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The Practice of Fiscal Federalism in Ethiopia: The Case of Oromia and Afar Regional States (1995 -2015)

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Declaration

I, the undersigned, hereby declare that the dissertation entitled ‘**A Critical Assessment of the Practices of Fiscal Federalism in Ethiopia: The Case of Oromia and Afar Regional States (1991–2015)**’ is my original work and it has been written by me in its entirety. I have duly acknowledged all the sources of information which have been used in the dissertation. This dissertation has not been submitted for any degree in any university previously.

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This is to certify that the dissertation prepared by Samson Mesfin, entitled: ‘**A critical Analysis of the Practice of Fiscal Federalism in Ethiopia: The Case of Oromia and Afar Regional States (1991–2015)**’ submitted to the Department of Public Administration and Development Management (PADM), College of Business and Economics (CBE) in partial fulfillment of the requirements for the Degree of Doctor of Philosophy in Public Management and Policy. The dissertation complies with the regulations of Addis Ababa University and meets the accepted standards of originality and quality.

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Dedication

I dedicate this PhD dissertation to my father, Mesfin Gebremeskel, who brought me up with love and care and was concerned about my educational achievement. He mentored me and did all he could for me to make me a successful person in life. Dad, I know all your efforts you have made for my educational success. Your daily prayers for me helped to achieve positive results. I am telling your spirits that I have completed my PhD research and reached this level. Thank you Dad!!

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Acronyms

ARS	Afar Regional State
BPT	Business Income Profit Tax
BoE	Bureau of Education
BoFED	Bureau of Finance and Economic Development
BoH	Bureau of Health
BoARD	Bureau of Agricultural and Rural Development
CIT	Corporate Income Tax
CSA	Central Statistics Agency
DLDP	District Level Decentralization Program
EPRDF	Ethiopian People's Revolutionary Democratic Front
FDRE	Federal Democratic Republic of Ethiopia
FGD	Focus Group Discussion
FGT	First Generation Theories
FY	Fiscal Year
GDP	Gross Domestic Product
GST	Goods and Services Tax
HoF	House of Federation
HoPRs	House of People Representatives
LGs	Local Governments
PDRE	People Democratic Republic of Ethiopia
PIT	Personal Income Tax
PMAC	Provisional Military Administration Council
PSNP	Productive Safety Net Program
MOFED	Ministry of Finance and Economic Development
NBE	National Bank of Ethiopia
NGOs	Non-Government Organizations
OECD	Organization for Economic Co-operation Development
ORS	Oromia Regional State
SNGs	Sub-national Governments
SNNPR	South Nations, Nationalities Peoples' Region
SGT	Second Generation Theory
TOT	Turn-Over Tax
USA	United States of America
UNDP	United Nations Development Program
VAT	Value Added Tax

Abstract

The main objective of this dissertation was to assess the practices of fiscal federalism in Ethiopia (1995- 2015) with reference to Federal-Regional interface and Woredas (districts) context by selecting two Regional States; namely Oromia (representing the relatively 'developed regions') and Afar (representing the 'emerging regions'). The study employed more of qualitative research approach to achieve the objective mentioned above. Both Primary and secondary data sources were used in gathering relevant data for the study. The techniques that have been used for gathering primary data are in-depth interview and discussion with key-informants at all levels of governments focusing on group discussion with local communities and field observation. Secondary data were gathered from published and unpublished materials available in various forms including books, journal articles and official annual reports of government institutions at federal, regional and local levels. The study also reviewed the experiences of some federal countries around the world on the issue of fiscal federalism with the aim of obtaining best practices and use as input in modifying the decentralized fiscal system of Ethiopia. To analyze the data gathered through above means, the study employed both qualitative and quantitative methods of data analysis.

The findings of the study indicated that the Constitutional assignment of expenditure responsibility in Ethiopia is more or less in compliance with the theoretical literature of fiscal federalism while the assignment of taxation power does not agree with the theoretical and empirical literatures of fiscal federalism. The practice, however, shows lack of clarity on the assignment of power and fiscal responsibilities, particularly on shared responsibilities. As the result, it creates duplication and overlapping responsibility problems and may lead to conflict between federal and regional governments as well as regional and local governments. The findings also show that the devolution of expenditure responsibilities to the sub-national governments (SNGs) is not accompanied by adequate financial resources, resulting in high vertical and horizontal fiscal imbalances in Ethiopia. As the result, SNGs in Ethiopia rely heavily on federal transfers to cover the costs of the functions that devolved to them by laws. This, in turn, limits the fiscal autonomy of authorities at sub-national levels, which adversely affected the efficiency of public service delivery and accountability at the grass root levels. Overall, the study found out that there are several problems and challenges faced while implementing fiscal decentralization at sub-national levels in Ethiopia. It includes lack of clarity in the assignment of power and fiscal responsibilities, particularly on shared responsibilities; lack of fiscal autonomy due to insufficient own revenues; weak administration and institutional capacity. This happened because of lack of trained and experienced human resources; poor political willingness and commitment of authorities at higher level to devolve taxing and spending powers in real sense; as well as lack of a stable, predictable and transparent intergovernmental fiscal transfer system. Thus, the research recommends that the federal government should give more emphasis to enhance the fiscal autonomy of sub-national governments so as to realize the potential benefits of effective fiscal federalism in Ethiopia.

Key words: Fiscal Federalism, Assignment of expenditure, taxing responsibility, vertical fiscal imbalance, Fiscal autonomy and Intergovernmental fiscal transfer.

1.0. CHAPTER ONE: INTRODUCTION

1.1. Background of the Study

Fiscal federalism, one aspect of a decentralized system in a multi-tiers government, has been an important topic among policy makers, researchers and academicians across the world in the last four decades. The interest towards fiscal federalism is not only limited in countries which have federal systems but also in countries which exercise unitary systems. It has also spanned across countries with different levels of socio-economic development such as in the USA, China, Africa and Latin American countries (Thiessen, 2003:1; Litvack, Ahmad and Bird, 1998). The main reasons for the increasing trend towards fiscal federalism in recent periods include failure of a centralized system in delivering efficient public services and promoting economic growth, transition to market economy, strengthening of democratic principles and growing need to recognize social, economic, and political diversity across regions within a nation (Tazi, 2001).

Fiscal federalism is concerned with allocation of expenditure responsibility and taxation power among different levels of government and an intergovernmental transfer mechanism for adjusting horizontal and vertical imbalances as well as sub-national borrowing (Oates, 1999). Fiscal federalism, therefore, deals not only with the allocation of expenditure and taxing responsibilities among different levels of government but also with fiscal interactions (both vertical and horizontal) among these levels of government (Wildasin, 1998 cited in Sharma, 2007:1). The basic economic rationale behind a decentralized fiscal system, in theory, is that it improves the efficiency of economic resources allocation (which will lead to an expected maximum society well-fare) by matching the provision of public services with the local tastes, preferences, and circumstances as compared to the centralized system which provide uniform public services across all jurisdictions (Musgrave, 1959; Oates, 1972). It also improves revenue raising efforts and efficiency of public service delivery at sub-national levels through competition between regional and local governments (Brennan and Buchanan, 1980). Moreover, it improves the local governance quality through enhancing the responsiveness of local authorities and accountability to local people by improving the political participation of local people (Lockwood, 2005).

However, empirical studies which were conducted in developed and developing countries show mixed results. Some of the studies state that if fiscal decentralization is practiced before the establishment of effective administrative and political institutions at local units of government, it might bring unintended outcomes such as undermining the efficiency of resource allocation, inequality and unbalanced developments across jurisdictions and bad local governance (Tanzi, 1996:26; Prud'homme, 1995:17). Nevertheless, many developing countries have developed and implemented various forms of fiscal decentralization as a possible strategy to improve the efficiency and effectiveness of public sector, mainly since 1990's. The practices, however, show that expenditure decentralization is given more priority rather than revenue decentralization in many developing countries. As a result, it creates high vertical fiscal imbalance and limits fiscal autonomy at sub-national levels. Thus, each country should find the appropriate balance of centralization and decentralization by taking into account its specific circumstances so as to realize the potential benefits of an effective decentralized fiscal system.

After practicing highly centralized and unitary political and administrative systems for a century, Ethiopia introduced a decentralized system and federal form of governance *de-facto* in 1991 and *de-jure* in 1995. The decentralized system was implemented in two phases. The first phase was implemented in 1991 by devolving power and responsibility from the central to regional governments and aimed at creating and empowering regional national governments (Tegegne, 1998). The second phase of decentralization was implemented by adopting a District Level Decentralization Program (DLDP) in 2002 through devolution of more power and fiscal responsibilities to Woredas (districts). The main purpose was to improve the efficient public services as well as to enhance the participation of local communities in political and development affairs in order to promote local good governance and local economic growth (Kumera, 2006; Mihret, 2007). The Woreda Decentralization Program (WDP) was initially launched in 430 Woredas covering the four major regions namely Amhara, Oromia, Tigray and SNNPR. Moreover, it was subsequently implemented in the Woredas of other Regional States such as Afar, Somali, Benshangul-Gumuz and Gambella as well.

This dissertation, therefore, attempts to assess the practices and challenges related to fiscal federalism in Ethiopia with particular reference to federal-regional states since 1995. It also examines the practices, achievements and challenges related to the implementation of fiscal

decentralization at the local level of government in Ethiopia by selecting two regional states, namely Oromia and Afar regional states. The study has selected these two Regional States using certain criteria which will be discussed in Chapter III on Research Design and Methodology.

1.2. Statement of the Problem

There a great consensus among public finance scholars with regards that fiscal decentralization is a powerful tool to address the problems of inefficient public sector, macroeconomic instability, and inadequate economic growth by enhancing the efficiency of resource allocation, promoting equitable distribution of resources, managing conflicts emanating from resource claim, and enhancing transparency and accountability (Ebel and Yilmaz, 2002; Boex, 2009). Although fiscal decentralization has several benefits, there is no a strong and clear relationship between fiscal decentralization and economic growth, efficiency of public service delivery and macroeconomic stability.

Theory of fiscal federalism argue that if a local government assigned a significant expenditure responsibilities, it should be endowed adequate taxation power that enable it to finance its functions as much as possible, so as to realize the benefits of an effective fiscal decentralizations. The analysis of Smoke (2004), identifies certain preconditions and circumstances which leads to effective fiscal decentralization system. Some of these are: strong legal framework; central government commitment; adequate financial resources of local government; effective administrative and political institutions at local level; sufficient flow of information; a well-established multi-party system with long experience of democracy, and effective participation and consultative mechanisms. Nevertheless, in many developing countries, expenditure decentralization is given more priority rather than revenue decentralization, which creates a high vertical fiscal imbalance and limits the fiscal autonomy of lower levels of government, which leads to less efficiency of public service delivery and accountability at grass-root levels (Kee, 2003). This indicates, therefore, the availability of sufficient financial resources at lower levels of government would matter to realize the benefits of an effective decentralized fiscal system.

The 1995 FDRE Constitution has endowed not only a significant power and functions including residual power for States (Art. 52), but also empowered to levy and collect taxes on several revenue sources including tax bases that have mobile nature like PIT, BPT, and VAT (Art. 97).

The practice, however, has shown that the fiscal system of Ethiopia is at an infant stage, which is characterized by high vertical fiscal imbalance and makes the regional governments heavily dependent on federal grants to cover the costs of functions they are responsible for (Solomon, 2006; Gebrehiwot, 2014). It, therefore, limits the autonomy of regional authorities to develop their own policies and prepare their own budgets in accordance to the needs and preferences of people living in their jurisdictions. Besides, there are wide fiscal capacity gaps across regions, mainly due to significant variation in terms of economic activities, resource endowment, demographic and geographic characteristics (Assefa, 2007).

Thus, the federal government has introduced various transfer/grant mechanisms to transfer financial resources for the Regional States to address the fiscal imbalance problems (both vertical and horizontal) and provide minimum basic public services to all Ethiopian citizens in an equitable and fair manner. In practice, however, the transfer systems are discouraged the States to generate adequate own revenue from their jurisdictions and made the States to develop dependency behavior on the federal transfer (Solomon, 2006). Besides, there is no stable and predictable system of transfer allocations. As a result, it limits the capability of regional governments in preparing their budgets effectively and planning the future budgetary development for their residents. Furthermore, there is lack of clarity with regards the conditions and terms under which the States can be borrowed funds from domestic credit sources (Worku, 2005; Mohammed, 2006).

Following the implementation of the second phase of decentralization since 2002, Ethiopia has been exercising fiscal decentralization at local units of government through devolving more power and functions as well as financial resources to respective Woredas (districts). The major objective was to enhance the participation of local communities in their political, economic and development affairs to improve the local good governance and deliver efficient public services and promote economic growth (Kumera, 2006). The practice, however, had shown that the objectives and the goals that were intended to achieve through fiscal decentralization such as enhancing good governance and efficiency of public service delivery at grass root levels are not fully achieved yet.

Overall, Although Ethiopia has been exercised fiscal decentralization at regional and local levels of government over the last three decades, the fiscal system of Ethiopia faced by multi-dimension problems and challenges. The implication is that the intergovernmental fiscal relation designed and implemented without fully taking into account the prescriptions of the second generation theories of fiscal federalism. Moreover, despite several research works have been conducted on decentralization policy in Ethiopia, a few studies has been conducted on fiscal decentralization, particularly at local government units. It is with this understanding; therefore, this dissertation attempts to assess the practices and challenges related to fiscal federalism in Ethiopia with particular reference to the federal-regional states and regional and local governments since 1995 by taking on Oromia and Afar regional states into focus.

1.3. Research Objectives

1.3.1. General Objective of the Study

The general objective of this study is to assess the practice of fiscal federalism in Ethiopia with reference to federal-regional States and regional–local levels of governments in Oromia and Afar Regional states in comparison with the Federal and Regional Constitutions since 1995.

1.3.2. Specific Objectives of the Study

The specific objectives of the study are:

- i. To examine the degree of fiscal responsibilities decentralized to State and Woreda Gov'ts in Ethiopia in theory and practices.
- ii. To explore the principles of fiscal federalism that governs the assignment of expenditure and taxing responsibilities b/n the Federal Gov't and States as well as State and Woreda Gov'ts in Ethiopia.
- iii. To investigate the degree of States & Woredas in Ethiopia fiscally independent from the Federal Government;
- iv. To assess the features and effectiveness of IGFTS of Ethiopia against the international useful practices.
- v. To examine the practices of States and Woredas borrowing in Ethiopia.

- vi. To investigate the major factors hindering the practices of an effective fiscal federalism in Ethiopia.
- vii. To provide workable recommendations based on the findings and fiscal federalism literature.

1.4. Research Questions

To achieve the research objectives, the dissertation has attempted to address the following research questions related to fiscal federalism in Ethiopia.

- i. To what extent fiscal responsibilities in Ethiopia are decentralized in theory and practice?
- ii. What principles of fiscal federalism governs the assignment of expenditure and taxing responsibilities between Federal Government and States as well as State and Woreda Governments in Ethiopia?
- iii. Does the State and Woreda Governments in Ethiopia are fiscally independent from the Federal Government?
- iv. To what extent the IGFTS of Ethiopia effective against the international useful practices? What are the factors hindering to adopt and practice an effective grant formula?
- v. Do the State and Woreda governments in Ethiopia have adequate autonomy in borrowing funds from domestic financial markets?
- vi. What are the major factors hindering the practice of an effective fiscal federalism in Ethiopia?

1.5. Scope of the Study

This research confines its scope essentially to assess the practices of fiscal federalism in Ethiopia, with particular references to federal-regional states and regional and local governments (in Oromia and Afar regional states), and it covers the time periods from 1995 to 2015 fiscal years. With this perspective, the study focuses on analyzing the major pillars of fiscal

decentralization, which includes expenditure assignment, revenue sources assignment, vertical and horizontal fiscal imbalances and design of intergovernmental transfer as well as sub-national borrowing. It also focuses on examining the autonomy (both political and administrative) endowed for sub-national governments to exercise the power and fiscal responsibilities which devolved to them as well as the major challenges they are facing.

To achieve the research objective, the study has taken the institutions of Federal, Regional and local (Woreda) governments as units of analysis. The reason for the selection of the Woredas (districts) as a unit of analysis in the study is that they are considered as a government unit for meaningful social and economic development at local level in Ethiopia. But, it is a difficult task to consider local governments located in all regional states of Ethiopia. Therefore, the study has taken into account the Woreda governments which are located in Oromia and Afar regions as representative of other Woreda governments located in the remaining regions of the country. The study selected these regional states purposely on the basis of various criteria such as fiscal capacity, population size and geographical area/distance, infrastructure and human development, and ethnic diversities. Hence, the Oromia region is selected to represent the relatively more developed Regional States (Tigray, Amhara and SNNPR) whereas the Afar Regional State is selected to represent the relatively less developed Regional States (like Benshangul-Gumuz, Gambella, Harreri and Somali). Additionally, the study also reviews the experiences of certain countries such as Nigeria, India, Brazil, Germany, Australia and Canada that adopted fiscal decentralization with the aim of obtaining certain lessons and use as inputs to modifying the existing fiscal federalism in Ethiopia.

1.6. Significance of the Study

Although fiscal decentralization has been receiving great attention from academicians, policymakers and civil society organizations (CSOs) in Ethiopia over the last two decades, little empirical studies have been conducted on the area, especially at district (*Woreda*) levels. Even the studies which conducted on the Ethiopian decentralization policy are focused on discussing the decentralization policy in a generic fashion. Some of these studies also focused on exploring the technocratic and technical problems which face the regional and local governments in implementing the decentralization policy of Ethiopia. Thus, it is important to critically assess the

constitutional framework in comparison with the practices on ground in Ethiopia for the following reasons:

First, the finding of the study might provide a practical framework for policy-makers in Ethiopia and many other multi-ethnic African countries, and uses it as input for making a reform their fiscal system. Although this case study is at the national level of Ethiopia, it would lay an applicable benchmark to many other African countries where significant fiscal decentralization reforms are taking place. With regard to Ethiopia, investigation of the factors that promote or challenge the practice of fiscal decentralization at local level in Oromia and Afar regions might provide a good lesson to other regions in Ethiopian federation and enable them to correct the potential fiscal problems prior to their occurrence. In other words, the findings of the study provide detailed and comprehensive information related to the process of fiscal federalism in Ethiopia for all decentralization stakeholders. Secondly, the findings of the study will fill the literature gap in fiscal federalism and also serve as a reference for researchers who have interest to conduct further study on the area, especially at local levels, in Ethiopia.

1.7. Limitations of the Study

The study was constrained by several factors, including financial resources, lack of availability of reliable and sufficient data, especially at sub-national levels, and unwillingness of public officials and staff to provide data. In addition to these, the study was also constrained by the following factors:

- i. Lack of sufficient prior empirical studies related to the subject matter under study in Ethiopia, especially at district (*Woreda*) level to be used as a reference. As a result, it adversely affected the process of the research project.
- ii. Lack of availability of reliable and adequate secondary data at sub-national level due to weak data collection and management capacities.
- iii. Lack of willingness of public officials and other respondents to give firsthand (primary data) information. In this respect, despite the researcher's visits to many government officials working at various regional and *Woreda* sector bureaus in Oromia and Afar regions, they were not interested to make a detail interview and they opted simply to provide highlights.

- iv. Lack of key informants such as researchers and practitioners that have detailed knowledge related to the subject matter under investigation, especially at the Woreda level in the selected Regional states.
- v. High staff turnover at Federal, Regional states and District (*Woreda*) institutions also made the data collection more difficult than expected, especially at local levels in the Regional states selected.

Although the researcher had faced the above mentioned limitations throughout the research project, he made significant efforts to minimize the negative impact of such limitations on the result of the study through employing some mechanisms such as combination of various data collection techniques (like in-depth interviews with field observation).

1.8. Structure of the Thesis

The study is organized into seven interrelated and logically sequenced chapters. The first chapter contains introduction of the study, background of the study, statement of the research problem and objectives and research questions of the study as well as the significance and limitations of the study. The second chapter presents the conceptual and literature review related to decentralization and fiscal federalism, the argument of various theories of fiscal federalism with regard to assignments of expenditure responsibilities, taxation powers at different levels of government, fiscal imbalances and design of intergovernmental fiscal transfer as well as sub-national borrowing. (These serve as a theoretical framework of the study). It also includes the historical government structure and fiscal system of Ethiopia.

The third chapter presents the research methodology and design. This chapter includes research paradigm and research approach, sampling design and selection of study areas, data type and sources, data collection techniques and data analysis method. The fourth chapter focuses on reviews of the practices and experiences of fiscal federalism in selected developed and developing countries around the globe with the aim of drawing some lessons and using it as an input to analyze the practice and challenges of the fiscal decentralization system in Ethiopia. Chapters five and six are the analysis parts of the study. Accordingly, in chapter five, the study focuses on assessing the practice of fiscal federalism in comparison with federal constitution provisions and theoretical literatures in particular reference to federal- regional states. The sixth

chapter, on the other hand, focuses on assessing the practice of fiscal decentralization at *Woreda* (district) governments in Oromia and Afar regional states. It also explores the major challenges the sub-national governments of Ethiopia faces while implementing fiscal decentralization in their jurisdictions, Chapter seven, the last chapter of the study, deals with the summary of the main findings, and it finally draws conclusion and offers recommendations which suggest relevant policy alternatives regarding the four main pillars of Ethiopian fiscal system. References and appendices are placed next to the closing chapter.

2.0. CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter of the study presents the conceptual and theoretical literature related to fiscal federalism and decentralization. To this end, the chapter attempts to systematically organize main concepts and theories of the study, which are used as framework to assess the legal framework and the practice on the ground related to fiscal federalism in Ethiopia. Thus, this chapter consists of four sections. The first section discusses the concepts of decentralization and fiscal federalism and its potential benefits and limitations. The second and third sections focus on reviewing various theories of fiscal federalism for assignment of expenditure responsibilities and taxation powers among different levels of governments as well as fiscal imbalances and mechanisms to address it; and sub-national borrowing. Finally, it reviews the historical government structure and fiscal system of Ethiopia.

