structural changes affecting the developing and transitional economies, to provide a forum for the advocacy of policies leading to robust, equitable and environmentally sustainable growth, and to promote capacity strengthening and training in the field of economic and social policy making. Its work is carried out by staff researchers and visiting scholars in Helsinki and through networks of collaborating scholars and institutions around the world.

UNU World Institute for Development Economics Research (UNU/WIDER)
Katajanokanlaituri 6 B, 00160 Helsinki, Finland

Camera-ready typescript prepared by Anna Kervinen at UNU/WIDER
Printed at UNU/WIDER, Helsinki

The views expressed in this publication are those of the author(s). Publication does not imply endorsement by the Institute or the United Nations University, nor by the programme/project sponsors, of any of the views expressed.

ISSN 1609-5774
ISBN 952-455-236-1 (printed publication)
ISBN 952-455-237-X (internet publication)