2.2. Definition and Concept of Decentralization

Although the term decentralization is a very important concept for public finance studies, it has varied meaning and purpose as well as the degree of its application depending on the perspective of a scholar. Thus, the term decentralization embraces multifaceted concepts and different scholars and sources defined it differently at different times. Decentralization for the political scientist, for instance, means a set of policy issues that focus on who has authority and responsibility; whereas it often means a fiscal decentralization for the public finance scholars, who usually focus on rearranging the intergovernmental fiscal relation. On the other hand, for the sociologist, whom they focus on the role of informal organizations and community groups, it often means participation (Camille et al, 1997:1-20 as cited in Mebratu, 2008).

Despite of the existence of varied meanings for decentralization, it is commonly has defined as “the transferring of authority and responsibility for public functions from a higher level of government to lower levels of governments which ultimately contributes to empowerment of people through their effective engagement and participation in the affairs of local government” (Boex, 2009).). It is also defined as the transfer of responsibility and authority for planning, management and the raising and allocation of resources from the central government and its

agencies to field unit level of government, semi-autonomous public authorities or corporations area wide regional or functional authorities or non-governmental private voluntary organizations that are closer to the public to be served . According to the UNDP, decentralization is the process of restructuring or reorganizing authorities based on the principle of subsidiary (people are the sources and the very basis of the legitimacy of all authorities/powers) and improving the authority and capacity of sub-national levels in order to enhance the quality, co-responsibilities and efficiency of the public sector at different level (UNDP, 2003).

According to Dafflon and Madiés (2011:6-7), the process of decentralization can be done by either top-down or bottom-up approach. The top-down approach of decentralization is done through delegation and seeks to serve the interests of the authorities at central level such as avoiding undesirable responsibilities (e.g. transferring of its budget deficit). In this approach, sub-national governments' powers and authorities are granted solely by the central government and can be revoked at any time by the wish of the authorities at center. Therefore, to evaluate top-down decentralization, researchers need to examine how well it is serving the interests of the authorities at national level, not the interest of citizens as a whole. The bottom-up decentralization, on the other hand, is a federal structure in which priority is given to the lower levels of government that are more closer to citizens and endows them substantial decision making autonomy. It generally gives more emphasis on political values such as improving good governance in the sense of local responsiveness and political participation. Thus, in the case of a bottom-up approach, the objective of decentralization is to improve not only the efficiency and equity of public service delivery through better information but also to increase local participation in decision-making on all matters that affect local people, hence improving political stability.

2.2.1. Dimensions of Decentralization

Decentralization has four dimensions, namely, political, administrative, fiscal and economic decentralizations. Even though each dimension of decentralization has unique characteristics, objectives and conditions for success, in reality they are interrelated in their causes and effects as well as there is considerable overlap among these dimensions (Boex et al, 2006). Thus, it is important to distinguish the various dimensions/types of decentralization for highlighting its

many dimensions and the need for coordination among these concepts, which overlap considerably.

I. Political decentralization

Political decentralization refers to the devolution of authority/power for decision-making to sub-national government units that are accountable to the people who elected them. It is argued that if decentralization is to be successful and sustainable there should be political decentralization that involves transferring of administrative, fiscal and political powers to lower units of government (UNDP, 2003). It requires changes in laws, a strong legislature, well established political institutions at local units of government, effective interest groups participating in the affairs of government, and legal geographical boundaries within which public functions are performed (Oates, 1972:138).

There is a great consensus among academicians with regards that political decentralization can improve the efficient resource allocation through empowering local governments to develop and implement their own policies and programs in line with the needs of people living within their jurisdictions (World Bank, 2004:23). Additionally, it can also enhance accountability by empowering local residents to elect their local authorities and policymakers and hence allowing them to participate in the policy making process through their representatives (Litvack and Seddon 1999). There are two conditions that allow political decentralization to bring about the promised improvements in efficiency of public services delivery, accountability and democracy at local level. These are: voters must be more likely to use information about the quality and quantity of local public goods in their voting decision; and local political promises to voters must be more credible than regional and national promises (Ibid: 89).

II. Administrative decentralization

Administrative decentralization is refers to the devolving of authority and responsibility to lower units of government for administering the human resource, material and financial resources, so as to deliver public services (e.g. health care services, operation of schools, building and maintenance of roads, and garbage collection) for local people. Although the central task of this dimension is service delivery, the role of administering the whole sectors falls under this

dimension. The aim of this decentralization dimension is to empower the sub-national governments to deal with their local affairs under a local regulatory framework. If local authorities are elected, but have no authority to administer their financial, human and resources, the decentralization of political power would have little or no value at all. In practice, however, administrative decentralization varies from one country to another and from sector to sector based on the degree of independent decision making devolved for the sub-national governments. Based on the degree of decision making autonomy granted for sub-national governments, three forms of administrative decentralization are distinguished, namely, de-concentration, delegation and devolution (Prud'homme, 1995).

De-concentration:- is all about the transfer of power and administrative workload from centrally located officials to offices outside the national capital (regional level) or headquarters without transferring adequate authority. Hence, the local authorities are under the direct supervision of the central government and have responsibility only to provide public services for local people. Accordingly, in de-concentration the local authorities have no authority/power to administer their local affairs, because the central government retains control over all resources (financial, human and material) and priorities (Ebel and Yilmaz, 2007: 62). The aim of decentralization is to build administrative capacity of the local government authorities under the direct supervision of central government ministries and to improve the operational efficiency of the center in a given jurisdiction (Dafflon & Madiés, 2011:8). Besides, central governments of many developing countries also used it as a mechanism to enhance their interventions on local affairs rather than promoting local autonomy and citizen participation.

Delegation, on the other hand, refers to the transfer of decision-making power for specific public functions to lower levels administrative units that are only under the indirect supervision of the central government ministries. In this case, hence, the lower levels authorities would have full freedom to exercise the delegated powers and functions, but they are fully accountable to the higher authority which retains ultimate responsibility for what is done and provides some or all of the necessary resources. However, the authorities at higher level can take back the delegated powers and responsibilities at any time, so that the local government authorities would have freedom to exercise the delegated powers and functions until revoked back by the authorities at higher levels of government.

In delegation, however, a principal-agent relationship exists between the authority at higher level and the authority at local level, as the result it may face some challenges for the principal such as lack of information about the agent's actual managerial and technical capacity, as well as the actual costs of the delegated functions. Bird (1998) argued that if delegation is accompanied by political decentralization it may also create confusion, because the lower authority not only becomes accountable to the higher authority (i.e. upwards accountability) but also to the people who elected them (downwards accountability). Thus, it is important to introduce some mechanism to ensure accountability at the local level. Delegation is often applied by the central government to increase the capacity of sub-national authorities in preparation for a subsequent move toward devolution.

Devolution, on contrast, is considered the most extensive form of decentralization, because the real authorities concerning decision making, financing, managerial tasks are transferred from the central government to the lower levels of government that are accountable to the people who elected them (Ebel and Yilmaz, 2007:63). This means, in devolution, the authority at center endowed power and functions for the lower levels of government without the possibility to revoke them back. Thus, the lower level authorities have full autonomy to exercise the power and functions devolved to them without any oversight/supervision of the higher levels of government (Gauthier and Vaillancourt, 2002). However, there is no pure devolution in real world, because even in highly decentralized system the sub-national governments are remain to some extent dependent on central transfers in form of conditional grants to carrying out some of their functions, in which they are supposed to follow the specific conditions stipulated by the grantor (Bird, 1998).

Generally, although devolution is the best option to maximize local autonomy and realize benefits of a decentralization policy, it is very difficult in practice and undesirable economically. This is because; such a policy/strategy would possibly limit the achievement of other important national objectives such as inter-jurisdictional equity or efficiency of economic resources. Thus, the practice shows that de-concentration, delegation and devolution are simultaneously present in every decentralized government system and the choice between them depends on various factors includes: the nature of the given public good or service; historical origins and socio-cultural context, economic and political systems as well as demographic and geographic conditions.

Therefore, each form of decentralization represents a different way of organizing the public-sector service delivery, and accordingly it influences the way the public sector is organized.

III. Fiscal decentralization,

Fiscal decentralization, widely regarded as the core dimension of decentralization, generally can be defined as the transfer of fiscal decision making and the authority of planning and management of public functions from the control of central government authorities to government authorities at sub-national levels - regional, provincial, municipal, etc. (Deresse, 2003). It is also referring to “the transfer of both expenditure responsibilities and revenue-raising power to lower levels of government with appropriate intergovernmental transfer methods’ (Bird, 1998). However, fiscal decentralization is not only concerned with allocation of public functions and resources, but also concerned with managing and spending these resources in an efficient manner. Thus, it plays a pivotal role in implementing an effective decentralization program, because the success of any decentralization reform is highly dependent on the existence of fiscal decentralization and financial autonomy. The rationale behind such argument is that, if sub-national governments are required to carry out decentralized functions effectively, they must have not only adequate level of financial resources either levied and collected by local governments or transferred from the central government, but also, they must have authority to make decision on allocation of expenditure on areas which give higher priorities.

The sequence of implementation, balances and demarcations among these forms of decentralization vary from country to country and from sector to sector based on the main interest of the central government, commitment to democratization, nature of the ruling party and the existing objective conditions. These sequences, balances and demarcations among these dimensions reflect the extent of autonomy granted by the central government on one hand and the maturity of the decentralization practice and the implementation capacity of local bodies on the other hand. The balances outweigh each other and their sequence and pace is determined based on the factors which initiate the introduction of the decentralization system such as politics, economy or service delivery. It also depends on socio-economy development level of a given country.

2.3 Concept and Rationales of Fiscal Federalism

Fiscal federalism is essentially concerned with "understanding which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government" (Oates, 1999). Thus, it deals with the allocation of expenditure responsibility and taxation power for various levels of government, as well as the design of transfer mechanisms for adjusting horizontal and vertical imbalances and the right of sub-nationals to borrow from financial institutions (Yusoff, Awang, and Efendi, 2016). Fiscal federalism, therefore, deals not only with the division of policy responsibilities among different levels of a government, but also with fiscal interaction among these levels of government.

The concept of fiscal federalism, however, is not only associated with fiscal decentralization in officially declared federations only, but it could be applicable also in unitary countries (having no formal federal constitutional arrangement). The reason is that unitary countries have government units at different levels with *de facto* decision-making authority. This does not mean that all forms of governments are 'fiscally' federal; it only means that 'fiscal federalism' is a set of guiding principles that helps to define the fiscal relations between the governments at different levels in all countries which implement 'fiscal decentralization' in their public sectors. The term fiscal decentralization, on the other hand, refers to is the actual application of the principles of fiscal federalism in form of power devolution from the higher levels to lower government levels (Ewetan, 2012:3; Sharma, 2009:7).

There is a great consensus among academicians with regards that a decentralized fiscal system enhances the allocation efficiency of economic resources (as the result maximum social welfare) by supplying public services as per the needs and preferences of local residents. The rationale behind such argument is that a decentralized government (closer to a local people) have better information about the demand or preferences of local citizens than of a remote central government. The more heterogeneous of the preferences of local people, the larger potential benefits can be realized by decentralization (Oates, 1972). Moreover, decentralization which places the allocation decisions for government levels more closely to the local communities. As the result, it fosters the responsiveness of local authorities and greater accountability to local people by brings the voice of local communities into the center of policy-making processes. This

is because; local governments have better information about the problems and the needs of local people than of the central government. Additionally, it helps to create “laboratories” for innovation and experimentation and innovation of various public service delivery techniques, which serve as models for the latter implementation by other local jurisdictions. Furthermore, it has potential to enhance democratic value and political stability at local level through improving the political participation of local people. Finally, it enhances fiscal discipline and public service delivery efficiency through competition among regional and local governments, which results delivery at sub-national levels (Brennan and Buchanan, 1980).

However, if fiscal federalism measures or principles are designed and implemented in a wrong way i.e. without considering the specific circumstances of a country such as economic, political, socio-cultural institutions; geographic and demographic conditions, it may lead to less optimum outcomes. First, it may reduce the efficiency of resource allocation, due to weak administrative capacity; lack of economy of scale and existence of inter-jurisdictional externalities at local levels. Second, it may increase economic development inequality across regions within a nation, because it may limit the ability of the central government to deal with structural fiscal capacity imbalances. Third, it may promote bad governance and corruption at the local level, due to capture of local government by local elites (World Bank, 2008). In addition to that, it may limit the capability of local authorities to generate adequate revenue from taxes under their domain because they may engage in destructive tax competition among them to attract individuals and business firms to their jurisdictions. Finally, it may limit the central government to implement redistributive and macroeconomic stabilization policy effectively, because it may not be able to influence local policies (Prud’homme, 1995; and Tazzi, 2001). Thus, each country should develop its own optimal fiscal decentralization structure by taking into account its specific conditions so as to realize the potential benefits of fiscal decentralization. However, there is also a general principle which states finance should follow the public function. Accordingly, sub-national governments should endow sufficient taxing power, at margin, that can enable them to finance the cost of functions they are responsible for, so as to realize an effective fiscal decentralization.

2.4 Theories (Approaches) of Fiscal Federalism

There is no generally accepted framework or prescribed set of rules for allocation of taxing and expenditure responsibilities that can be applied to all countries, since each country varies in terms of history, political and economic system and demographic conditions. But there are several propositions which provide principles regarding how the federal fiscal systems should behave or making generalizations on how they actually practice. There are two alternative theories (approaches) of fiscal federalism with different views related to the determination of an optimal fiscal decentralization structure: traditional approach, commonly known as “First Generation Theories” and the Political Economic approach, commonly known as “Second Generation Theories”.

The FGT is based on the studies of four authors on public finance, namely, Tiebout’s (1956) ‘vote-by-own-feet’ hypothesis, Olson’s (1969) principle of fiscal Equivalence, Musgrave’s (1959) trio of public sector functions, and Oates’ (1972) decentralization theorem. These authors’ contribution focused on the nature of public goods, and the conceptualization of the roles of the private and public sectors; as well as the active and positive role of the public sector with regards to correcting various forms of market failure, establishing an equitable distribution of income, and stabilizing the economy at high levels of employment with stable prices as set in the Keynesian theory (Oates, 2005). Thus, FGT provides the first conceptual framework or guidelines regarding which public functions should be carried out by central government and sub-national governments.

The basic assumption of these mainstream literatures is that governments at all levels are benevolent social planners and seek to maximize the welfare of the entire society as a whole. The theory considers only economic criteria (like efficiency and equity) as a basis for assignment of expenditure and taxing responsibilities among different levels of government. The reason is that such theories focus on enhancing economic efficiency rather than improving political participation. This group of fiscal federalism literature has been developed in the context of more developed market economies (such as Canada and the United States), as the result of uncritical application of the normative framework in the context of developing countries like Africa could be misleading.

In contrast, the new approach of fiscal federalism or SGT considers the assumption of benevolent government unrealistic and assumes that bureaucrats and politicians have their own objective functions and seek to maximize their own gain rather than the welfare of the society. Thus, it argues that the effectiveness of fiscal decentralization depends to a large extent on the establishment of an effective fiscal and political institution at local levels as well as introduction of hard budget constraints (Oates, 2005). Unlike FGF, the SGF is more pragmatic, less bound to convention, and positive in approach. The main goal of this approach fiscal federalism is not only to ensure the efficient allocation of resources, but also to protect liberty and restrain the power of government; share legislative and fiscal competencies; foster political participation; and preserve markets (Brennan and Buchanan, 1980). This branch of literature on fiscal federalism draws and develops models by incorporating theories in new disciplines such as public choice theory, Principal-Agent problem, and the economics of information and organization theory.

The theory has modeled the behavior of politicians in terms of principal-agent problem by applying the framework of industrial organization and microeconomic theory to fiscal federalism. As a result, it focuses on the importance of a decentralized system for ensuring fiscal discipline and accountability at local levels (Oates, 2005). It also emphasizes the importance of competition (both vertical between government units at different levels and horizontal among governments presented at the same level) so as to improve the efficiency of public service delivery. The rationale is that competition between regional and local governments, like competition in the private sector, can limit the capacities of a monopolist central government to increase its control over the economy's resources (Brennan and Buchanan, 1980:184). The reason is that rich individuals and business firms could penalize local governments that have incentive to inflate tax rates unnecessarily by out-migration to other local jurisdictions with relatively lower tax rates.

Furthermore, the SGT also argues that fiscal decentralization could be the best strategy to ensure fiscal discipline and improve efficiency of public services at local levels through yardstick competition. The rationale is that a decentralized system enables local people living in one jurisdiction to evaluate the performance of their own local authorities by using other governments' performance as a benchmark. This, in turn, is an incentive for the local authorities

to provide comparable public services at similar tax rates like the neighboring jurisdictions. The new theory of fiscal federalism, generally argue that the allocation of expenditure and revenue responsibilities among various levels of government should be done that it leads to high degree of competition (both vertical between government units at different levels and horizontal among governments the same level).In the next section, therefore, the study attempts to reviews the theories of fiscal federalism on the allocation of expenditure and taxing responsibilities among different levels of government and uses as an analytical framework to analyze the practice of fiscal decentralization in Ethiopia.

2.5 Theoretical Framework of the Study

Fiscal decentralization, one aspect of a decentralized government, refers to the transferring of power and fiscal responsibilities from the control of central authorities to the sub-national governments (regional, province and municipality). Smoke (2007); identifies the basic preconditions that leads to an effective fiscal decentralization system. These include: an adequate enabling environment; assignment of an appropriate set of functions; assignment of appropriate own revenue sources; design and implementation of an effective intergovernmental fiscal transfer system and adequate sub-nationals access to financial markets. Here, it is important to note that all those pillars must be operated together in order to realize the potential benefits of an effective fiscal decentralization.

2.5.1 An Adequate Enabling Environment

An adequate enabling environment can begin with constitutional or legal mandates for some minimum level of power and fiscal responsibilities to the sub-national governments. This provides a foundation in which to build decentralization, but it does not by any means guarantee for effective fiscal decentralization.

2.5.2 Assignments of Expenditure Responsibility

Assignment of functions/responsibilities means deciding which government functions or responsibilities are assigned for the central and the sub-national governments. This means that the allocation of the authority and responsibility for the public-sector decisions among different levels of government. It is the first fundamental step for designing fiscal decentralization,

because assignment of expenditure responsibilities should come first before financing these expenditure responsibilities. Thus, without clear and specific assignment of expenditure responsibilities, it is too difficult to assess the adequacy of the tax and revenue assignment as well as fiscal transfers to the different levels of government. Accordingly, it is important to clearly define the assignment of expenditure responsibilities ahead of assigning tax sources in order to enhance accountability, avoid unproductive overlap, duplication of authority and legal challenges (World Bank 2003: 117).

There is no a single best mode for optimum allocation of expenditure responsibility among different levels of government. But, there are two approaches to fiscal federalism with different views for allocating public functions among different government levels in an optimum manner; namely: traditional (FGT) and political-economy (SGT). Musgrave (1959), identifies three roles (functions) of government in an economy, namely: macro-economy stabilization, income or wealth redistribution, and resource allocation. In this sub-section, therefore, the study reviews the theories of fiscal federalism for assignment of those public functions among different levels of government in a decentralized system in detail as follows.

The macro-economic stabilization function: - basically involves the role of fiscal policy and monetary policy in managing the overall level of economic activity such as full employment, price stability and high economic growth/poverty reduction. The former policy attempts to stabilize the economy by matching the supply of money with the growth rate of real GDP; while, the latter policy attempts to promote a strong and sustainable economic growth by controlling the amount and structure of taxes and expenditures, as well as managing the budget deficit or surplus.

The traditional approach (FGT) argues that the central government should have responsibility to carry out both monetary and fiscal policies in order to maintain the macroeconomic stabilization. The rationale behind such an argument is that, if sub-national governments are empowered to implement monetary policy independently, they would have an incentive to follow expansionary monetary policy and rapidly issuing money irresponsibly to finance their expenditure responsibilities. As a consequence, it creates macroeconomic instabilities such as higher inflation and unemployment in a nation as a whole (Oates 1972:4). The same argument is for centralized

fiscal policy for two interrelated reasons: first, local governments are highly small and open economy, so that the action of one local government has a direct effect on other local jurisdictions in a federation. As a result, there is little chance that fiscal measures (like additional expenditure or tax rate reduction) initiated at local level will bear fruit in the same local jurisdictions. For instance, if the economy exhibits a high unemployment, the effects of additional expenditure made by a local government for achieving the objective of stabilization policy such as reducing unemployment would largely flow over the border of that local government (Oates, 1999: 1128). Thus, if a local government takes fiscal measures solely for the purpose of macro-economic stabilization, it would bear the full cost of its action while obtaining only a small part of its benefits due to spillover effects of the local expenditures. Consequently, it discourages local authorities to undertake any stabilization measures at local level in the future.

Second, if a local government takes fiscal measures solely to achieve the objectives of macroeconomic stabilization, the benefit of its actions may have spillover effects to neighboring local jurisdictions. As a result, it would create free riding behavior at local level, because it could encourage other local government units to adopt a waiting strategy (letting the other local governments implement stabilization policies whose effects would spill over in their favor) without internalizing the associated costs (Oates 1972:4). Third, deficit finance policies through debts at the local level have not been considered desirable, since the debt repayment would involve substantial real income transfers to creditors external to debtor jurisdictions (Shah, 2004).

In practice, however, in most developed countries such as the USA and Western Europe, a large part of aggregate national spending is undertaken autonomously by the sub-national governments, as a result, they take fiscal measures without negatively affecting the macro-economy situations of the nations (World Bank, 2004). Moreover, the empirical studies conducted on Canada have provided results that show the budget growth of sub-national governments have had a stabilizing effect on the economy (Sewell, 1996). This indicates that the major expenditure responsibilities which often are carried out by the larger sub-national governments, such as public funding of health and education, act as automatic stabilizers because they are recurrent and not very flexible. As a result, such practices have raised the concern that the central government alone may not be able to stabilize the macro-economy effectively with its

own fiscal tools only (Dafflon, 2006:273). This indicates, sub-national governments that have sufficient fiscal capacity can play a great role in macroeconomic stabilization efforts through manipulation of both monetary and fiscal policy instruments.

Thus, the political-economic (SGT) approach argues that macroeconomic stabilization function should not be carried out solely by center only, but through the combination of all levels of government such as center, regional and local governments. But, this requires coordination of policies both vertical between government units at different levels and horizontal among government units at the same level (Boardwary, 2009:70; Dafflon, 2006:276). However, in reality, it is too difficult a task to coordinate the policies of all governments at sub-national levels for one goal, because they may not have the same interest in the outcome of the policy coordination.

Income redistribution function: - involves the role of government in changing distribution of income and wealth or other indicators of economic well-being to make them in more equitable way than would otherwise to be the case. Governments are undertaking such functions by using taxing and spending as instruments. The traditional theory of fiscal federalism also argues that redistributive function should be carried out by the central government only. The logic behind such an argument is that decentralized governments are ineffective to ensure income equity at national level by using taxes as instruments, due to mobility of production factors like capital and labor for tax reasons (Oates. 1972:5). The reason is that if a decentralized government imposed progressive tax rate on rich individuals and business firms for the purpose of income redistribution, these individuals and business firms may relocate their living and business areas to other local jurisdictions with low income tax rates in order to avoid payment of higher income taxes. On the other hand, poor individuals could move to local jurisdictions that have relatively better redistribution policies (Idib: 6). As a result, the tax bases of local jurisdictions which adopted a redistributive policy could be reduced and in turn their fiscal capacity would be reduced, limiting them to provide welfare services for the low-income individuals living in their jurisdictions. Thus, mobility of the factor productions would limit the capabilities of sub-national governments to achieve the objective of redistributive policy in their jurisdictions by “soaking the rich and redistributing to the poor” (Oates, 2005:5). This implies, the central government can implement a geographically more balanced distribution policy by transferring resources from

rich people and business firms to poor people through applying of progressive personal and corporate income tax rates (Musgrave, 1998:68). The reason is that the mobility of business and people is easier within a nation than across a nation.

However, the SGT argues that the redistribution function should be shared responsibility of all levels of government such as central, regional and local governments. The rationale behind such argument is that sub-national governments may design and implement effective and complementary redistributive policy packages by coordinating their policies (Dafflon, 2006:279; Boardway, 2009:73). In other words, if the redistribution programs or actions of each sub-national governments are properly coordinated, it may reduce the gap between the rich and poor people in a federation (achieve national equity objective). Particularly, decentralized governments could implement income redistributive policy effectively through horizontal coordination, when the mobility of individuals and capital occurs in few regions of a federation. But, the income redistributive policy should be implemented by the center only, when the mobility of factor production such as labor and capital is occurring across all regions of a federation (Boardway, 2009 cited in Gebrehiwot, 2014:101).

However, the mobility of production factors like labor and capital may not be a restrictive factor to carry out a redistribution policy at sub-national levels in developing countries for three reasons. First, mobility of individuals in developing countries involves high social costs like strong social and psychological feelings towards the birth place. Second, language and culture differences may limit individuals to move from one region to another within a country, especially if the regions are demarcated based on ethnic and language criteria. Third, local governments (closer to citizens) are in a better position than the central government to identify the beneficiary groups (disadvantaged people) and to mobilize support for them in a targeted way through social and redistributive policies. As a result, they can formulate, implement and manage the redistributive policy in more efficient and effective manners as compare to the center (Dafflon 2006:278). In general, the main responsibility for income distribution should remain at the central government level, so as to ensure the provision of minimum national standard basic public goods and services. However, regional and local authorities can play important roles through the delivery and management of basic services that benefit the poor people. Nonetheless,

the central government needs to retain a monitoring role to ensure that redistributed goals are met (World Bank, 2004:111).

Resource Allocation- basically involves the role of government in deciding the mix of public and private goods that are provided by the economy or the public sector. The traditional approach of fiscal federalism (FGT) argues that the local governments (which are closer to local people) should have roles in the resource allocation. The rationale is that decentralized levels of government can improve the efficiency of resource allocation (leads to maximum social welfare) by matching the supply of public service with the preferences and condition of the local people. Such an argument lies behind the Tiebout model of consumer choices, which state that a decentralized system enables individuals to choose living areas in jurisdictions that will provide them a mix of public services at favourable tax rates. Moreover, Oates' well-known decentralization theorem states that in the presence of diverse preferences and needs, provision of public services by a decentralized level of government generally will lead to efficient resource allocation and maximum welfare. The rationale behind such an argument is that local governments are in a better position than the central government to administer and deliver public services to citizens as a result of the informational advantage they have about local conditions and preferences (Oates, 1999). Likewise, the SGT also argues that decentralized governments could improve the efficiency of public services delivery and enhance social well-fare through competition- both vertical between different levels of government and horizontal among different government units at the same level (Brennan and Buchanan, 1980).

The FGT generally argues that a level of government that has control over the minimum geographic area capable of internalizing the benefits as well as costs should have the responsibility for provision of the public service. Accordingly, the central government should have responsibility on national policies and provision of public services that have nation-wide effects (like Defense, foreign relation). The reason is that, centralized these public functions would improve the efficiency of resource allocation and lead to maximize well-fare society as whole, due to realizing the benefit of economic scale and internalizing the interregional externalities (Oates, 1972:37). The sub-national governments, on the other hand, should have roles in provision of public goods and services that have regional and local benefit effects for

local residents. Thus, the resource allocation function should be carried out by units of government at various levels.

Overall, the assignment of functions among various levels of government can be summarized as follows:

Table 2.1: Theoretical Basis for Assignment of Expenditure Responsibilities

Expenditure Category	Service Responsibility	Service Provision	Comments
Defense	F	F	Homogeneous preference at national
Foreign affairs	F	F	Homogeneous preference at national
International trade	F	F	Homogeneous preference at national
Environment	F	F	Homogeneous preference at national
Banking & currency	F	F	Homogeneous preference at national
Internal commerce	F	F	Homogeneous preference at national
Immigration	F	F	Homogeneous preference at national
Airways/railways	F	F	Homogeneous preference at national
Industry & agriculture	F,S,L	S,L	Significant interstate spillover effect
Education	F,S,L	S,L	Transfers in kind
Health	F,S,L	S,L	Transfers in kind
Social welfare	F,S,L	S,L	Transfers in kind
Police	S,L	S,L	Heterogeneous preference at national
Highways	F,S,L	S,L	Some roads have interstate spillover, others are primarily local
Natural resources	F,S,L	S,L	Promotes a common market
<i>Notes:</i> F = Federal, S = State, L = Local <i>Source:</i> Adapted from Anwar Shah, 1994.			

Source: Adapted from Boadway and Shah, 1994..

2.5.3 Assignment of Revenue Sources

Once expenditure assignment has been determined, the next key question is which revenue sources are assigned for which levels of government in order to finance the costs of functions they are responsible for. It is concerned basically with which levels of government should have taxing power on what revenue sources (tax base) and which level of government should administer the tax bases (Ambrosano and Bordinon, 2006). The traditional approach (FGT) argues that an optimal tax assignment is directly related with the normative optimal assignment of public sector functions. The rationale behind such an argument is that taxation powers are instruments to carry out public functions. Hence, a logical point to start is to identify the public sector functions of each level of government, and assign taxes that are instruments of these public functions to the level of government that they have responsibility for. Thus, the traditional

approach argues that central government should levy and collect tax on tax bases with predominant stabilization effects like corporate and progressive personal income taxes; international trades (customs duties); non-benefit mobile tax bases; unevenly distributed tax bases (like natural resource); and taxes that involve considerable administrative economies of scale (like VAT), so as to carry out both macroeconomic stabilization and redistributive functions effectively (Oates, 1972:137; Musgrave, 1983).

On the other hand, the traditional approach suggests that sub-national governments should use only these tax bases whose yield is more insensitive to the macroeconomic conditions such as consumption taxes, general sales taxes and excise to avoid forecasting and planning problems at sub-national levels. It also argues that decentralized governments should impose *benefit taxes* such as service charges or fees on residents as payment for public services which they provide. Additionally, they should also levy taxes on relatively immobile tax bases like property tax and benefit taxes on mobile factors of production when they receive benefits from the public services provided by them (Mclure, 2001:14).

Generally, Oates (19972:137) and Musgrave (1983) argue that revenue sources should be allocated among different levels of government on the basis of the following general principles.

(P1)-Tax bases with predominant stabilization effects or highly sensitive to general economic conditions (like corporate and progressive personal income taxes) should be levied and collected by the central government. The rationale is that the center has a greater capability to deal with cyclical fluctuation in revenue such as fiscal deficit through borrowing, and also basic instruments for the center to achieve the objectives of macroeconomic function such as promote economic development and full employment by either reducing corporate income tax rate or providing tax relief to attract investors (Oates, 1972:55).

(P2)-Tax bases that are unevenly distributed such as natural resources and transfer by gift should be imposed by central government, so as to ensure national income equity and avoid political instability. The reason is that, if these tax bases are decentralized, it may create a wide horizontal fiscal disparity and distorts the efficient of resource allocation. This, in turn, may become a potential source of conflict between resource endowed regions and poor regions, which bring the intention of separation from the federation by poor regions (Boadway, 2009:152).

(P3)-The tax bases that have a mobile nature and create externalities such as PIT and CPT should be imposed by the central government. The logic is that, decentralized taxes that have a mobility nature would distort the efficiency of resource allocation and limits to implement an effective redistributive policy. The reason is that, if decentralized governments are empowered to impose tax on mobile tax bases, it may encourage rich individuals and business firms to relocate their living and business areas to local jurisdictions with low income rates and attract poor people to their jurisdictions (Oates, 1999:1127). However, decentralized governments could impose taxes on mobile factors of production when they receive benefits from the public services provided by them.

(P4)-Tax bases should be assigned to a level of government that has capacity to reduce both compliance cost to the taxpayer and administrative costs to the government. Thus, the centre should impose border tax bases such as VAT, corporate and personal income tax, foreign trade taxes (like custom duties). Because, the centre has better capacity to administrate efficiently these tax sources through economies of scale and scope (Shah, 2007:23).

(P5)-Benefit tax bases such as user charges and fees should be assigned to the level of government that provides the public services. Thus, decentralized governments should levy and collect benefit tax bases such as service charges or fees on residents as payment for public services which they consumed. The logic is that local jurisdictions are mainly concerned with resources allocation functions, because people are paid for the amount of service they receive from local governments (McLure, 2001:14). Moreover, benefit taxation such as taxes and user charges not only can be a useful mechanism to address negative local externalities, but also provide information on the demand level of public service for local authorities/officials.

(P6)-Revenue sources should be matched with their expenditure needs, so as to ensure accountability and improve efficiency of public services delivery at grass root levels. Thus, local governments should have power to impose taxes on productive revenue sources and freedom to decide at least tax rate, so as to establish a strong linkage between revenue raising and spending decisions at local levels. Moreover, local taxes should be highly visible so that the tax burdens are clearly perceived by the local people (Boardwary, 2009:158).

(P7)-Tax and non-tax revenue sources should be assigned to different levels of governments by taking into account the political, historical, and institutional backgrounds of a country.

From the above discussion, one can be observed that some principles of taxing assignment have conflict objectives. For example, for the reason of tax administration efficiency major tax bases concentrated under the central government and thereby compromising the fiscal autonomy and accountability of authorities at sub-national levels. Thus, the decision of which tax sources needs to assign for sub-national or central government must be made with high care, by trade-off between the need to achieve fiscal autonomy and accountability at sub-national levels in one hand, and the disadvantages of having a fragmented tax system such as inefficiency of productive resource allocation, macroeconomic instability, unbalance development across regions and high administration and compliance costs, on the other hand.

Based on the general principles mentioned above, the assignment of taxation power among different levels of government can be summarized as follows.

Table 2.2: Theoretical Basis for Assignment of Taxation Power

Tax type	Determination of		Collection & Administration	Comments
	Base	Rate		
Customs	F	F	F	International trade taxes
Corporate income	F	F	F	Mobile factor
Personal income	F	F,S,L	F	Redistribution, mobility, stabilization
Wealth taxes (incl. capital, inheritances)	F	F,S	F	Redistributive
Payroll	F,S	F,S	F,S	Social program
Value added tax	F	F	F,S	Admin. Costs, stabilization
Resources taxes:				
Rent (profit) tax	F	F	F	Unequally distributed
Royalties/fees	S,L	S,L	S,L	Benefit taxes
Conservation charges	S,L	S,L	S,L	Environmental preservation
Sales tax	S	S,L	S,L	Higher compliance costs
“sin” taxes	F,S	F,S	F,S	
Alcohol, tobacco	F,S	F,S	F,S	Health care shared responsibility
Gambling, lotteries	S,L	S,L	S,L	State and local responsibility
Taxation of ‘bads’:				
Motor fuels, effluent charges	F,S,L	F,S,L	F,S,L	Tolls on road use/by extent of pollution
Congestion toll	F,S,L	F,S,L	F,S,L	Tolls on road use
Parking fees	L	L	L	Local congestion
Motor vehicles Registration, driver’s licenses	S	S	S	State revenue sources
Business taxes	S	S	S	Benefit tax
Excises taxes	S	S	S	Immobile base
Land fee and property taxes	S	L	L	Benefit tax, immobile
User charges	F,S,L	F,S,L	F,S,L	Payment for services

Notes: F = Federal, S = State, L = Local

Source: Adapted from Boadway and Shah, 1994..

2.5.4 Fiscal Autonomy

Fiscal autonomy refers to “the freedom that SNGs to control over own revenue through taxation power and then to determine the spending these revenues independently”. It is basically depends up on the ability of SNGs to finance the expenditure responsibility from own revenues and the freedom to determine the expenditure patterns. Thus, fiscal autonomy of SNGs should be measured through analyzing the freedom in generating own revenues and spending the revenue in areas that gives high priorities. Fiscal autonomy mainly consists of spending autonomy and revenue autonomy.

SNGs’ spending autonomy refers to the extent to which the Regional/Local governments can control their budget resources. In other words, it refers to the ability of SNGs in developing their own policies and allocating their overall budget resources between recurrent and capital expenditures as well as across various sectors without the influence of central government (Shah, 2007). Theoretical and practical experiences of many federal countries around the world suggests that lower levels of government should have spending autonomy in order to prioritize their own expenditure programs based on the needs and preference of local people. Many scholars has been employed quantitative indicates of fiscal decentralization such as SNGs’ expenditure to total national expenditure to measure the degree of their fiscal autonomy.

Pola (1999), however, suggests that expenditure decentralization does not indicate the real decision making autonomy of SNGs. This is because, some part of expenditure responsibilities of SNGs might not be financed out of their own revenue sources; that is, some part of its expenditure responsibilities could be financed by federal transfers. Thus, public finance experts has been concerned on the qualitative aspect of fiscal decentralization such the degree of SNGs’ power to decides tax bases and rate as well as tax administration over own revenue sources, to measure fiscal autonomy of SNGs (McLure, 2001).The rationale is that central government is influenced the spending autonomy of SNGs through conditional grants.

Tax autonomy generally can be defined as the extent of freedom SNGs have to introduce or abolish taxes, set tax rates, define the tax base, and administrate the tax bases without influences higher level of government. It is commonly measured by the extent of regional/local governments decision-making power in determining tax bases and tax rates on own revenue

bases independently (Bahil, R, 2009). The Organization for Economic Co-operation and Development (OECD 1999), developed a new framework for measuring the degree of sub-nationals control their own tax bases and rates. The framework consists eight main categories of taxation, range from type (a) sub-national taxes where SNG have full power to decides on both tax rates and bases, to 'e' where central government has full power to determine both tax bases and rates. Category "d" represents tax-sharing arrangement, which in turn is divided into four sub-categories: ranges from 'd-1', where the SNGs in influencing tax sharing allocation formula to the other extreme "d-4", where central government can solely decide the revenue split . That means, degree of SNGs' influence on tax sharing arrangement decline as it goes from "d₁" to "d₄". Finally, category "f" represents non-allocable taxes.

Overall, SNG shave a higher degree of tax autonomy over their Own taxes ("a", "b" and "c"), because they have freedom to choose the taxes they levies, define the tax bases, set the tax rates and administer the taxes. Thus, the higher SNGs' reliance on own taxes, the more fiscal autonomy they enjoy. This, in turn, provides several benefits for lower level authorities. First, it improves the effectiveness of their budget preparation, since they can estimate their revenues with an acceptable degree of certainty and thereby helps to plan their expenditure flows accurately. Second, it enhances accountability at local levels, since it enables local authorities to increase or decrease the amount of their revenues by changing tax base and/or rate and at the same time they become responsible for the consequences of their actions. Finally, it improves the responsiveness of local authorities to delivery adequate and quality public services as per to local citizens, due to strongly linkage between revenue raising and spending decisions (McLure, 2001). On contrast, SNGs have no tax autonomy on "e" category, because they have no any authority over the choice of tax bases, tax rates, or tax administration. Likewise, they have a little tax autonomy over revenue-sharing arrangement (i.e. on "d" category), because, only federal government has responsibility to levy and collect the tax revenue and shares it with one or more other levels of government (regions). Thus, the higher SNGs are depends on tax sharing, the less fiscal autonomy they enjoy.

Table 2.3: Classification of Tax Powers as Per OECD

-
- a. Sub-national governments set tax rate and tax base
 - b. Sub-national governments set tax rate only.
 - c. Sub-national governments set tax base only.
 - d. Tax-sharing arrangements are in place
 - d.1 The sub-national governments determine the revenue split
 - d.2 The revenue split can be changed only with the consent of sub-national governments.
 - d.3 The central government can unilaterally change the revenue split fixed by legislation.
 - d.4. The higher-level government determines the revenue split as part of the annual budget process.
 - e. central government sets tax rate and base
 - f. None of the above categories a, b, c, d or e applies
-

Source: Organization for Economic Co-operative and Development, 1999.

2.6 Fiscal Imbalances (Vertical and Horizontal Fiscal Imbalances)

2.6.1 Vertical Fiscal Imbalance and Its Measures

Vertical fiscal imbalance refers to the mismatch between the cost of functions and the available financial resources of government units at different levels. This often occurs when the taxation power on major tax bases are assigned to the central governments; while the responsibility for provision of several public service that have higher costs assigned for sub-national governments for efficiency reason.. This, in turn, limits SNGs to cover the costs of services they are responsible for by their own revenues (Daflon, 2006:281; Shah, 2006:29).

Thus, vertical fiscal imbalance (VFI) can be addressed through a combination of different alternative policies such as reassignment of some expenditure responsibilities to the center or devolving more financial resources to lower levels of government, or allowing SNGs to levy supplementary rates on a national tax base or transferring funds in forms of grants (Shah, 2006:30). However, other scholars argues that reassigning expenditure responsibilities to center and/or devolving more revenue-raising power to lower level of governments may reduce the socio-economic welfare of citizens. For instance, Oates (1999:57) argues that assigning mobile

tax bases such as corporate and progressive personal income taxes to SNGs may create unintended results such as inefficient allocation of productive resources and further widening horizontal fiscal disparities. Thus, it commonly argues that vertical fiscal imbalance should be bridged through intergovernmental fiscal transfers or grants such as revenue sharing or/and unconditional formula-based transfers. But, such policy option should employ only on last resort, because it may undermine the accountability to local taxpayers.

Vertical fiscal imbalances commonly measures by the share of sub-national expenditures are financed by their own revenues under domains. Hence, VFI can takes values between zero and one. When the values are closer to one, it indicates a low vertical imbalance. This implies that the regional/local governments have freedom to determine the allocate budget resources into recurrent and capital expenditure as well as across various sectors without the influences of higher government level. This occurs when the share of regional states' own revenue becomes equal to their share of total expenditure. However, low values or coefficients can be misleading because the ratios do not indicate the degree to which the spending in a particular level of government relates to the amount of public service that ought to be provided for residents. That means, a sub-national level may be generating adequate own revenue from its jurisdiction to finance whatever services it is providing to local residents, but the quantity and quality of those services may significantly lower what should be provided. On the contrary, when values are closer to zero, it indicates the existence of a higher vertical imbalance. This implies that the sub-national levels are under absolute control of the federal government, because they heavily depend on federal transfers to finance larger parts of expenditure responsibility (Boex, 2006). Here, it is important to note that although a high value of VFI is desirable, a value of one has never been a goal in any federation due to efficiency and equity reasons.

2.6.2 Horizontal Fiscal Imbalance and Its Measures

Horizontal fiscal imbalance refers to a gap between the revenue raising capacity and the expenditure needs of government units presented at the same level. This occurs when revenue raising potential of SNGs are vary substantially, due to difference in terms of economic activity and opportunities. For example, some regional/local governments located in area that have abundant natural resources and high economic activity will have high revenue raising potential

as compares others which located in agrarian areas (Boadway, 2006:233). Similarly, expenditure needs of SNGs are also significantly vary due to several factors such socio-demographic characteristics of their populations (like population dispersion, urbanization, social composition and age structures), and physical features (like altitude, weather climate and other environment factors). Additionally, they have also difference capacity in realizing benefits from economies of scale, because certain public services require a minimum threshold of population size to provide it at lower average costs.

Thus, if expenditure and taxing responsibilities are highly decentralized, some regional/local governments would have capacity to provide the similar quantity and quality of public services at lower tax efforts for their citizen as compares to other regional/local governments. This in turn creates high variation of net fiscal balance (the difference between benefits of public services delivery and tax rate) between regional/local governments in a federation. Accordingly, identical people living in two different local governments will receive different public service benefits from the expenditures of their respective local governments. As the result, identical people are treated differently because they choice to live indifferent places in a federation. This is the source of horizontal fiscal inequities to the extent that poorer peoples do not move to relatively rich local governments. Besides, such situation also is incentive individuals and business firms to move from their local jurisdictions to other local governments with high fiscal capacity. This in turn also distorts the efficiency of resources allocation due to highly concentration of factors productions in few local governments of the federation (Shah, 2011:29). Thus, horizontal fiscal disparities have both efficiency and equity implications. This requires design of fiscal equalization program to enable all SNGs to provide similar public services at comparable tax efforts. This implies, transfer mechanisms from central to lower levels of governments become not only an empirical reality but also an instrument of compensating internal disparities or inequality.

2.7 Intergovernmental Fiscal Transfer and its Forms

Intergovernmental fiscal transfers are the third pillar of intergovernmental fiscal relations and an important revenue source of the lower levels of government in both developed and developing countries (UNDP, 2005). It has many names such as grants, subsidies, subventions etc. Many countries across the globe are designed and implemented various intergovernmental transfer systems to achieve different national objectives. However, the process, extent, the nature of transfers to address the fiscal imbalances varies from one country to another, since countries vary in terms of specific conditions. Some countries design the transfer systems to be very decentralizing in nature while others are centralized.

2.7.1 Economic Rationales for Intergovernmental Fiscal Transfers

According to fiscal federalism literature, there are four major economic rationales or reasons for intergovernmental transfer or grants (Boadway, 2006: 57-62).

- I. Central governments are often granted most of buoyant and elastic taxes and income taxes; while SNGs empowered to provide public services which involve high costs, for efficiency and equity reason. Thus, it leaves SNGs with inadequate financial resources to finance their expenditure responsibilities. It requires intergovernmental fiscal transfer in order to close the vertical fiscal imbalance.
- II. Sub-national governments in any federation have no equal fiscal capacity except by chance, due to variation in revenue raising capacity and expenditure needs between them. Thus, some regional and local governments that have poor fiscal capacity would impose higher tax rates to provide similar quality and quantity of public services for their residents. this require design of fiscal equalization schemes to close horizontal fiscal imbalance, so as to provide a minimum national standard public service to all citizens of the country regardless of their choice of living location.
- III. Spillover effect occurs when the benefit and cost of public service provided by a sub-national government affect not only the well-being its residents, but also the residents living in other sub-national governments of a country. Example pollution control (water or air), inter-region highway, higher education, and fire production. If a local government is not reaping all benefits from the public services, it would incentive to under invest in

these services. Therefore, the central government should provide grant in form of conditional matching grant to victim jurisdictions, so as to avoid such problems of under provision and improve efficiency of public service delivery. The amount of transfer provide by central governments should be consistence with the degree of spill-over. It also important to consider spill-over effects in the assessment of local expenditure needs, so as to ensure inter-jurisdictional equity.

- IV. Central government has comparative advantage in mobilizing resources when compared with the SNGs, because it has better capacity to levy and collect revenues in more efficiency manner, due to economic of scale and scope. Thus, it is less costly for central government to collect taxes and then allocate the revenues to SNGs in form of transfer.

In addition to that, many federal countries have been also used transfers as mechanism to strengthen the unity of their country by empowering the lower levels of government to pursue their own goals while influencing their priorities through conditionality (Shah, 2006:30). Central governments may also use fiscal transfers to achieve certain political goals such as to protect the minority groups from manipulation and obtain political benefits (for example to stay in power) (Sorenson, 2003 as cited on Gebrehiwot, 2014:282). Finally, central government may be used transfers to discourage the autonomy of local government. This is because; authorities at center, especially in developing countries, often resistant to give up control over governance that would come with giving revenue raising powers to local governments.

However, the intergovernmental transfer programs may have conflicting objectives or provide unintended results. For instance, specific grants that provide to wealthier areas may offset the redistributive effects of an equalizing grant. Transfers may also substitute for, rather than stimulate local tax effort, thereby failing to increase public spending as much as expected. For instance, a transfer mechanism which designed to address only the vertical fiscal imbalance may reducing the effort of local governments to generate more own revenues (Ter-Minassian, 1997:74). Moreover, fiscal transfers may create incentive problems such as bailout problem at sub-national levels, because, it may incentive the regional/local governments to overspend and over borrow, by expecting that their public expenditures will ultimately be subsidized by center through raising more tax revenue in other jurisdictions. Finally, transfers may also reduce the

autonomy of sub-national governments if they involve federally set priorities or conditions. Therefore, to put in place effective intergovernmental fiscal transfer system that can live up to its objectives, transfer system must be designed to avoid undesirable side effects such as loss of autonomy for government units, incitement to inefficiency, reduced accountability, and high monitoring costs.

2.7.2 Forms of Intergovernmental Transfers or Grants

Intergovernmental transfers or grants generally can be classified into three major categories, namely, general-purpose (unconditional), specific-purpose (conditional or earmarked). Each form of transfers is discussed in detail as follows.

I. General Purpose (Unconditional) Grants

Unconditional grants refer to transfers of funds from central government to lower levels of governments without any preconditions attached to the transfers. As a result, it provides full autonomy for the SNGs to allocate the transferred funds in any areas or programs which they give higher priorities (Shah 2007:25). Central governments often used such types of grants to address horizontal fiscal disparities across regional and local governments, so as to ensure the provision of minimum standards of public services. However, such grants may reduce the incentives of sub-national authorities to generate adequate own revenues from their jurisdictions and utilize the transferred fund in efficient manner. It also may reduce accountability at sub-national levels, due to lack of a strong linkage between revenue raising and spending decisions (Weingase, 2014). In principle, there are two major questions that needs to address in designing a mechanism for transfer funds in form of general purpose grants from central government to lower levels of government: how the aggregate grant pool be determined? And how the total grants pool to be distributed among lower levels of government?

Concerning the first issue, the federal government can determine the total grant divisible pool base on three approaches: (i) a fixed proportion of central government revenues, (ii) on an ad hoc basis i.e. based on negotiations with lower levels of government or (iii) on a cost reimbursement i.e. a proportion of specific local expenditures to be reimbursed by the central government. Each approach has its own advantages and disadvantages. The advantage of Ad-Hoch basis approach

is that it provides high flexibility for center and enables it to change its spending priorities without changing expenditure assignment. Such approach has also several limitations such less transparent, and highly subject to political manipulation as well as unpredictable and unstable (Shah 2007:25).

Once the total pool of federal grants is determined, the distribution of such grants among sub-national governments can be done in three approaches: on political negotiations; or on Ad-hock (discretionary) basis, or by using a predetermined grant formula. Each approach has its own advantages and disadvantages in terms of data requirements and in strictly compliance to the fundamental principles and provisions of the constitution. In the first approach, the federal government is allocating the grant pool to each region through negotiation with individual regional governments. The limitation of this approach is that less transparent and endowed full power for the federal government to determine the financial needs of each region. In the second approach, the federal government retains full power in allocates the grant pool for each regional/local governments. Thus, this approach gives the central government high flexibility to response to changing and unexpected fiscal needs arising among SNGs. However, it create uncertainty for SNGs, because they do not know how much grant fund they will receive. The unconditional grants further can be categorized into two forms (types) of transfers or grants, namely: revenue-sharing transfer and fiscal equalization) transfer. The nature of each types of unconditional grants is discussed in detail as follows.

A. Revenue Sharing

Revenue sharing is an arrangement whereby tax revenue collected by central government divided vertically between central and sub-nationals as well as horizontally among sub-nationals. The proceeds from shared taxes can be distributed vertically between the federal and SNGs either on a tax-by-tax basis or on the entire pool of tax revenues collected by central government. In the first approach, the revenue collected by the federal government from each tax base (like PIT, CIT and VAT) is shared between the federal and the regional/local governments using percentages set by the constitution or other pertinent legislation. The limitation of this approach is that it may incentive the authority at center to concentrate its collection efforts on the taxes that are either not shared or shared to a lesser degree (Ahmad and Craig, 1997). In the second approach, on the other hand, a portion of the proceeds collected from all shared taxes is

transferred for SNGs on the basis of a predetermined formula. Thus, such revenue sharing arrangement may be preferable approach, because, it enhance SNGs' fiscal autonomy and enable to realize the potential benefits of uniform application and administration of a tax policy like efficient tax administration, avoid unhealthy tax competition and treat taxpayers in the same manner (Balh and Linn, 2001).

There are two general principles or rules for allocating the shared revenue horizontally among the Regional/local governments: *Principle of derivation and equity considerations*. In the first case, a specified portion of the revenue generated from shared tax bases are transferred to the Regional/local government from which it is collected. Although this approach is encourage SNGs to mobilize more revenue from their jurisdictions, it further wedding the fiscal capacity gaps between regional/local governments. This principle is practiced widely in many developing countries, but the taxes shared, and the rating of the share varies from country to country (Shah, 2004). In the second case, on the other hand, the shared revenue is allocates for each Regional/local governments by a predetermined formula that takes into account the fiscal capacity of each regional/local governments in delivering of some standardized level of public services for local citizens. The rule to adopt is dependent up on the purpose to be achieved through other forms of fiscal transfers such as grants.

B. Fiscal Equalization Grants

Many academicians agree that a formula-based fiscal equalization grant is preferred over the other approaches, if properly designed and implemented because it improve the predictability and the fairness of the transfer system by removing judgments. It can also eliminate the incentives of sub-national authorities to maximum their share of federal transfer by lowing tax efforts and over-spending. Finally, it also provides effective means to address fiscal capacity disparities and enhance efficiency of public service delivery and, accountability at sub-national level. In practice, however, it is too difficult to design and implement an effective and efficient a formula-based fiscal equalization transfer system, mainly due to the complexity of dimensions involved in the process of design such grant formula.

According to fiscal federalism literatures, there are four types of fiscal equalization grant system: Revenue Raising Capacity Equalization (RRCE) Formula; Expenditure Needs Equalization

(ENE) Formula; Equalize Per-Capital Equalization (EPCE) Formula; and Revenue Raising Capacity and Expenditure Needs Equalization (RRCENE) Formula (applied in Australia) (Shah, 2004, and Broadway, 2006). The first approach is estimated the fiscal capacity of each regions based only on their ability to generate revenue from own sources by using either macroeconomic indicators or Representative Tax System (apply in Canada and Germany). The second approach is measures the expenditure needs of each regions based on some “needs” indicators to allocate the federal grant pool (apply in India). The third approach is allocates the federal grant pool for regions on an equal per-capital basis (apply in Germany’ VAT sharing and Canada’ Established Financing Program). Finally, in the last case, it allocates federal grant pool by considering both the revenue raising potential and expenditure needs of each regions (apply in Australia. Of these approaches, the third approach is more appropriate way for allocating federal grant, because it offers the potential for full equalization and measure the horizontal fiscal gaps in more accurate manner (Vaillancourt and Bird, 2005). However, this approach requires extensive data to estimate the revenue raising capacities and expenditure needs of sub-nationals.

II. Conditional (Specific Purpose) Grants

Conditional (specific purpose) grants refer to grants attached with some kind of preconditions the grantor wants to achieve or they may require attainment of certain results in public service delivery (Shah 2007:25). Thus, the recipient government will in effect be left with no option but of spending the transfer funds in the area specifically required by the grantors. As a result, these grants are restricting the spending autonomy of sub-national governments and thereby partly against the arguments for decentralization. The conditions which impose by conditional grants can be on input-based or output-based. In the first case, the type of expenditure that grants can be used for impose it, while in the second case the grants require the achievement of certain results in public service delivery. In principle, output based grant is better than input based grant, because it do not only incentives the sub-national authorities for cost efficiency but also enable to achieve national goal such as provision of minimum standards of basic public services such as health and education (Ahmad and Craig, 1997:87). Additionally, such type of grants play roles in reducing financial embezzlement and corruption, because the federal government retains the power to set conditions, to control and audit the spending of the grants (Ibid: 89).However, such

grants may impose significant administration cost for the central government and compliance cost for the lower levels of government.

Conditional grants can be classified into matching or non-matching grants. In the first case, the recipient government requires contribute resources either in cash or kind to cover a portion of the total cost of a specific project/program. As the result, this type of grants is sometimes called *cost-sharing programs*. Such types of grants are often used to encourage regional and local governments to maximize their initiatives for self-financing. However, matching grants are forced regional and local governments with weak fiscal capacity to shift their scarce resources toward the priorities set by the national government. Consequently, the structure of local priorities and spending may be distorted and in turn could negative effects on the overall welfare of the recipient residents (Shah, 2006:34).Furthermore, matching grants can also be either *open ended* or *closed ended*. In the case of open-ended matching grant, a grantor contributes the same level of resources to be spent by the recipient governments in specific area. Such grants are often used to incentive the sub-national authorities to design their expenditure programs by considering any positive spillover effects to neighboring jurisdictions, so as to improve the efficiency of resource allocation in a federation (Boadway, 2009:62).In case of close-ended matching grants, the grantor specifies the maximum amount of funds that it will contribute in order to put a ceiling cost borne by it. It is argued that such grants are preferred and used in many countries, because it takes into account the budget constraint of the grantor government.

Conditional non-matching grants, on other hand, are provides certain amounts of financial resources to lower levels of government without requiring local matching as long as the financial resources are used for a specific purpose. These transfers are usually used to subsidizing activities in which the higher level governments assigns high priority, but are given low priority by lower levels of government; such as rural road construction, primary education, and basic health services, etc. Thus, such grants are usually used to address horizontal fiscal disparities and achieve the provision of minimum national standard basic public services. However, such grants may discourages sub-national authorities to generate adequate own revenues from their jurisdictions, since they do not impose any matching requirements.

2.7.3 General Principles of Intergovernmental Grants

Intergovernmental fiscal transfer systems should design by considering the following general guidelines or principles, so as to meet national goals such as addressing fiscal problems (both vertical and horizontal fiscal imbalances), and internalizing interregional externalities/spill-overs.

- i. **Autonomy:** The transfers should provide adequate independent and flexible for SNGs to allocate the transferred fund on expenditure programs that gives them high priorities. That means, SNGs should not be constrained by the categorical structure of programs and uncertainty associated with decision making at the center.
- ii. **Clarity in grant objectives:** grant objectives should be specified clearly and transparent. In particular, when conditional grants are part of the transfer system, each grants should be focused on a single clearly specify objective in order to assess the effectiveness of the transfer program appropriately.
- iii. **Predictability:** The amount of transfers should be known well in advance in order to enable the SNGs to prepare their budget effectively and plan long-term objectives to provide efficient public services for local residents. Additionally, it is important that the amount of transfers which allocated to SNGs should be actually distributed for their use on a timely basis.
- iv. **Equity:** The grants should be allocated across SNG by taking into account of their fiscal capacity. Thus, the amount of transfer should vary directly with expenditure need factors such as costs of public service provisions and inversely with the revenue raising capacity of each SNGs, so as to enables them to provide comparable public services at comparable tax rate to all citizens of the country regardless of their choice of living locations.
- v. **Revenue adequacy-** the transfer system should be adequate financial resources SNGs that can enable them to carry out the functions they are responsible for effectively. Thus, transfers should take into account of the imbalance in resource availability of SNGs presented at different levels and between regional/local governments. Additionally, the amount of transfer should grow proportionally with the SNGs' expenditure needs over time.

- vi. ***Incentives***: Transfers should encourage SNGs to have a sound fiscal management system, to generate more own revenue from their jurisdictions, but it should discourage inefficient practices..
- vii. ***Responsiveness***- The grant program should be flexible enough to accommodate unforeseen changes in the fiscal situation of the recipient governments.
- viii. ***Efficiency***-The design of the transfer system should be neutral with respect to SNGs' choices of resource allocation into recurrent and capital expenditures as well as across various sectors. That means, the transfer system should encourage lower levels of governments to spend their limited resources carefully and in the most productive way possible, so as to promote local social-economic developments.
- ix. ***Simple, Transparency and stability*** - Both the fiscal transfer formula and the allocation decisions should be disclosed appropriately to all fiscal transfer stakeholders, so as to achieve general consensus among the stakeholders on the objectives and operation of the transfer programs. This will enable the local authorities and their peoples to ascertain how their share of a particular transfer was determined. Even if they are not satisfied, at least they will understand why they received a different amount than other jurisdictions. Additionally, the grant formulas should be easily implemented and understandable by all stake holder involved in the design process.
- x. ***Avoid sudden and large change***-During the introduction of new transfer mechanism, the transfer system should avoid sudden large changes in the amount of transferred funds for SNGs, and the changes should try to hold SNGs "harmless" during the transition to a new allocation mechanism.
- xi. ***Accountability***:- The grantor must be accountable for the design and operation of the transfer program. The recipients must be accountable to the grantor and the citizens for financial integrity and better utilization.

2.8 Sub-national Borrowing

Sub-national borrowing is the last and important pillar of fiscal federalism. It is referring to the capability of SNGs to borrow money from capital markets to cover the costs of functions which they are responsible for. Sub-national borrowing/debt is appropriate for financing only capital-intensive projects with yield rates above the interest rate and the ability to pay back total

investment cost within due dates (Bailey, 2012). The basic rationale behind such fiscal rule revolves around the intergenerational equity, efficiency and distribution and macroeconomic considerations (Ebel and Yilmaz, 2001:24).

The basic rationale for sub-national borrowing is that it improve the efficiency of resource allocation by matching the supply of long-term infrastructural projects with the needs and preferences of local people. The logic that decentralized governments have better knowledge about the preferences and conditions of local people as compared to the centralized system, which provides a uniform public services across all local jurisdictions (Musgrave, 1959; Oates, 1972).

The argument behind the intergenerational equity is that the burden and benefit of capital project should be spread out across generations through debts. Thus, sub-national authorities should not be allowed to finance their recurrent expenditures through long-term debt, so as to avoid transferring of debt burden to future generations without any additional physical assets. Similarly, financing the capital projects through imposing higher tax rates on current generation is also undermines intergenerational equity, because future generation will receive benefits from the capital projects without paying for it. But, it is possible for sub-national authorities to borrow funds to smooth out their revenue inflow and outflow within a single fiscal period as far as it is to be repaid at the end of the fiscal year.

In practice, however, the SNGs in developing countries are restricted by central government to borrow funds extensively for financing the capital projects in order to ensure macroeconomic stability in long-run (Prud'homme, 1995). But, many countries around the world applied different debt control approaches to preserve macroeconomic stability and ensure fiscal discipline at sub-national levels. These approaches are discussed in detail as follows:

Market discipline: - under this approach, the capital markets or financial institutions are enforcing the discipline and sound borrowing practices of SNGs by imposing high borrowing costs or by denying access to source of finances when the economic fundamentals are too bad. Such mechanism is incentive the sub-national authorities to improve their solvability by reducing spending or increasing own revenue. Thus, in this approach, the central government would not set any limits on sub-national borrowing; as a result, they are free to decide the amounts, sources

and uses of the borrowing. Bahal and Linn, (2001) specifies the following conditions for the markets to exert effective discipline on the sub-nationals borrowing: (i) The capital markets should be not only open and financial deep, but also should not be required to accord a privileged position to the sub-national governments; (ii) there should not be a possibility of bailout for the sub-nationals' debts by the central government; (iii) information regarding sub-nationals outstanding debt and debt servicing capacity should be available to the potential lenders; and (iv) the sub-nationals should have sufficient capacity to ensure a proper policy response to signals from the market before being excluded. However, this approach will not be an effective mechanism, if the SNGs are able to run fiscal deficits through borrowing from the financial institutions owned by federal/ regional governments. It is also less important for small size SNGs, since they highly depend on transfer. This indicates, therefore, the market-based approach is not an effective mechanism to discipline the sub-national borrowings in developing countries including Ethiopia.

Rule based approach:- under this approach the central government has control sub-national borrowing by imposing a fiscal rule. Many federal and unitary countries are applies various type of fiscal rules (which are specified in the constitution or in laws) to control sub-national borrowing. There are three main types of fiscal rules, namely, budget balance rules, expenditure ceilings and borrowing limits. In the first case, for instance, SNGs are allows to borrow funds only for financing capital projects (commonly known as a golden rule). However, the effectiveness of these fiscal rules in discipline the sub-national borrowing is depends on the ability of sub-nationals to circumvent the rules. Fiscal rules are often introduced numerical targets on the basis of ratios that use either the level of GDP, tax, or total sub-national revenues. Moreover, the fiscal rules may be imposed by higher levels of government or self-imposed by SNGs themselves. The main advantages of this approach are: it is transparency, equal treatment to all SNGs and an implicit check on political bargaining as well as easy to monitor.

Cooperative approach:- under this approach, borrowing controls for sub-national governments are designed through a negotiation process between the central and the lower levels of government. In this case, the central and the lower levels of government are actively coordinating their actions to set the key macroeconomic objectives and the fiscal parameters that reinforce these objectives. They may also develop a mechanism to monitor the agreed upon

targets and revise the targets if the economic situation is required. Besides, they may also set the borrowing and spending limits in absolute terms periodically at national and sub-national levels. This approach has several advantages includes (i) It promotes dialogue and exchange of information across various levels of government, (ii) it allows the SNGs to discipline the federal government by questioning the rationale of its fiscal policies and/or conditioning their fiscal conservatism with the practice at the federal level; and (iii) it enables lower levels of government to develop a common understanding among them with regarding the effects of their budgetary decisions on macroeconomic objectives (Shah, 2007). This approach, however, works effectively when the central government is strong and able to steer the intergovernmental negotiations in effective manner.

Administrative approach: - under this approach, the central government is empowered by laws to directly control the borrowing activities of sub-national governments. The control mechanism may take various forms, such as setting of annual limits on the overall debt of individual SNGs; and reviewing and authorizing of individual borrowing operations includes approval of the terms and conditions of the operation (Teresa T. and Jon., 1997:162). Central governments may exert control over all lower levels of government or only some. However, this approach has two main limitation includes: create moral hazard problem, because lenders may perceive that existence of an implicit bailout guarantee; and central governments may not adequate capacity to assess the feasibility of SNG' projects when deciding which ones to finance. In practice, many countries have been applied various enforcement mechanism to ensure that fiscal rules are compliance by SNGs. Some of these are: requiring the non-compliance SNGs to improve their budget transparency, imposing financial penalty, requiring to follow restructuring plan, and imposing sanction elected officials severely.

2.9. International Experience of Fiscal Federalism in Selected Countries

Although the theoretical justification for fiscal federalism and decentralization is sound, its practicability widely varies across countries in the world. These variations are normally a reflection of the historical, socio-cultural condition, political and economic systems, and the demographic and geographical characteristics of each country. The variations are dynamic because there are different challenges to be dealt with and the choices to be made. This diversity

among countries resulted in a wide range of differences on the systems adopted for the resolution of inter-governmental fiscal relations. despite such diversity in arrangement of fiscal power makes difficult to come up with a single “best” model of fiscal federalism that can be applied to all countries around the world, it is helpful to identify the feasible options in modifying the fiscal system of a specific country. The purpose of this section, therefore, is to review the experiences of some federations around the globe, with vary level of socio-economic developments, having long history of democracy and modern fiscal system, related to fiscal federalism. The selected countries are: Nigeria, India, Brazil (from developing counties) Germany, Australia, and Canada (from developed countries). The purpose is to find out certain lessons and use it, if necessary, as input in modifying the decentralized fiscal system of Ethiopia.

2.9.1. Expenditure Assignment

Although, the general principles for assignment of expenditure responsibilities mentioned in previous section are useful, in real world there is no a single optimum model for assignment of expenditure responsibilities that can be applied across countries because each country vary in terms its own specific conditions. Thus, countries across the globe are varies in terms of the models they follow for the assignment of power and functions among different levels of government. For instance, Canada, Australia and India resembling to follow a ‘dual’ federalism model since they attempted to clearly demarcate the competency areas of each levels of government separately. In this model, the regional governments have high decision making autonomy while the local governments are the creation of regional governments and have little or no direct relationship with federal government.

Germany, Nigeria and Brazil, on the other hand, follow a cooperative federalism model since they are institutionalized a shared competency. In these countries, power and functions that have regional nature but have impacts beyond one regional states are list in the concurrent legislative power. Accordingly, the federal government is empowered to determine national policy and standards on the shared functions while the SNGs have responsibility to implement and administer the nationally determined policy. In Germany, for instance, the Federal government has the right to enact framework legislation aimed to ensure uniformity implementing of policies and service provisions across the federation. But, within the framework, the Landers have the

right to issue their own legislation within the limits set by the federation (Watts and Hobson, 2000).

As can be seen from table 2.4.below, although the selected federal countries employ different approaches for allocating power and functions, they taken into account the general principles of fiscal federalism (such as subsidiary principle, economics of scale, spill-over effects, macroeconomic stabilize and income redistributive factors) in allocating public functions among various levels of government. In most of the selected countries, functions that have national importance are assigned exclusively for Federal government; while functions that have regional and local benefits impact are assigned exclusively for SNGs. In principle, if State/local governments are responsible for the provision of public services with spill-over effects, center should be designed an effective transfer system to provide funds for lower levels governments to incentive them to increase the provision of such public services. However, the experiences of almost all federation shown that this task has not yet been satisfactorily solved the problem (Thiessen, 2003).

Moreover, the extent and nature of the expenditure decentralization is varies between the selected countries, and across policy areas. For instance, it is strongest in Canada; fairly strong in Brazil, Australia; and relatively weak in Germany, India, Nigeria. As the result, the expenditure share of sub-national governments in Canada and Brazil is higher compared to the other selected federal countries. The experiences of the developing countries, however, shows that there are many problems related with the assignment of expenditure responsibilities among various levels of government; which includes: lack of formal assignment, inefficient assignment, ambiguity and co-sharing responsibilities. This, in turn, create duplication and overlapping problems and would breeds conflict among government units at different levels and thereby reduces the efficiency of public service delivery and accountability at sub-national levels.

Table 2.4. Assignment of Power and Functions among Different Levels of Government in International Countries

Countries	Power and Functions			
	<i>Federal Government</i>	<i>Regional States</i>	<i>Local Governments</i>	<i>Shared</i>
Nigeria	Defense, international relations, banking, currency and legal tender, citizenship; weights and measures; nuclear energy; traffic on federal trunk roads; and external relations (including borrowing and foreign trade)		Establish of cemeteries, markets, motor parks, public conveniences and refuse disposal; local roads, streets and public parks; primary education and primary health care; and agriculture and natural resources.	industrial, commercial and agricultural development; post-primary education; and secondary health care
India	Defense, international trade, foreign affairs, operation of railways, posts and telegraphs, national highways, shipping and navigation on inland waterways, air transport, atomic energy, space, regulation, and development of oilfields and major minerals, inter-State trade and commerce	Public order, provision of public health, agriculture, irrigation, land rights, fisheries and industries and minor minerals	Establishment and maintenance of markets, motor parks, public convenience, refuse disposal, constructions and maintenance of local roads	Education and transportation, administration of justice; social and economic planning; social security and social insurance
Brazil	Defense, foreign relations, currency, postal services, nuclear energy, national highways and regulation of labor conditions, foreign and ; interstate commerce, finance, banking and insurance, commercial advertising, inter-state transport, telecommunications and data processing, energy, mining, employment insurance, social security, immigration and naturalization	Construct and maintenance of Regional highway systems, provision of low-cost housing, public infrastructure (like telephone) and transit police	Construction and maintenance of local roads, creation and maintenance of public parks and museums, and delivery of primary education; and provide municipal services such as water, sewerage, and garbage services.	
Germany	foreign affairs and defense, citizenship and immigration, rail and air transport, criminal policing and foreign trade			Civil and criminal law, regulation of nuclear energy, labor relations, environmental protection, and road transport.
Australia	Foreign affairs, foreign trade, defense, immigration, inter-Regional trade and commerce, currency and banking, maritime activities, posts and telegraphs and social security payments	Provision of education, health, public and social services	Provision of water supply, sewerage, garbage disposal, etc. and maintaining the road system, recreation and cultural services	
Canada	National defense, social services, debt charges, internal trade, and administration of railway, harbors and canals	Provision education, health-care, municipality services, and ownership and exploitation natural resources	Provision of municipal services such as water, sewerage, and garbage services	Agriculture, forestry, fishing and public health

Source: Federal Constitutions of the Selected Countries and Other Published Materials

2.9.2. Taxation Power Assignment

Although, the general tax principles which mentioned in pervious section are useful, the assignment of taxation power to various levels of government in real world highly influences by specific circumstances of each countries such as historical, socio-cultural, economic and political institutions. Thus, the approach for the assignment of taxation power among various levels of government are varies among countries across the world. Each country is generally followed one or a mix of three basic approaches, namely tax separation (tax base and rate autonomy); concurrent taxation (co-occupancy of tax bases along the autonomy to set tax rates); and tax-revenue sharing (both tax bases and rates under the control central government but a fixed percentage of revenue share with the States).

As can be seen from table 2.5 below, Canada and Brazil are practiced the first approach and empowers the sub-national authorities to determine tax bases and rates on taxes under their domain without the influences of central government. Such approach, however, leads to horizontal tax competition between the regional states to attract rich individuals and business firms to their jurisdictions, and could leads to “*race to bottom*”. In practice, the adverse effects of horizontal tax competition could avoid through establishing an effective fiscal institutions like the ‘harmonized tax agreements’. In Canada, for example, although the regional states are granted a legislative tax power on tax bases with mobile nature (like CIT and PIT), horizontal tax competition is limited through tax harmonization and fiscal equalization system. Australia is practiced the second approach and leads to vertical tax competition between federal government and regional states. Nigeria, Germany and India, on the other hand, are practiced the third approach and enables them not only to avoid the potential problems related to both vertical and horizontal competition, but also improve the efficiency of tax administration. Such approach, however, limits the regional states to determine tax rates and tax-bases on tax bases under their domain due to harmonization of the tax systems by central government.

Table 2.5: Assignment of Taxation Power among Different Levels of Government in Selected Countries

Countries	Revenue Sources			
	Federal Government	Regional States	Local Governments	Concurrent (Shared)
Nigeria	Custom duties, mining rents and royalties, petroleum profit tax, CIT, excise duties and VAT, and PIT	PIT, stamp duties, capital gains tax, and BPT on individual traders; and pools betting and other betting taxes; motor vehicle and drivers licenses; entertainment tax and registration and survey fees; property taxes; and market and trading license and fees		Mining rents and royalties, petroleum profit tax, PIT, CIT, excise duties and VAT
India	Tax on income and wealth from non-agricultural sources, corporation profits, taxes on production (excluding those on alcoholic liquors) and customs duty	Land revenue tax, tax on agricultural incomes and wealth, professional tax, state excise duty, stamp duties and tax on the sale and purchase of goods	Tax on urban property and user fees on municipal services like electricity, drainage and water supply	Goods & Service Tax on a common base of economic activity
Brazil	CIT and PIT, foreign trade, rural properties, payroll, wealth, banking, finance and insurance, hydroelectricity, mineral and Industrialized Products and VAT on manufacturing sector	Sub-national VAT on Circulation of Goods and Services (ICMS), inheritance and gifts, and motor vehicles registrations	User charges on municipal services and collect taxes on retail sales of fuels (except diesel), on property transfers (intervolves), and special assessments (frontage).	PIT and Industrialized Products Tax; and sub-national VAT
Germany	Mineral oil tax, tobacco tax, income tax from Regional monopoly, insurance tax and custom duties.	Capital and land transfer tax, motor vehicle tax, inheritance tax, gift tax, beer tax, and fire protection tax		CIT, PIT, and VAT
Australia	PIT, CIT, excise duties, custom duty (tax on foreign trades), and Goods and Services Tax (GST)	Tax on payroll, land use, financial and capital transaction, gambling, insurance, motor vehicles and mining royalty	User charges on municipal services	PIT, CIT, and Goods and Services Tax (GST)
Canada	PIT, CIT, VAT, and succession and estate taxes as well as customs duties and, excise taxes	PIT, CIT, payroll tax, sales tax (VAT in some places), excise taxes on items like alcohol, tobacco and petroleum, succession and gift tax, health and social insurance levies, and property taxes	Property taxes	

Source: Federal Constitutions of the Selected Countries and Other Published Materials

Overall, there is variation among the selected countries regarding the degree of tax autonomy endowed for Regional states. In Canada and Brazil, for instance, regional States have relatively high tax autonomy as compared to the regional States in other federations. As the result, they incentive to engage in tax competition to attract mobile factor productions, especially business firms, to their jurisdictions. The experiences of the selected countries generally suggests that centralized tax system through harmonization process is necessary to avoid unhealthily tax competition, while decentralized tax system is essential to reap the potential benefits of tax competition. Thus, tax competition and harmonization becomes an important issue among policy-makers and academicians around the globe recently. There is no consensus among scholar regarding tax competition, some scholars argue that tax-competition has potential to improve fiscal system of a country while other scholars argue that it leads to race-to-bottom. Therefore, the devolution of legislative power on taxes to lower levels of government should be made with care, by balancing the costs and benefits of tax competition and harmonization in each specific country.

The experiences of developing countries, however, shown that taxation power is more centralized than dictated by fiscal federalism principles may be due to various reasons. First, they placed a premium on tax harmonization than tax competition. Second, they believed shifting expenditure responsibility downward was politically more feasible than allowing finance to follow functions. Third, sub-national authorities are less than enthusiastic about assuming taxing powers but very interested in receiving fiscal transfers from the central government with little accountability to local taxpayers. As a result, the assignment of taxation power in the selected developing countries often create inefficiencies in the resource allocation and cause fiscal capacity disparities among lower levels of governments. Therefore, assignment of tax power to different levels of government should be made with care, balancing the costs and benefits of fiscal decentralization in each country. In addition to that, the 'preferred tax assignment' should be changed over time with changes in the economy, for example in response to globalization as well as with changes in the available 'technology' of tax assignment.

2.9.3. Fiscal Imbalances (Vertical and Horizontal Fiscal Imbalances)

Fiscal systems of most countries across the world are characterized by both vertical and horizontal fiscal imbalances. The vertical imbalance occurs due to high concentration of most productive tax revenues at the federal level and decentralization of expenditure responsibilities at sub-national levels of government, for efficiency and equity reasons. While the horizontal imbalance occurs due to existence of fiscal capacity gaps between States and local governments in a federation, mainly due to a significant variations among regions in terms of economic activities and infrastructure developments. However, the causes and extent of both the vertical and horizontal imbalances considerably varies across the selected countries. Canada and Brazil, for instance, have minimal vertical imbalances due to tax power devolution, harmonized tax system and the revenue sharing mechanisms (refer table 2.6 below). Additionally, the fiscal systems of all selected countries with exception of Australia are characterized by a wide horizontal fiscal capacity disparities, mainly due to variation in economic activity and industrial development among regions within the federations. In Canada, for instance, despite the existence of a high degree of decentralization in taxation power, significant difference in fiscal capacity is observed between the States due to significant variation in economic activities and endowment of natural resources across the regions.

Table 2.6.: Revenue and Expenditure Share of Selected International Countries

Country	Level of Government	Revenue Share	Expenditure Share
<i>Nigeria</i>	Federal Government	80%	47%
	Sub-national governments	20%	53%
<i>India</i>	Federal Government	67%	37%
	Sub-national governments	33%	63%
<i>Brazil</i>	Federal Government	54%	45%
	Sub-national governments	46%	55%
<i>Germany</i>	Federal Government	70%	29%
	Sub-national governments	30%	71%
<i>Australia</i>	Federal Government	69%	54%
	Sub-national governments	31%	46%
<i>Canada</i>	Federal Government	44%	37%
	Sub-national governments	56%	63%

Source: Author own compiled data from various Published Materials

2.9.4. Intergovernmental Fiscal Transfer Systems

The sub-national governments in almost all selected countries are heavily depends up on intergovernmental fiscal transfer for financing a larger portion of their expenditure responsibilities. Thus, central governments of the selected countries are designed various intergovernmental fiscal transfer mechanisms to address fiscal problems (both vertical and horizontal fiscal imbalances) and achieve the provision of minimum standard public services. The selected Federations, however, vary in terms of approaches or institutional arrangements to transfer resources for lower levels of government due to the fact that countries differ by policy objectives and circumstances (like history, political-economic systems). In Germany and Brazil, for instance, the total grant pool is determined by the Constitution and the federal Senate determines the allocation of grant pool among State and local governments. On the other hand, Australia, India and Nigeria are established an independent grant commissions to make recommendations with regard to the grant formula for allocating such transfers but the total grant pool is predetermined by legislation. In Canada, unlike other selected federation, there is no permanent institution to manage intergovernmental fiscal relations. This function is performed through ad hoc decisions reached at administrative conferences (France St- Hilaire, 2007).

Moreover, the design of the intergovernmental grants and fiscal equalization system varies from one country to another. For instance, India, Nigeria, Germany and Brazil are employed the revenue-sharing mechanism to address fiscal problems and ensure the provision of minimum standard services. The countries, however, vary in the criteria of allocation of shared-revenues horizontally among government units at the same level. For instance, in Nigeria the proceeds of shared-revenues is distribute horizontally based on derivative principle while India and Brazil distribute on the basis of a grant formula that considered fiscal capacity. Germany, on other hand, the revenue collected from joint income taxes such as PIT and CIT are shared equally between the federal government and Landers (Basic Law, Art. 105 (3)). Presently, the landers in group receive 42.5% and 50% from the proceeds of PIT and CIT respectively and each lander receive revenue based on derivative principle. While, the Lander as a group receive 48.4% from VAT revenue and two-third (75%) of the VAT revenue is apportioned among the landers based on equal per capita income which is a simple form of equalization.

Table 2.7.: Comparison of Intergovernmental Transfer Systems of the Selected Countries

Country	Source of finance	Form of Fiscal Transfer	Vertical grant allocation bases	Indicators included in the Horizontal allocation
<i>Nigeria</i>	Vertical	Revenue-Sharing	Grant formula	Derivatives
<i>India</i>	Vertical	Revenue-sharing	Fixed %age	Both Revenue capacity & expenditure need (filling gap)
<i>Brazil</i>	Vertical	Revenue-sharing	Grant Formula	Only expenditure needs
<i>Germany</i>	Vertical	Revenue sharing	Fixed %age	Derivative (PIT, CIT) & Per-Capital (VAT)
	Horizontal	Equalization grant	_____	Only Revenue-raising capacity
<i>Australia</i>	Vertical	Equalization grant	_____	Both Revenue potential & expenditure needs
<i>Canada</i>	Vertical	Equalization grant	_____	Only revenue-raising capacity

Source: Federal Constitutions of the Selected Countries and Other Published Materials

Germany, Canada and Australia, on the other hand, are employed fiscal equalization mechanism to bridge the fiscal capacity disparity across the regional states and ensure all SNGs to provide comparable quality and quantity public services at comparable taxing efforts. The horizontal fiscal equalization payment is determined based on grant formula in these countries. However, there is variation among the countries in terms of finance sources of the fiscal equalization program and factors included in the grant formula. The fiscal equalization system of each of these country will be discussed in detail as follows.

A. Germany

According to Feld and Hagen (2007), there are four stages in the fiscal capacity equalization process of Germany. In the first stage, the revenue collected from joint income taxes such as PIT and CIT are shared equally between the federal government and Landers (Basic Law, Art. 105 (3)). Currently, lenders in group receive 42.5% and 50% from the proceeds of PIT and CIT respectively and each lander receive revenue based on derivative principle. The revenue amount each Lander received from income taxes is added to their own revenues which used as initial vertical distribution base. While, the Lander as a group receive 48.4% from VAT revenue and two-third (75%) of the VAT revenue is apportioned among the landers based on equal per capita income. In the second stage, the fiscal capacity of the poorer landers is up-lifted by distributing the remaining one-third (25%) of the VAT revenue to Landers which have a per capita revenue less than 92% of the national average. The aim of this transfer is to foster the fiscal capacity of these landers which have poorer fiscal capacities to the national average (Feld and Hagen, 2007).

In the third stage, fiscal capacity equalization system that taken into account only the revenue raising capacity of Landers is applied to bring the fiscal capacity of the landers to the 95.5% national average by transferring financial resources from Landers that have a fiscal capacity significantly above the national average. Such procedure is unique in nature, because in other countries (like Australia and Canada) the fiscal capacity of poorer regional states is uplifted to the national average without affecting the fiscal capacity of the richer regions. In the last stage, the federal government is transfers additional resources to the Lander whose fiscal capacity still remains below the national average even after equalization payments, provide in form of conditional grants. In this stage, the federal government uses the fiscal capacity of each Lander generated in third stage as a reference to distribute funds among Landers. The main aim of this conditional transfer is that either to further lifting the fiscal capacity of the poor Landers to 99.5% national average or to reduce specific burden of Regional states such as high unemployment.

B. Australia

The fiscal equalization program of Australia is distributes financial resources among regional states based on a horizontal fiscal equalization principle, which states that “Regional (and territory) governments should receive funding from the pool of GST revenue such that if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency”. The fiscal equalization system is financed by Goods and Service Tax (GST) and distributed horizontally among regional states by considering indicators of both the revenue raising capacities and expenditure needs of each Regional states. The main aim of such transfer program is to equalize the fiscal capacity of each Provinces in order to provide comparable public services at comparable tax efforts for all citizen of the country, regardless of living location (Moris 2007: 57). Such fiscal equalization system is allowed the assessment of all circumstances that affect the relative expenditure differences a Regional state is faced in delivering standard services, which includes additional expenditures faced by each Regional government in meeting requirements of large cities and in providing services in rural areas and remote locations. As the result, a Regional state’s differential per capita revenue or expenditure needs which considered beyond the control of the Regional authorities are estimated and compensated for the fiscal gap (Ibid). Although, the Australian fiscal equalization program is

criticized on the grounds of efficiency, complexity and reliance on internal standards rather than best practices, many public finance scholars argued that it is the best equalization mechanism in the world. Because, it considers not only the per-capital revenue and expenditure needs but also the cost differences of public services across regions.

C. Canada

The fiscal equalization system of Canada is taken into account only the per capita revenue-raising potential (spending capacity) of each regional states to distribute the general-purpose grant pool (financed by centrally collected revenues) horizontally among regional states. The main aim of this fiscal equalization system is to equalize the spending capacity of all provinces without any explicit attempt to measure the expenditure needs of each province. Since, it is implicitly assumed the expenditure needs are equal on per-capital basis. The fiscal equalization system measures the revenue potential of each provinces by using a Representative Tax System (RTS) that includes all thirty-three provincial revenue sources and takes into account a tax rate that corresponds to the national average of each tax sources. This RTS is used to determine the per capita revenue capacity of each province based on the tax documents provided by the tax payer to them. Accordingly, the data of some provinces are used to obtain the average per capital revenue that is taken as national average per-capital revenue for equalization purpose. Then after, the provinces with per capita tax revenue below the national average revenue will receive an equalization payment which is equal to the difference between the province's revenue capacity and the national average multiplied by the province's population size. On the other hand, those provinces whose per capita revenue is above the national average will not receive any equalization transfer from federal government (Broadway, 2006). As a result, it achieves fiscal equity by enhancing the weak fiscal capacity of provinces to undertake comparable level of spending at comparable tax efforts. The equalization payments which received by the provinces are totally unconditional in nature so that they can allocate in areas that gives high priorities without any restrictions. However, the equalization system does not eliminate all fiscal differences across provinces, because it fails to take into account the cost of public services provision differences.

As mentioned above, the fiscal equalization system vary among the selected countries in terms of the variables included in the grant formula and source of finance. Germany and Canada are taken into account only revenue raising capacity, while Australia considered both fiscal capacity and expenditure needs for distributing the grant pool among regional states. Although, there is no consensus among public scholars regarding on which fiscal equalization mechanisms (revenue raising capacity or fiscal capacity gap) is appropriate; many scholar argues that fiscal gap equalization is more appropriate because it enables all regional states to provide minimum public services at comparable tax efforts to all citizens regardless of living location (Vaillancourt and Bird, 2005). However, this approach requires extensive data to estimate the revenue raising capacities and expenditure needs of sub-nationals. The countries also vary with regards the direction of fiscal equalization, Canada and Australia are followed vertical equalization while Germany is followed horizontal equalization.

Overall, the experiences of selected countries regarding the grants and equalization scheme show that there is a disincentive effects for recipient governments to generate sufficient own revenue and failed to improve public service efficiency and accountability of sub-national authorities or to reduce fiscal capacity disparities across regions. Moreover, although it's believes the German equalization system is effective in addressing the fiscal capacity gaps and enhance solidarity among the constituent member Landers of federation, it creates extremely high fiscal pressure on the rich Landers. Moreover, federal governments in the selected countries also provide conditional grants to influence the spending decisions of authorities at sub-national levels for achieving nationwide standards or policies in basic public service. However, the size of conditional grants and the allocation of grant pool among sub-national governments are done not based on a formula basis, but on Ad-hock basis in almost all federations. In Australia, unlike other federations, the conditional grants are considered in the assessment of the fiscal capacity of provinces and thereby the provinces which received a higher conditional grants will receive a lower share of equalization grant.

2.9.5. Sub-national Borrowing

Sub-national borrowing autonomy refers to ability of a regional/local government to borrow fund from financial markets and/or from public institutions without the influence of central

government. There is a wide variation among the selected federal countries with regarding to sub-national borrowing policy. For instance, Canada has endowed power for sub-nationals to borrow funds from domestic and foreign financial institutions for financing only capital expenditures without imposing restrictions. On the contrast, other federal countries are endowed borrowing power for sub-nationals under a high control of central government, due to the fact that unrestricted sub-national borrowing practices may increase the risk for macroeconomic instability (Bird, 2001). It is believed that if a regional/local government has endowed borrowing right without imposing any restriction, authorities at sub-national levels would incentive to borrow and spend excessively and leads to bailout problem and macro-economic instability (Prud'homme, 1995). Thus, Sub -national governments in all selected developing countries have limited access to credit sources, particularly on long-term loans, due to underdeveloped capital markets and weak creditworthiness of SNGs (Shah, 2004).

Overall, lack of fiscal discipline at sub-national levels is a major concern of federal governments in all selected federal countries, particularly developing countries, due to lack of sub-national autonomy combined with an opportunity for a federal bailout. It is argued that bailout of SNGs' over-spending could cause high inflation and debt-GDP ratio at national levels. As the result, the selected federal countries are introduced different debt control mechanisms such as cooperative federalism and fiscal rules to ensure fiscal discipline at sub-national levels. Germany and Canada are adopted legislated fiscal rules, which taken the form of budgetary balance controls (Golden Rule), debt limit, and tax or expenditure controls. Some federal countries have special arrangements such as loan council in Australia and provincial bank in Canada, to assists sub-national borrowing for financing capital projects.

Moreover, local debt in forms of bank credits and municipal bonds are relatively new financial measures to cover the expenditure needs of SNGs in most developing countries. But, municipalities in India and Brazil grants power to borrow funds from domestic and foreign financial institutions and issue bonds; while local governments in Nigeria are allowed to borrow funds from domestic institutions only with special permission (OECD, 2002). The borrowing policies of selected developing countries generally are focused in controlling sub-national borrowing activity rather than facilitating the sub-nationals to borrow funds from financial institutions. Thus, it needs to provide adequate access for LGs in developing countries to

financial market, so as to enhance their role in provision of public services and ensure accountability at local levels, since still now they have very low revenue raising capacity due to lack of tax autonomy. Therefore, the appropriate mechanism to provide adequate access for LGs to financial market is establishing Municipal Finance Corporations that operate on commercial principles and devolving more tax power to LGs, an important factor for the establishment of the private sector's confidence to local governments.

2.9.6. Lessons Learned from the Experiences of Selected Federal Countries

Despite of these limitations, several lessons can be drawn from the diverse experiences of developed and developing countries related to fiscal federalism. Some of these are discussed as follows.

- i. It is important to clearly demarcate the expenditure responsibilities of each levels of government in order to avoid overlapping responsibilities and assign adequate taxation power for each government levels and design an effective transfer system. Moreover, period review of expenditure assignment is essential to rearrange responsibilities in line with changing economic and political circumstances.
- ii. Asymmetric federalism arising from symmetric and uniform principles helps the fiscal federalism system to become effective and efficient. Thus, the assignment of expenditure responsibilities and taxation powers among sub-national governments should not be equal (i.e. Asymmetric). This is because sub-national governments may vary in terms of population size and density; administrative and institutional capacities to rise own revenues and spend the revenues.
- iii. Finance should follow function in order to improve the responsiveness and accountability of local governments to local residents. Thus, the devolution of public functions should be accompanied as much as possible by adequate taxation powers and effective transfer system, so as to improve the efficiency of public service delivery and ensure accountability at sub-national levels.
- iv. Intergovernmental fiscal transfer system should be designed and implemented in a manner to ensure a balanced regional development and provide minimum standards of basic public services for citizens regardless of the choice of their living locations.

- This is because, it contributes to achieve political stability and promote economic growth in the federation as a whole. For instance, the German fiscal transfer system has given special emphasis on the equalization transfer in which the richer Regions make fiscal contribute to the poorer Regions an amount equal to two-fold of the assistance that all industrialized countries provide for developing nations.
- v. Intergovernmental fiscal transfer system should be designed by balancing the equity and efficiency objectives.
 - vi. Central (federal) government must provide a useful framework to ensure fiscal discipline and fiscal policy coordination at all levels of government in the federation. In addition to that, it is essential to make sub-national governments responsible for any financial consequences of their decisions in order to avoid bail-out problem and ensure fiscal discipline at grass roots in the federation.
 - vii. The system of intergovernmental fiscal relations should be consistent with the system of political organizations, so as to effectively coordinate the policies of different government levels in general and administrate the tax system efficiently in particular.
 - viii. Fiscal decentralized system should be developed by considering the specific circumstance of a particular country such as historical, socio-cultural context, economic and political institutions as well as demographic and geographic conditions, so as to realize potential benefits such as improved efficiency of public services delivery; enhance the responsiveness and accountability at local levels; and promote economic growth.
 - ix. The framework for fiscal decentralized system must be open for periodic reviews in order to incorporate changes in view of changing the socio-economic situations of the country.
 - x. Fiscal decentralization should begin with a real desire to devolved fiscal power for lower levels of government. The roles of sub-national governments, in practice, should be determined according the constitutional intent, and not by extent to which the center chooses for administrative or political purposes. Moreover, it is essential to restrict the SNGs' roles to their authority, so as to make the decentralized decision-making process effective and efficient. Because, it is too difficult to make democratic the decision of lower levels of government through direct central control mechanisms.

Hence, direct-democracy provisions are helpful in restraining governments from undemocratic practice.

- xi. Devolution of more taxing power and access to capital markets for local governments are important in order to enhance the fiscal autonomy and role of local governments in delivering adequate public services to the local people, and ensure intergenerational equity by financing capital projects through borrowing.

2.10. Brief History of Fiscal Federalism and Decentralization in Ethiopia

The purpose of this section of chapter is to review the history of Ethiopian administration structure focusing on the intergovernmental fiscal relations during the imperial regime, the military dictator (Derge regime) and the post 1990 period. Thus, in the first part of this section, it focused on reviewing the government structures and fiscal system of the pre-1974 (i.e. imperial regime); and then reviewing the administrative structure and fiscal system of the country before 1991 (i.e. Derge regime) in the second part. Finally, it reviews the administrative structure and fiscal system of post-1991 in the last (third) section.

2.10.1. Decentralization and Fiscal System during the Imperial Regime (1930-1974)

Like the previous regimes, Emperor Haile Selassie, who took power in 1930, was further centralized the political, administrative and fiscal powers by introducing various new administrative, political and fiscal reforms (Meheret, 2007). During this period, the Emperor was introduced a new fiscal reform to support the centralized political and administrative systems. As the result, new tax revenue sources were introduced such as fixed tax, agricultural land tax, entertainment tax, income tax, and excise and consumption taxes (Gebrehiwot, 2014:19). These tax revenue sources were levied and collected centrally. This indicates that, the purpose of the fiscal reform was to enhance the financial capacity of central government and diminish the financial power of the traditional regional governors or lords.

The Emperor, however, was attempted to introduce a decentralization reform and recognized the provincial administration by issuing a new administrative decree in 1942. Accordingly, it created a four-tier local government structure that included: Awraja (*counties*), Woreda (*district*) Meslenes (*sub-districts*) and mekitil Woreda (*communes*) level administrations (Asmelash,

2000). The first comprehensive administrative decree No. 1 of 1942 defined the power and role of the Ministry of Interior as the principal central government department to supervise local government throughout the country Governor Generals (*Enderasses*) for *Teklay Gizats* and Governors for *Awraja*, *Woreda* governments which were appointed by the central government to act as the representatives of the Imperial throne in the periphery (Meheret, 2007). As a consequence, the autonomy and power of the traditional regional lords was drastically eliminated, because the *Awraja* administrators were directly appointed by the center. The local administrative units were created mainly on the basis of physical features and ethnic lines to lesser extent (Gebrehiwot, 2014:20).

During this period, the emperor was also introduced a new monetary taxation and public expenditure system under the Ministry of Finance and thereby improved tax system and structure of the country. Accordingly, several types of tax like income tax, land tax, education tax, health tax, road tax, stump duty, and customs and export duties were levied and collected by the Ministry of Finance. Salaried tax officers were appointed from the center to all levels of Administration units. But, all collected taxes had to be transferred to the central treasury, which levied nothing to the provinces. Consequently, the tax reform was curtailed the privileges of the regional nobilities to levy and collect taxes (Keller, 2005:94). With regard to expenditure system, the allocation of public resources to the various functions of government and to the different regions of the country had been decided at the center. Thus, it can be argued that the basic intention of all reforms which introduced during this period was not to enhance the fiscal capacity and autonomy of the lower level units of government.

In some areas, however, it is reported that decentralized system of governance was attempted during this regime. The first one was related to municipal governance. In this reform, mayor-ship system which includes Municipal Council and municipal management under a 'Kentiba' (Mayor) or Town Officer was introduced in 1945. Accordingly, certain functions were devolved to Municipalities, which includes: provision of public health and hygiene services, water supply and sewerage, electricity and street lighting, registration services of properties (land, building, weapons) and civil status, provision of public amenities; construction of intra-town roads, bridges and squares; slaughter houses; supervision of animal and vehicle traffic; issuance of driving and small business licenses; demarcation of market and cemetery areas; management of

fire brigades; provision of welfare services like poor relief, hospitals, asylums, and schools; and approval of plans for private constructions (IGE,1954(a) and IGE,1954(b)). They were also endowed power to fix local rates on fares for taxis, carts, and saddle; and on all immovable properties; to assess and collect charge fees for water supply, and for municipal public services such as licenses on trade and professions, use of market place, vehicles and driving license, slaughtering and meat delivery fees, sanitary charges, land survey and registration fees, advertising, cattle registration, and to collect rental income tax, as well as health tax (Ghebrehiwot, 2014: 16).

The intention of devolution of expenditure and taxing responsibilities for the municipalities during period was essentially presumed to improve the participation of local people in political and development affairs. However, in practice, the devolution of these powers remained static throughout the regime. Ghebrehiwot (2014) pointed out two reasons for the failure of municipality governance's in promoting accountability and local participation at local levels. First, the municipalities were not recognized as a distinct level of government, and Mayors/Town Officers were appointees of the Emperor. As the result, the local communities had no full power to elect or demote their local authorities from power. Second, municipal Councils had no power to determine municipal budget, local tax rates, and municipal fees but merely to propose to a higher authority and wait for decision of the Ministry of Interior or respective Governor-General (Asmelash 1987:41-42). Thus, the municipalities had little fiscal power and thereby further limited them to carry out municipality functions in efficient manner and to ensure accountability of Mayors.

The second decentralization reform was also made by the Proclamation No 94/1947 through issuing "Local Education Board". Accordingly, each province was allowed to establish a local education board in its jurisdiction (except Addis Ababa) with the view of empowering the provinces to manage the development of elementary schools through financing their expenditure from their own education tax (Meheret, 2007).

The third move towards decentralization was also made during the Imperial Regime when the Emperor submitted to the parliament, the *Awraja* self-administration No. 43 of 1966. The draft bill proposed to grant administrative autonomy to 50 *Awraja* governments drawn from the

majority of the country on the basis of their potential to be self-sufficient. The *Awrajas* were demarcated mainly based on economic and physiographic factors such as mountains, gorges and rivers. The order empowered the *Awrajas* or sub-province administrative units to make decisions and to carry out functions in some areas such as education, public works, water supply, agriculture and community development, trade and commerce and other fields in their jurisdiction. Likewise, the *Awrajas* were also assigned taxation power on some revenue sources such as education and health taxes; property tax related to urban land and buildings; land and cattle taxes; revenue from licenses for trade, professional and vocational activities; charge fees payable for surveying, and registration of real property; charge fees for considering and approving construction plans, and revenues from fees chargeable in respect of other services rendered by the *Awrajas* like water rate; Grants-in-aid from the center (based on the recommendations of the Ministry of interior), borrowing (based on the approval of the Ministry or respective General-Governorate) and community contributions. In practice, however, this decentralization reform with the objective of empowering citizens and devolving power was not exercised during the Emperor's Regime (Meheret, 2007, and Kassahun & Tegegne, 2004). The main reason was some conservative members of the parliament at that time were not ready to devolve authority to local governments, because they believed that decentralization is a potential threat to the central administration and could put unity of the country in danger (Tegegne, 1998).

2.10.2. Decentralization and Fiscal System during the Derge Regime (1974-1991)

The Derge, by overthrowing the Imperial Regime, took power in 1974 and operated a significantly different political framework from that of the Imperial Regime. But, it had no better record at decentralizing power from the center to the periphery than its predecessor (Meheret, 2007). During this Regime, even the exercise of centralized administrative system continued to a higher level as compared to the Imperial Regime. For instance, even regions that were established to be autonomous were not designed to bring in meaningful devolution of power from the center. Both autonomous and administrative regions were not created in a way to have broad political administrative and fiscal decentralization. They were given limited powers and functions (Ibid).

However, throughout the Derge regime three reforms were introduced related to decentralization. The first reform related to decentralization was the establishment of *Kebele* Peasant Associations

(KPAs) and *Kebele* Urban Dwellers Associations (KUDAs) in the rural areas and urban centers respectively. The major objectives of the *KPA* was to empower local people by bringing the administrative units closer to the people and its major responsibilities were land redistribution, construction of primary schools, rural roads, and clinics; establishing cooperative shops and distribution of some consumable goods at reasonable price; administering local security and providing social tribune service (PMAC, 1975a). Like the *KPA*, the *KUDAs* have similar objectives and responsibilities except land redistribution. In addition to that, *KUDAs* also have responsibilities of administering public houses, collecting house rent, and establishing and administering recreation centers (PMAC, 1975b). The officials or administrators of the lower level governments were elected by the dwellers lived in their respective jurisdictions. But later elected council members were member of the Workers' Party of Ethiopia and were accountable to the party rather than to the people who elected them. As a result, they did not act on behalf of the interest of the people rather they were serving as policy implementers and defenders of the central government (Meheret, 2002).

With regard to taxation power, the assignment of tax sources to different levels of government during this period was similar to those imposed during the imperial regime. But, during this period, the proclamations related to different components of taxes of the previous laws were amended. For instance, during this period, with the exception of municipal fees, all sources of revenue were apportioned to the Central Government, leaving nothing to the local administration units including *Kebeles* (Ghebrehiwot, 2014).

The other decentralization reforms were made in 1987 following the foundation of the Peoples' Democratic Republic of Ethiopia (PDRE). During this period, the regime tried to stabilize the political situation of the country by devolving some power and authority to the regions that resisted the regime highly. Accordingly, the Derge Regime reorganized the territory of the country into five Autonomous and 24 Administrative regions by issuing a proclamation No.14 of 1987. The regions which were given autonomous status are: Asseb, Eritrea, Ogaden, Dire Dawa and Tigray regions. These were the troubled areas where both ethnic/civil conflicts were raging and sentiments for separation were high throughout most of the 19970s and 1980s. Moreover, both the autonomous and administrative regions were further divided into *Awrajas*. Accordingly,

the regime was divided into three-tier administrative units such as *center, regions and Awraja* (Tegegne, 1998).

Although the autonomous regions were designed principally in a way to devolved political, fiscal and administrative powers, in practice, they were established to act as subordinate bodies of the central government without having any political and fiscal autonomy. That means, they were established mainly to implement the policies and directives formulated by the central government (Meheret, 2007:75). This indicates, like that of the previous regime, the allocation of resources to various public functions in different regions of the country had also been decided at the center. Thus, the fiscal system of the Derge and Hailesilasse regimes could be characterized by high centralization and concentration of fiscal decision-making power at the center

For the discussion in above, therefore, one can clearly understand that decentralization was not the regime's policy priority to devolve power down to the regions, but instead it was the respond or reaction for the problems of ethnic uprising and political instability of the country. As a result, the Derge regime failed to establish genuine decentralized government, and was not enabled to address important issues such as fiscal decentralization and empowering the people to make decision about their own political, economic and development affairs. In addition, the regions had no power to legislate their own law and policies for their own jurisdiction without the intervention of the center, but they were established to implement the policies and directives which formulated the center. Besides, they were also directly accountable to the center than to the people who they administer. The regime was also had no political commitment to give space for popular participation and to have reliable self-governments. Accordingly, the failure to grant significant powers for the selected regions in the one hand and increasing demand of autonomy on the other hand, together intensified nationality grievances and finally led to the overthrow of the regime from power by the Ethiopian Peoples' Revolutionary Democratic Front (EPRDF)-a coalition of political force- in 1991 (Meheret, 2007; Negalegn, 2010).

2.10.3. Post-1991 Decentralization and Fiscal System in Ethiopia

After exercised a highly centralized and unitary political system and administrative setup as well as centralized fiscal system for over a Century, Ethiopia has introduced a federal form of governance and decentralized system as well as democratization process immediately after the

military (Derge) regime was defeated in May 1991 by EPRDF. The federal system was introduced to address the problems attributed to previous highly centralized and unitary political systems through balancing the forces of unity and diversity (Assefa, 2007). The government was implemented the decentralization programs in two phases, with aim of ensuring self-administration at local levels by empowering local people to participate directly on their political and development affairs and making local authorities responsive with their real needs and preferences (Dickovick and Tegegne, 2010:5).

The first phase of the decentralization program, which implemented during the transitional period from 1991-2001, was focused on devolution of power and responsibility from the central to regional governments and aimed at creating and empowering regional national governments devolution of power from the center to the Regional (Tegegne 1998). During this period, a federal-like government arrangement that had two levels was established, namely: the transitional government at the center and the regional governments at regional level. Accordingly, 14 autonomous administrative units was formed on basis of ethno-linguistic criteria and settlement pattern (Proclamation No. 7/1992). However, in 1995 the country's territory was re-demarcated and established 11 autonomous administrative units by merging the five regional states located in the southern part of the country into one regional state under the name of SNNPs. Thus, currently the federal system of Ethiopia comprises nine regional States, namely: Tigray, Afar, Amhara, Oromia, Somali, Benishangul-Gumuz, SNNP, Gambella and Harari as well as two Charter cities such as Adiss Abeba and Dire-Dawa. Generally, the regional states are highly varied in terms of natural and human resources, population size, geographic areas and ethnic diversity.

Each regional state has its own legislative, executive and judicial functions. Each regional government has also its own flag, a constitution, a regional working language, an elected council, a President appointed by the council; an executive Committee appointed by the President, Supreme and Higher Court judges appointed by the council. The administrative structure of regional states is further divided in Zones, *Woredas*/Urban Administrations and *Kebeles* (Villages). In all regional states with the exception of Amhara and SNNP, zonal administrations are organized as an executive sub-body of the regional governments without having any legislative power. They function as de-concentrated agents of the regional sector bureaus. The

Woreda Administrations are designed to have legislative and executive councils as well as judicial bodies. They are also recognized by regional constitutions and endowed with a power to prepare and decide concerning social services and economic development; and plans and implements policies and directives issued by the higher levels of government have significant responsibility for provision of basic public services. Thus, they are considered as key local units of government and have significant responsibility for provision of public services. Each *Woredas* is further sub-divided in lowest unit of government known as “*Kebele*”. Each *Kebele* has an elected legislative council, executive administration committee, social courts, a manager and a pool of civil servants. They have responsibility for delivering basic local public services like primary school, health posts, extension services, social courts, and community policing.

Although FDRE constitution (Art. 50) grants the power for regional governments to establish local government units in their respective jurisdictions and require to devolve adequate power and fiscal responsibilities for them that can enable to acts as self-administrative units. In practice, however, they had limited decision-making power to effectively engage in democratic self-rule, due to lack of power and resources. In addition to that, the authorities at zonal and regional levels were practiced high level of controlling, checking and monitoring on the in internal affairs of local governments, particularly the *Woreda Administrations*. Thus, the Central Government was prompted to undertake the second phase of decentralization in 2002 by adopting District Level Decentralization Program (DLDP), with aim of deepening the devolution of power and fiscal responsibilities to local levels of government; to institutional the decision-making process at the local level with the view of enhance local communities participation in their political and development affairs (Kassahun and Tegegne, 2004).

The DLDP was initially launched in 430 *Woredas* covering the four Regional States with larger population size, namely; Tigray, Oromia, Amhara, and SNNP during 2002-2004. But, it was subsequently implemented in the *Woredas* of the remaining Regional States and the two city administrations (Addis Ababa and Dire Dawa) during 2005-2008 (Dickovick and Tegegne, 2010). The overall objective of DLDP is to enhance the administrative and political capacity in an integrated and coordinated manner at *Woreda (district)* levels, so as to ensure local democratic governance, empower local people to engage in development activities and enhance the quality and quantity of delivery of basic services at local level (MCB, 2004). It was during

this phase of decentralization, *Woredas* governments were endowed with power to make decisions on all fiscal aspects such as local spending, taxing and borrowing that they would need to meet local development objectives (Garcia and Rajkumar, 2008). In addition to own revenues, the *Woredas* are also granted the right to receive block grants from their respective regional governments.

However, the DLDP has not fully achieved its intended objectives such as enhancing democratic governance and participatory development at local levels of government. According to Worku, 2005; and Meheret, 2007, the *Woreda* decentralization program is not implemented effectively in almost all regional states. The major challenges which faced the *Woreda* governments while implementing DLDP in the respective jurisdictions are: poor administration and institutional capacity, due to lack of well-trained human power; top-down decision and authority structures afflicting the state system; lack of transparency and accountability at the local level and lack of budgetary autonomy, due to shortage of financial resources.

3.0. CHAPTER THREE: RESEARCH DESIGN AND METHODOLOGY

3.1. Introduction

Research methodology commonly refers to the instruments and techniques applied to obtain information on a particular subject under investigation. It enables to understand the different ways in which knowledge can be created. In social science research, the research methodology should follow the subject under investigation (Bryman, 1984). Accordingly, it is important for a study to apply the appropriate research method to analyze the subjects under investigation. In this chapter, therefore, the researcher has attempted to discuss in detail about the research design and methodology of the study. It includes research approach, sampling technique and selection of area of the study, data type and source, data collection method as well as data analysis methods.

3.2. Research Approach

There are several types of research methods in social science to choose from. For the purpose of this study, a case study research approach is employed. This is because; the purpose of the study is to provide and gather sufficient information and obtain a deeper understanding with regards the implementation of fiscal decentralization at regional and local, particularly woreda (district), levels of government units in Ethiopia by selecting two regional state; namely; Oromia and Afar regions. The rationale for adopting such an approach is that it provides an opportunity for the researcher to gather detail information on the topic under investigation through exploring the attitude, behavior and experience of knowledgeable individuals related to the research topic. This is because; such research method is that it effectively deals with and a full variety evidences from various data collection techniques such as interview, Focus Group Discussions, field observation and document analysis. Generally, the study has employed both qualitative and quantitative approaches to achieve the research objective.

3.3. Sampling Design and Selection of the Study Area

The study has taken not only the institutions at federal and regional levels of governments, but also the institutions at local level of government, particular *Woredas* (districts) as units of analysis. The reason is that *Woredas* (districts) are considered as a unit of government for meaningful social and economic development at local levels. But, the study has taken into account *Woreda* governments, which are located in Oromia and Afar regions, as representative of other *Woreda* governments located in the remaining regions of the country. The study selected these regional states purposefully on the basis of various criteria, such as fiscal capacity, population size and geographical area or distance, infrastructure and human development, and ethnic diversities. Hence, Oromia Regional State is selected to represent the relatively more developed regional states (Tigray, Amhara, and SNNPR), whereas Afar Regional State is selected to represent the relatively less developed regional states (like Benshangul-Gumuz, Gambella, Harreri, and Somali). The reason for the selection of the *Woreda* Administrations located only in the two regions is that a survey of all *woredas* located across the nation limits conducting a detail analysis of the subject matter. Additionally, it is too difficult task to cover *Woreda* governments located in all regional states of Ethiopia due to time and finance constraints.

For the purpose of primary data collection, the study purposely selected two *Woreda* Administrations, namely, Gewane and Gelan from the Afar and Oromia regions, respectively. The main reasons for the selection of *woreda* is its convenience for the researcher with regards to its accessibility and proximity. Additionally, the Gelan *woreda* is selected to represents the *woredas* located *in urban areas* (due to its better economic and infrastructure developments); while the Gowane *woreda* selected to represents all *woredas* located rural areas across the nation. Overall, the researcher believed that the selected two *Woreda* Governments are core and represents the selected Regional States in particular and the nation in general relatively better in terms of their *political, economic and social activities*.

Moreover, the study also reviews the experiences of some federations from both developed and developing countries around the world related to fiscal federalism with the aim of obtaining certain relevant lessons and use it as an input in making necessary modifications to the Ethiopian

fiscal system. Accordingly, Nigeria, India, and Brazil from developing countries, while Germany, Australia and Canada from developed countries are selected based on certain criteria. Nigeria is selected for it has been experiencing federal system of governance for a long time in Africa and India because it has the largest federal democratic system with its local democracy strengthened after the 73rd and 74th amendment of its Constitution in 1992. Brazil is selected for its relatively better implementation of federal structure of political governance within a larger population size and geographical area in Latin America. On the other hand, Germany, Australia and Canada are selected to represent other developed countries for reasons of having modern and effective decentralized fiscal systems in Western countries.

3.4. Data Sources and Data Collection Techniques

The study deals with both primary and secondary data. The primary data were collected through employing various data collection techniques including key informant interview, focus group discussion and observation while the secondary data were gathered from various sources using a technique of document analysis. Thus, in this sub-section, the researcher has attempted to describe each of the data collection techniques in detail.

3.4.1. In-depth Interview and Discussion

The study has conducted an in-depth interview and discussions with key-informants (like politicians, budget experts, public officials, staffs and sector office heads) from government institutions at different levels (federal, regional and local). The key-informants were selected according to their level of expertise with regarding the subject under investigation. That means, they are targeted on the basis of the right information or knowledge related to fiscal decentralization issues and its practices at all levels of government due to their political position and professional capacity. The rationale behind using of an in-depth interview in the study is that it does not only provides better opportunity for the respondents to express their opinion and respond freely but also enables the researcher to interact with respondents freely as per the interview guide and helps to obtain more information from them by probing more questions during the interview periods. The questions asked to respondents were related to decentralization policy issues in general and more specifically about fiscal decentralization. This enables the researcher to identify the factors that promote or challenge the implementation of fiscal

decentralization at sub-national levels as well as to substantiate the data gathered from secondary sources.

Accordingly, the researcher has made in-depth interviews with eighteen key informants who are from some federal institutions (such as House of Federation, House of People's Representatives, and Ministry of Finance and Economic Development, Ethiopian Revenue and Custom Authority, as well as Ministries of Education and Health). In-depth interview and discussions were also conducted with twenty-two key informants who are from regional institutions (such as BoFED, Regional Council Bureau, BoRAA, BoH, BoE, BoWMER, BoRRA, BoARD, and CSB). In addition, in-depth interview and discussions were also conducted with twenty three key informants from *Woreda* institutions in Oromia and Afar regions (such as *Woreda* BoFED, *Woreda* Council, *Woreda* Sector Bureaus like Education, Health, Water Supply and Agricultural and Rural Development). Of the total of in-depth interviews which were conducted with key-informants from *Woredas'* sector bureaus; sixteen and seven interviews were made in Oromia and Afar regional states respectively. The information obtained from an in-depth interview and discussions was documented using note-taking because participants did not consent for audio recording.

3.4.2. Focus Group Discussion

The study employed focus group discussions (FGDs) in order to gather information related to the implementation of fiscal decentralization at local level in Ethiopia. Two FGDs (each group consist 5-8 individuals) were held in Gowane *Woreda* (Afar region) and Gelan *Woreda* (Oromia region) with individuals that have different background, status, age and sex categories. They were selected purposefully according to their specific knowledge or the right information on the issue of fiscal decentralization and its practices at *Woreda* level and the position they hold in the community

The study used semi-structured questions for FGDs so as to gather primary data. During the FGD, the participants discussed about the trend towards decentralization system in general and fiscal decentralization system in particular, as well as the challenges they encountered while implementing the policy at *Woreda* level in the selected Regional States. They were also asked to comment on the extent and quality of basic public services delivery and the level of

participation of local communities in preparing local budgets and decision-making process such as identifying, selecting, implementing and monitoring of local projects, etc. Even though the researcher has facilitated the FGDs and encouraged the participants of the FGDs to express their beliefs and attitudes freely by assuring about the confidentiality of the information they provided, the participants did not permit audio recording of their discussion. Hence, the information taken from the FGD was documented by the researcher through note taking

3.4.3. Field Observation

The study also used checklist-guided field observations as means of obtaining first-hand information regarding the practices of fiscal decentralization at regional and local levels of government in Ethiopia. Accordingly, the researcher, while stayed for over a month in Afar and Oromia Regional States to collect data, had an opportunity to watch, learn through informal communication with workers of various institutions at regional and Woreda levels. The researcher had also the opportunity to observe the corresponding official letters between government units at different levels. This enabled the researcher to observe the extent in which the Woreda authorities exercised the power endowed to each of them by regional governments. In general, the information gathered from field observation was useful to identify the sources of data, the major challenges faced by the local authorities during providing public services for residents and to have a general picture of what is going on regarding to the implementation of fiscal decentralization at regional and Woredas levels.

3.4.4. Document Analysis

Document analysis is used on the secondary data that are related to the actual practice of fiscal decentralization in Ethiopia. Accordingly, the researcher has collected, arranged, analyzed and interpreted various documents, published and unpublished, available in the form of books and journal articles, Federal and regional constitutions, proclamations, regulations, policy statements, census reports, statistical bulletins, and annual plans and actual annual reports of the institutions at federal, regional and local levels as well as research studies which were conducted and presented for policy discussion and conferences, etc. For instance, panel data (1998-2015) related to fiscal decentralization in Ethiopia such as on budget allocation and federal subsidy as well as actual expenditure and revenue were gathered from annual reports of the federal and

regional institutions and thoroughly analyzed and interpreted in the study. This helped the researcher to investigate the practice and extent of fiscal responsibilities decentralized in Ethiopia. Furthermore, it also used to review the experiences of some federal countries around the world related to fiscal federalism so as to obtain certain lessons and use it as input, if necessary, in modifying the current fiscal system of Ethiopia.

3.5. Data Analysis Method

As mentioned in the other sections, the study mainly employed descriptive data analysis method to analyze data and information gathered from both primary and secondary sources. Accordingly, the primary data obtained through interviews, focus groups, and field observations were analyzed using the qualitative data analysis technique (Content analysis) and supplemented with the secondary data. Similarly, data gathered from secondary sources (such as budget allocation, fiscal transfers, actual revenues, and expenditures) were analyzed using descriptive statistical analysis techniques such as average, percentage, and ratio values. After the raw data were converted into ratios such as expenditure and revenue ratios, they were presented in the form of tables and figures. Then after, it analyzed and interpreted using the descriptive technique in light of the study's objective. To achieve the maximum validity of the data, the researcher employed the triangulation method.

3.6. Ethical Issue

In this research, the researcher has made the necessary efforts to address the ethical considerations of confidentiality and privacy. To maintain the confidentiality of information, a guarantee was given to the participants that their names would not be associated with their responses during the coding and recording processes. Besides, the participants were involved in the interview and discussions based on their expressed willingness and informed consent. Accordingly, the researcher has given a verbal and written description of the study for the participants to obtain their consent. The researcher also provided refreshment for the participants of the study after obtaining information and appreciated them for their cooperation in the data collection process.

4.0. CHAPTER FOUR: FISCAL DECENTRALIZATION IN ETHIOPIA

4.1. Introduction

Ethiopia has practiced a highly centralized and unitary political and fiscal system as well as administrative setup in its public sector for over a Century. However, the country has introduced a federal form of government and decentralized system in 1991 *de-facto* and 1995 *de-jure* in attempting to ensure a self-administration at sub-national levels. Accordingly, the country has taken important measures to devolve the political, administrative and fiscal powers for sub-national governments by issuing a proclamation in 1992 and FDRE Constitution in 1995.

Having this in mind, this chapter tries to assess the legal framework in comparison with the practice on the ground of fiscal federalism in Ethiopia between 1995 and 2015 with particular reference to federal government and regional states. With this perspective, the analysis is made on the major pillars of fiscal decentralization, which includes the extent of enabling environment, assignment of appropriate expenditure responsibility and revenue sources with reference to federal and regional levels of government, vertical and horizontal fiscal imbalances, and design of intergovernmental transfer as well as adequate regional access to capital markets.

4.2. Assignment of Expenditure Responsibility in Ethiopia

The FDRE Constitution divided the expenditure responsibilities/functions either exclusively to the Federal governments (Article 51) or to the Regional States (Article 52) or shared between the Federal government and Regional States. This section, therefore, focused on describing the assignment of expenditure responsibilities between Federal government and regional States as well as shared between the two levels of the government as it is stipulated in FDRE Constitution. It also made attempt to examine to what extent the constitutional expenditure assignment has considered the principles of fiscal federalism discussed in chapter two of the study. This enabled the researcher to determine whether the divisions of power and functions have centralizing or decentralizing trends. Then, it investigated the degree of decision-making autonomy which regional states actually exercised in allocating their budgets between capital and recurrent expenditures as well as across various sectors.

4.2.1. Description of the Constitutional Assignment of Power and Functions in Ethiopia

Article 51/3 of the FDRE Constitution has assigned functions that have nation-wide impacts such as developing national socio-economic, monetary and fiscal policies; defense and national security; foreign relations; immigration, nationality and refugee issues; building and administration of major development infrastructures (like air, rail, sea transportation, interregional roads, postal and telecommunication services) exclusively for federal government. The logic is that decentralized public functions that have national impacts may reduce the efficiency of resource allocation and macro-economic stability, due to spillover effect and lack of economic scale.

Moreover, Article 51/12 of the EFDR Constitution also assigned the power and responsibility of regulating inter-State and foreign commerce exclusively to the Federal Government. The reason behind the assignment of such tasks to the federal government is that if these functions were decentralized, regional authorities could limit the free movements of capital, trade and goods across the nation by imposing higher taxes on goods and services entering their jurisdictions. Thus, providing these functions for the Federal Government is important to avoid Regional authorities from enacting and practicing any restrictive policies on movement of goods, capital and labor across the nation as well as to build single economic community in the federation.

In addition to that, article 51/3 of the FDRE Constitution mandates the Federal Government to establish and implement standards and basic policy criteria for public health and education and science and technology etc. Similarly, FDRE Constitution under Article 51/7 assigns the power to determine the conditions and terms under which Regional States can borrow money from internal sources to the Federal Government. Furthermore, Article 51 of the FDRE Constitution also allows the Federal Government to delegate its powers and functions listed in the constitution to the regional States and to provide financial and material resources to support them under Article 50/9.

Article 52 of the FDRE Constitution also stipulate the power and functions of the Regional governments which includes: formulating and implementing their own language, culture and education policies; enacting their own constitutions (but in conformity with the federal

constitution); formulating and execution of own economic, social and development policies, strategies and plans; administrating of land and other natural resources in the territory; levying and collecting of taxes; designing standards for regional level civil services and payment; and establishing and administering a regional police force and maintaining public order. They are also empowered to provide several public services that have local and regional benefit impacts such as referral and zonal hospitals, primary, secondary and post-secondary education (like TVET); construction of rural roads; water supply and sanitation, parks and sport frequenting sites and other municipal services.

In addition to these power and functions, the FDRE Constitution (Art. 52) also reserves all residual power and functions to the Regional States. That means, power and functions that are neither assigned explicitly to the Federal Government exclusively nor concurrently, Regional States are reserved for regional states. The rationale behind the provision of the residual power to the Regional States is to avoid any interference or pressure that could be applied by the Federal Government on significant matters that can directly and/or indirectly affect the internal affairs of the Regional States (Interview with KIs at federal level). This implies that the Regional States in Ethiopia have autonomous decision making power with respect to matters not exclusively assigned either for the federal government or jointly for both levels of government. However, the Regional States may not have legislative power over all residual powers because the FDRE Constitution imposed some restrictions on the residual power of the regional states. For instance, Article 98 of FDRE Constitution stipulated that the Regional States should not immediately assume the power of taxation that is not assigned exclusively either for the federal government, the regional states, or concurrently to both by FDRE Constitution. It has to be determined by a joint session and a two-thirds majority vote in the HoF and HoPRs is required.

The FDRE Constitution has also shared certain responsibilities and tasks that have benefit impacts beyond two or more regional states such as agriculture, education, health-care services, natural resources, science and technology as well as the protection and preservation of cultural and historical legacies between Federal Government and Regional States (Article 51(3)). Moreover, Article 51/2 and 51/3 of the FDRE Constitution allocates the right to formulate socio-economic development policies, strategies and plans concurrently to both levels of governments. However, this does not also mean that both levels of government involve jointly in determining

all socio-economic policies and strategies. Rather, it means that the Federal Government has the authority to determine socio-economic policies and strategies that have effects on the nation as a whole, whereas, the Regional States have the authority to implement socio-economic policies and strategies that have effects at regional and local levels only.

However, the FDRE Constitution fails to demarcate explicitly the responsibility of each levels of government in each aspect of the shared tasks such as production, supply, and service delivery. It also does not indicate any mechanism to resolve potential conflicts that could arise from the shared responsibilities or tasks. As a result, it leads to overlapping and duplication of laws or policies between the federal government and Regional States. These problems in turn reduce further the efficiency of public services delivery and accountability at both levels of government because it motivates the authorities at both levels of government to develop behaviors to transfer its own responsibility to another level of government.

The major powers and functions assigned exclusively to the Federal government and Regional States as well as jointly to both levels of government by FDRE Constitution are summarized in Table 4.1, below.

Table 4.1: Major Powers and Functions Assigned by FDRE Constitution

Regional States	Federal Government	Shared
<ul style="list-style-type: none"> ● Enactment of Region constitution and laws; ● To establish a Region administration that best advances self-government, a democratic order based on the rule of law; ● to protect and defend the Federal Constitution; ● Formulation and execution of economic, social and development policies, strategies and plans; ● Administration of land and other natural resources in accordance with federal laws; ● Formulate regional Region laws; ● Establish executive administrations ● Establish Region councils and operate Region courts ● Fire protection and Water supply ● Levy and collection of taxes assigned to the Regions; ● Designing standards for Region level civil services and payment; ● Establish and administer a regional police force and maintain public order, and ● Residual power, i.e. any functions that are not assigned to federal government exclusively and shared between the federal and Regions by the EFDR constitution 	<ul style="list-style-type: none"> ● Administer National Defense and security ● Immigration and Citizenship ● Formulate Foreign policy/international relationship ● Utilize water sources connecting two or more Regions and crossing national boundaries ● Regulates inter-Region and foreign commerce ● Civil aviation, postal and Tele-Communications ● Constriction of highway roads ● Issuing Currency and coins ● Formulate/execute National monetary policy, and Regulate foreign exchange ● Establish uniform standard of measurement ● Establish national standards 	<ul style="list-style-type: none"> ● Police and internal Security ● Health and Social welfares ● Education (Post-Secondary) ● Science and Technology ● Economic and Social Policies ● Land and Natural Resources ● Agricultural ● Roads ● Environmental protection ● House Development ● Recreation and culture ● Preservation of culture and historical legacies

Source: Article (51) and (52) of FDRE Constitution (1995)

From the discussion above, one can observe that Ethiopia follows the dual model (Canada model) in the allocation of power and functions between the federal government and regional States. As the FDRE constitution clearly specifies and allocates, the responsibilities and tasks of the federal government and regional States separately as well as reserved the residual powers to the regional States. The practice, however, shows that federal government is empowered to formulate national policies and standards on basic public services while the regional governments are only empowered to administrate and the provision of public services (51(3)). This shows that Ethiopia tend to follow a cooperative federalism model (Germany model) in real sense.

In general, although the FDRE constitution fails to specify explicitly the underlying principles behind the assignment of power and functions between the federal government and regional states, it reasonably infers that it has taken into account various principles of fiscal federalism such as subsidiary principle, economies of scale, spillover effects (externalities), cost of information and decision-making as well as macroeconomic stabilization and income equity considerations as well as cost of information. Thus, it can argue that the existing expenditure responsibility assignment system in Ethiopia complies with the basic principles of fiscal federalism and agrees with the experiences of other federal countries. However, there is lack of clarity in the assignment of power and functions, particularly on shared responsibilities. Thereby, it creates overlapping and duplications responsibility problems, and becomes a source of conflict between the authorities of the federal and regional levels of government. Therefore, it requires more clarity on the assignment of responsibilities and tasks to avoid conflicts and improve efficiency of public services and accountability at all levels of government.

4.2.2. Degree of Expenditure Decentralization in Ethiopia

Many public finance scholars use different approaches to measure the degree of expenditure decentralization or centralization in a federation. The most common approach applied in measuring the degree of fiscal decentralization is the share of SNGs' expenditures to the total national expenditures. Thus, the study has applied this approach to measure the degree of expenditure decentralization in Ethiopia. Prior to computing the expenditure share of the regional states in Ethiopia, it is important to consolidate the expenditure data of each level of government

in order to net out intergovernmental transfer grants. This is because, if we sum the expenditure data of each level of government without excluding the intergovernmental grants, it would provide inflated total national expenditure. This is due to double recording of the intergovernmental grants as expenditure by two or more levels of government. Thus, the researcher has consolidated the expenditure of Federal Government by deducting the federal subsidy from its total expenditure data.

As displayed in Table 4.2 below, the expenditure share of Regional States including the two city administrations to total national expenditure was 36.82% on average during 1995/96 – 2013/14 FYs. This indicates that expenditure decisions, particularly on capital expenditure, are highly centralized in Ethiopia over the study periods. However, the expenditure share of regional states has shown an improvement over time (from 26% in 1999/00 to 47% in 2009/10) and indicates the existence of a movement towards higher degree of fiscal decentralization on recent periods. The implication is that the role and performances of the Regional States in the provision of public service delivery has been shown an improvement over recent periods in Ethiopia.

Table 4.2.: Expenditure Share of Federal Government and Regional States, 1995/6-2013/14 FYs

Fiscal year	Expenditure			Expenditure Ratio (%)			
	Federal	subsid y	Total Exp. (A)	Regiona l (B)	National (C) (A+B)	Federal (D) A/C	States (E) B/C
1995/96	5,658	NDA	NDA	3,797	9,456.76	59.8	40.2
1996/97	7,723	NDA	NDA	4,324	12,056	64.1	35.9
1997/98	6,740	NDA	NDA	4,633	11,373	59.3	40.7
1998/99	5766	3527	9293	4,763	14,263	65.6	33.4
1999/00	8339	2475	10814	4,535	16,952	73.2	26.8
2000/01	5790	3076	8866	5,531	16,295	65.1	33.9
2001/02	4616	3340	7956	5,935	18,175	67.3	32.7
2002/03	4605	4556	9161	6,226	16,682	60.0	40.0
2003/04	4328	5056	9384	7,515	19,713	59.8	41.2
2004/05	4905	5556	10461	8,840	30,073	65.21	34.79
2005/06	5335	7056	12391	13,182	36,031	65.35	34.65
2006/07	5792	9056	14848	13,386	39,305	65.63	34.37
2007/08	7215	13556	20771	19,856	50,485	59.89	40.11
2008/09	8860	16556	25416	28,271	55,300	56.0	44.00
2009/10	10287	19556	29843	39,042	54,407	52.74	47.26
2010/11	53,228	24,000	77,228	39,042	116,270	66.42	33.58
2011/12	86,417	31,394	117,812	55990	173,801	67.78	32.22
2012/13	101,007	36,001	137,008	76802	213,810	64.08	35.92
2013/14	111,387	43,516	154,903	94,614	249,517	62.08	37.92
Average	23578.84			22962.32	60734.99	63.13	36.82

Note: A = Federal Expenditure, B = Regional Expenditure, C = National Expenditure

NDA = No data available

Source: MOFED database, 2012 and Garcia and Rajkumar, (2008)

4.2.3. The Pattern and Performances of Recurrent and Capital Expenditures in Ethiopia

Table 4.3 below shows the trend of recurrent and capital expenditure at federal and regional levels in Ethiopia for the last 14 fiscal years (i.e. from 1998/99 to 2012/13). Accordingly, the share of recurrent is more than the share of capital expenditure in Ethiopia over the study periods. On average about 65% of the total national budget is allocated for recurrent expenditure

while the remaining 35% of the budget is allocated for capital expenditure in Ethiopia during the same fiscal years.

Table 4.3: Share of Recurrent and Capital Expenditures at Federal and State levels in Ethiopia during 1998-2012/13 FYs

Fiscal Years	Recurrent Exp.		Capital Exp.		Total Exp.		Share of Rec. to total Exp.		Share of Cap. to total Exp.	
	Federal (A)	Regional (B)	Federal (C)	Regional (D)	Federal	Regional	Federal A/A+C	Regional B/B+D	Federal A+B/E	Regional C+D/E
1998/99	5766	2954	955	1538	6721	4492	0.86	0.66	0.14	0.34
1999/00	8339	2894	883	1035	9222	3929	0.90	0.74	0.10	0.26
2000/01	5790	3439	941	1646	6731	5085	0.86	0.68	0.14	0.32
2001/02	4616	3868	1209	1532	5825	5400	0.79	0.72	0.21	0.28
2002/03	4605	4593	1771	1470	6376	6063	0.72	0.76	0.28	0.24
2003/04	4328	5333	3482	1918	7810	7251	0.55	0.74	0.45	0.26
2004/05	4905	6498	5864	2501	10769	8999	0.46	0.72	0.54	0.28
2005/06	5335	8120	7788	2997	13123	11117	0.41	0.73	0.59	0.27
2006/07	5792	9680	10164	3668	15956	13348	0.36	0.73	0.64	0.27
2007/08	7215	13686	12424	5853	19639	19539	0.37	0.70	0.63	0.30
2008/09	8860	16679	14192	8520	23052	25199	0.38	0.66	0.62	0.34
2009/10	10287	19175	20992	9693	31279	28868	0.33	0.66	0.67	0.34
2011/12	8660.2	16679.2	14192.1	8520.3	22852	25389.0	0.38	0.66	0.62	0.34
2012/13	10287.0	19175.2	20992.2	9693.1	31279	29714.2	0.33	0.66	0.67	0.34
Average	6770.37	9483.81	8274.95	4327.4	15045.32	13811.27	0.55	0.70	0.45	0.30

Note: - **Recur**= Recurrent, **Cap.**= capital, **Exp.**=expenditure,
Source: MOFED database 2012

However, the share of recurrent expenditure to total national expenditure declined progressively from 78% in 1998/99 to 52% in 2012/13 while the share of capital expenditure increased from 22% to 48% respectively during the same fiscal periods (refer table 4.3 above). This implies that the government has been gradually shifting its budget resources for development of social and economic infrastructures over time. The factors contributed for the higher share of recurrent

expenditure in Ethiopia are high inflation, expansion of the public services, the implementation of the democratic process, increased domestic and foreign debt service (interest payments only) as well as rise in the payment of salaries and allowances for civil servants at all levels of governments.

Nevertheless, it is important to analyze the expenditure trend and performances of the Federal Government and Regional States separately so as to obtain additional insights with regard to the existence of any unique features of public expenditure over the study periods. As it can be also seen from Table 5.3 above, the share of recurrent expenditure at regional level is higher than at federal level during the selected fiscal years. On average, the Regional States and Federal Government were spent about 70% and 55% of their total budget resources for recurrent expenditure respectively while the spends 55% of its total budget resources for recurrent expenditure during the 1998/99-2012/13 FYs. Concerning the share of each component of recurrent expenditures, Federal Government has been allocating significant amount of its recurrent budget for administration and general services (on average about 72%) and followed by social service accounting about 20% on average during 2004/05-2010/11 fiscal years. Whereas, the regional states have been spending about fifty percent of their total recurrent budgets on social service sectors particularly on education and health services followed by general and economic service sectors, which are about on average 31% and 19% respectively throughout the study periods (refer table 4.4 below).

On the other hand, the share of capital expenditure in total budget at regional level is lower compared to federal level in the selected fiscal years. On average, the Federal Government has spent about 45% of its total budget for capital expenditure, whereas the regional States spent about 30%. Particularly, the Federal Government allocated significant amount of its capital expenditure, on economic development (on average about 73%) and social development (on average 24%) during 2003/04 to 2010/11 FYs. This indicates that despite the FDRE Constitution assigns responsibility for the provision of several public services to regional states, in practice, the decisions on capital expenditure, particularly on expenditure related to socio-economic infrastructure developments are carried out through federal sector bureaus. This implies that the role and participation of regional sector bureaus in provision of social developments as well as

promoting economic growth is the minimum in Ethiopia. Thus, it can be argued that the existence of a gap between the constitutional provision and the reality on ground in Ethiopia.

Table 4.4: Distribution of Recurrent and Capital Expenditure at Federal and Regional Levels, 2003/04- 2011/12 (in %)

Expenditure	2004/0	2005/0	2006/0	2007/0	2008/0	2009/1	2010/1	Mean
	5	6	7	8	9	0	1	
Total States Exp. (%)	100	100	100	100	100	100	100	100
Recurrent Exp.	0.62	0.72	0.72	0.72	0.69	0.66	0.65	0.68
<i>General Services</i>	0.32	0.29	0.29	0.29	0.31	0.33	0.32	0.31
<i>Social services</i>	0.49	0.48	0.51	0.52	0.51	0.49	0.51	0.50
<i>Economic services</i>	0.19	0.23	0.20	0.19	0.19	0.18	0.17	0.19
Capital Exp.	0.25	0.28	0.27	0.27	0.29	0.34	0.33	0.29
<i>General Development</i>	0.25	0.08	0.08	0.11	0.10	0.16	0.24	0.14
<i>Economic Development</i>	0.56	0.76	0.72	0.71	0.74	0.66	0.53	0.67
<i>Social Development</i>	0.19	0.16	0.20	0.18	0.16	0.18	0.23	0.19
Total Federal Exp.	100	100	100	100	100	100	100	100
Recurrent Exp.	0.55	0.45	0.41	0.36	0.37	0.38	0.38	0.41
<i>General services</i>	0.77	0.80	0.78	0.73	0.69	0.66	0.64	0.72
<i>Social services</i>	0.14	0.14	0.17	0.20	0.24	0.25	0.28	0.20
<i>Economic services</i>	0.09	0.06	0.06	0.06	0.08	0.09	0.08	0.08
Capital Exp.	0.45	0.55	0.59	0.64	0.63	0.62	0.67	0.59
<i>General Development</i>	0.04	0.02	0.02	0.05	0.03	0.02	0.02	0.03
<i>Economic Development</i>	0.59	0.76	0.78	0.71	0.78	0.77	0.73	0.73
<i>Social Development</i>	0.37	0.22	0.20	0.24	0.19	0.21	0.25	0.24
States' economic dec. ratio^A	0.22	0.24	0.27	0.21	0.29	0.35	0.29	0.27
States 'Social centr. ratio^B	0.34	0.30	0.26	0.27	0.31	0.34	0.25	0.30

Source: MoFED annual report, (2012)

Note:

- A. Regions' social decentralization ratio is the percentage of social expenditure sector spent by all Regions to total national social expenditure
- B. Regions' economic decentralization ratio is the percentage of economic expenditure sector spent by all Regions to total national economic expenditure

4.2.4. Spending Autonomy of Regional States in Ethiopia

SNGs' spending autonomy can be defined as the extent to which the States/LGs can control their budget. In other words, it refers to the ability of SNGs in developing their own policies and allocating their overall budget resources between recurrent and capital expenditures as well as across various sectors without the influence of central government (Shah, 2006). Public finance scholars commonly use the share of SNG expenditure to the total national expenditure to measure the degree of spending autonomy of SNGs. However, such measurement practice has several limitations. For instance, a higher SNGs' expenditure ratio does not necessarily indicate that they have a higher spending autonomy because larger part of their expenditure responsibilities could be financed by federal transfer with conditional nature. Hence, the real spending autonomy of SNGs could be measured by the share of its own revenues and unconditional grant to their total expenditure. This suggests that, if the SNGs are financed large part of their expenditures by conditional grants, they would be highly influenced and manipulated by authorities at federal levels in developing their own policies and programs; and preparing own budgets through imposing various conditions. Therefore, the study has utilized this technique to measure the degree of spending autonomy of Regional States in Ethiopia.

As it can be seen from table 4.5 below, the Regional States in Ethiopia financed larger portion of their expenditure from own revenues and unconditional federal grants; accounted on average about 90% during 1998/99-2012/13 fiscal years. By nature, these sources of finance give autonomy for the Regional States to spend their budget resources across different development sectors (such as SD, ED, GD) and programs which they give them high priority. Thus, it can reasonably be inferred that the Regional States in Ethiopia have more decision-making power over spending of their budget resources during the study period.

If we take the political-institutional factors into account such as the national regulation on expenditure decision of Regional States (particularly on capital expenditure), however, the picture changes completely. That means the Regional States have very low autonomy in developing their own policy and spending their budget resources based on the needs and preferences of the people living in their jurisdictions. This is due to the fact that regional states have fiscal capacity to finance on average only 31.7% of their expenditure using own revenue

and highly depends on federal subsidy to finance the remaining 69% of their expenditures (see table 5.5). As a result, the Federal Government has been influencing the Regional States to allocate the federal subsidies into various sectors and programs in line to national objectives such as ensuring citizens equal access to basic public services, reducing poverty and promoting economic development. Moreover, the regional authorities have responsibility to provide basic public services such as education and health in accordance to the standards and norms established by the Federal Government.

Table 4.5: Revenue Share of Regional States Excluding Specific Purpose Grants to Total Regional Expenditures, 1988/99-2012/13 FYs

Fiscal years	RSs' TOR	FUG	RSs' TR		RSs' TE	Spending autonomy	
	A	B	C	=	D	E (C/D)	F(A/D)
			(A+B)				
1998/99	1,539	3527	5,066		4,763	1.06	0.3231
1999/00	1,768	2475	4,243		4,535	0.9356	0.3899
2000/01	1,874	3076	4,950		5,531	0.8950	0.3388
2001/02	1,875	3340	5,215		5,935	0.8787	0.3159
2002/03	2,119	4556	6,675		6,226	1.072	0.3404
2003/04	3,088	5056	8,144		7,515	1.084	0.4109
2004/05	3,221	5556	8,777		17,317	0.5068	0.1860
2005/06	4,386	7,833	12,219		21,246	0.5751	0.2064
2006/07	4,385	9,880	14,265		23,348	0.6110	0.1878
2007/08	5,478.4	14,261	19,739		25,030	0.7886	0.2189
2008/09	8,250	17,438	25,688		34,115	0.7530	0.2418
2009/10	9,835	20,933	30,768		29,908	1.0288	0.3288
2010/11	12751	24,000	36,751		2383	1.54	0.5350
2011/12	20132	31,394	51,526		55990	0.9203	0.3560
2012/13	28579	36,001	64,580		76802	0.8409	0.3721
Average	7285.36	12621.73	19907.09		22806.2	0.8997	0.3170

Note: FUG = Federal Unconditional grant, RSTOR = Regional States' total own revenue, RSTR = Regional States' total revenue, RSs' TE = Regional States' total expenditure

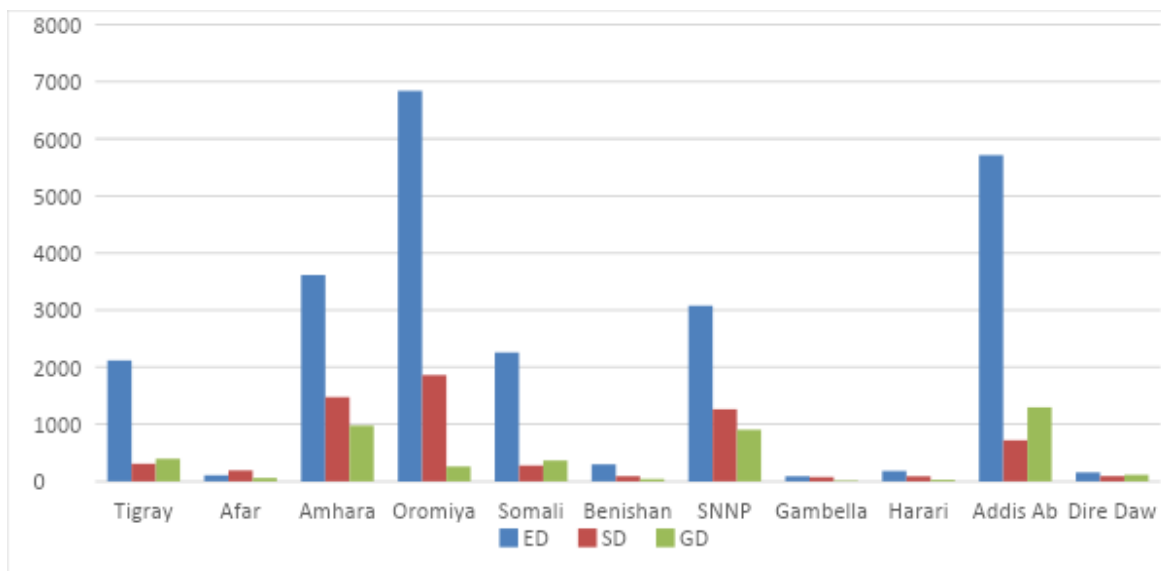
Source, MoFED annual report, 2012

This indicates that although the Regional States have constitutional power to develop and execute socio-economic development policies, strategies and plans without the influence of other

levels of government at higher level or at same level, in practice they highly depend on the Federal Governments' decision to allocate their budget resources for capital and recurrent expenditures as well as across sectors. This implies that Regional States in Ethiopia have limited decision-making power on spending their total budgets, particularly on capital budgets. That means, Regional States in Ethiopia have no decision-making power to allocate their capital budget resources on programs or sectors that are highly demanded by local population mainly due to high financial dependency on the Federal Government. The implication is that the middle-level decentralization program of Ethiopia is implemented without devolving sufficient financial resources.

This can be evidenced by investigating the actual practices of regional states in Ethiopia in allocating their capital budgets on various development sectors. As can be seen from Fig 4.1 below, all regional states, with exception of few, allocated most of their capital budgets on economic and social development sectors. During 2013, for instance, Tigray, Oromia, Addis Abeba, Dire-Dawa, Amhara and Gambella regions are exhibited to be more development orientation in allocating their budgets, since they allocated more than 90% of total capital budgets respectively for economic and social development sectors, which is in-line to national objectives. While, Afar, Benshangul-Gumuz, and Somalia are less development oriented, since, they allocated relatively a larger portion of their total capital budgets (about 24% on average) into general administration and service sector during the same period. The reason explained by key-informants at federal level for the latter groups of regions to allocate less share of their capital budgets into socio-economic sectors is that they have weak managerial and technical capacity in identifying and implementing long-term infrastructure projects.

Figure 4.1: Capital budget Allocation of Regional States, 2013 FY.



Source: MoFED annual report, 2014

4.3. Constitutional Assignment of Taxation Power in Ethiopia

Once expenditure assignment is defined, the next basic questions are which levels of government should tax what (tax bases) and which level of government determines the tax base and tax rate, as well as administrative taxes. Article 94/1 of the FDRE Constitution clearly specifies that the Federal Government and Regional States should have responsibility to bear all financial expenditures necessary to carry out the functions which are responsible for. Thus, the FDRE Constitution endowed power for the federal government and regional states to exercise their legislative and administrative powers independently on tax bases that fall under their respective jurisdictions. Hence, the revenue generated from the respective tax bases belongs exclusively to each level of the government. However, if the Federal Government has delegated some responsibilities to Regional States, it is responsible to transfer adequate financial resources to the delegated regional government to carry out the given tasks effectively.

The FDRE Constitution divided the taxation power into three categories, namely, “federal power of taxation”, “Regional State power of taxation”, “concurrent power of taxation” under Articles of 96, 97 and 98 respectively. Here, it is important to note that the titles the “Power of Taxation” not only deal with taxes but also with other non-tax revenues like fees, charges, rents and other

revenue sources. However, unlike some developing countries like India and Nigeria, the FDRE Constitution assigns the power of determining the allocation of residual taxes (undesigned taxation power) between the levels of government to the two houses of federal government such as HoF and HoPR. In this section, therefore, the study attempted to describe the constitutional assignment of taxation power between Federal government and regional States as well as concurrently to the two levels of government as it is stipulated in FDRE Constitution. It also tried to examine the extent of the constitutional assignment of taxation power which is considered the general principles of taxation assignment. This enables the researcher to determine whether the division of taxation power has centralizing or decentralizing trends. Finally, it investigated the degree of tax autonomy which regional states actually exercised in determining tax bases and rate over revenue sources under domain.

4.3.1. Taxation Power Exclusively Assigned for Federal Government

The FDRE Constitution Article 96 provides taxation power on certain revenue sources exclusively for the Federal Government under the title of 'Federal Power of Taxation'. With regarding to ownership principle, the Federal government has exclusive power to levy and collect taxes on profit of public enterprises, income obtained from leasing of houses and properties owned by the Federal government (Art. 96 (6)). With regard to the category of tax payers, the Federal Government has also power to tax on income of employees of the Federal Government and its public enterprises and international organizations (Art. 96 (2) and (3)). Based on the principle of origin, the Federal Government has also an exclusive taxation power on sales and excise tax from the sale and production/services of public enterprises owned by the Federal Government (FDRE Constitution, Art.96 (3)). In addition, the federal government has also power to levy and collect VAT on the sale and production or services of corporate form of business. According to the benefit-received principle, the Federal Government has the power to determine and collect fees and charges related to licenses issued by organs of the Federal Government (Art.96 (7)). It also has power to levy and collect stamp duties for services delivered by the bodies of the Federal Government (Art.96 (9)).

In the case of administrative convenience, the Federal Government has the power to levy and collect tax on income of employees in international organizations, taxes on incomes of air, rail, and sea transport services; tele-communication, banks and insurance; taxes on monopolies and road funds as well as on income from chance winning from national lotteries (Art.96 (4), (5) and (12)). With regard to national concerns, the Federal Government has exclusive power on custom duties and taxes and charges on international trades like import and exports. These sources of revenue are the major sources of revenue of the Federal Government in Ethiopia (Solomon, 2006). The rationales behind the assignment of the powers on custom duties (taxes on foreign trades) for Federal Government in Ethiopia are: (i) to protect the distortions of interregional trade in the federation and improve the efficient of tax administration; (ii) to empower the Federal Government to fulfill international obligations by reducing tariffs or imposing restrictions on unfair trading practices and control anti-dumping measures and contraband activities; (iii) to enable the federal government carry out its redistribution function effectively because the nature and type of export items in Ethiopia are not only few in number but also highly concentrated in few regional states. At federal level, it is the federal parliament (the legislative branch of federal government) which is responsible for levying taxes assigned to the federal government (FDRE Constitution, Art. 51 (2)).

4.3.2. Taxation Power Exclusively Assigned for Regional States

Article 97 of the FDRE Constitution also specifies the taxation power of Regional States under the title of ‘State Power of Taxation’. Accordingly, they have exclusive power to levy (legislate) and collect (administer) on the revenue sources under their domains. With regard to taxpayer category, Regional States have exclusive power to levy and collect income taxes on employees of the Regional Government and private enterprises (Art 97 (1)). Based on the principles of ownership, the Regional States have the power to determine and collect rent on houses and other properties owned by the regional government. On origin principle, they have the power to levy and collect profit, sales, and excise taxes on income, sales and productions/services of public enterprises owned by the Regional States (Art 97 (6)). Based on the form of business organization, Regional States have the power to levy and collect on revenues generated from firms registered as sole proprietorship or individual traders (Art. 97 (4)).

Concerning to origin principle, Regional States have the power to levy and collect from the revenue sources such as rental income tax derived from private houses and capital transfer taxes on properties, tax on incomes from transport services rendered on waters within the boundary of Regional State, and on income of private farmers and farmers incorporated in cooperative associations (Art. 97 (3) & (5)). The basic logic behind the assignment of those revenue sources for the Regional States is that these revenue sources derived entirely within the boundary of Regional States. Likewise, with regarding to the Regional/local concern of the taxes and administrative convenience, Regional States have exclusive power to levy and collect on some revenue sources such as profit and sales taxes on proprietorship form of business, agriculture income and fees on land use rights, on income from transport services rendered on waters within their territory, and on income, as mentioned earlier, derived from private houses and other properties within the Regional States(Art. 97 (3) and (5)). In addition, regional states have the power to levy and collect royalty and land lease fees on income derived from small mining operations and forest resources (Art. 97 (2) (10)).

Based on the benefit receipt principle, Regional States have the authority to determine and collect fees and charges on license issued and services rendered by different organs of the Regional States and fees for land use rights (Art.97 (9)). While on the base of Domiciliation Principle, regional States have taxation power to levy and collect tax on the incomes of private farmers and farmers incorporated in cooperative associations, employees of domestic NGO and musicians or sportsmen/women. At state level, Regional Councils (the legislative branches of regional governments) are responsible to levy taxes on those tax bases (Art. 52(2)).

4.3.3. Main features of Taxation Power Assignment in Ethiopia

The purpose of this section of the study is to examine how the general principles of tax assignment and other countries' experiences are considered in separating taxation power between the Federal Government and regional States in Ethiopia. This enable the researcher to determine whether the constitutional division of taxation power has centralizing or decentralizing trends in theory and practice that might support in recommending for efficient and effective tax assignment in Ethiopia.

Table 4.6: Summary of Constitutional Division of Revenue Bases in Ethiopia

Types of Tax	Federal Government	Regional States
Customs Duties & other charges on exports and imports	Assigned only for federal government	-----
Monopoly taxes	Assigned only for FG	
Personal Income Tax	On incomes of employees of the Federal Government and international bodies; and enterprises owned by the Federal Government	On incomes of employees of domestic NGOs and the Private Sector; enterprises owned by the States; and income of private farmers and farmers incorporated in cooperative associations
Business profit tax	On profit of enterprises owned by the FG; and on air, rail, sea transport services	On profit of enterprises owned by the RS; on individual trader carried; on transport services provided on water within their territories; on gains on renting of patent right within the region; on income derived from small scale mining operation
VAT and excise tax	On enterprises owned by the FG, and incorporate business	on enterprises owned by the Regional States and on individual traders
Rental income tax	On income of houses and other properties under FG ownership	On income derived from private houses and on other properties within the States; royalties and land rentals on small scale mining operations
Fees and charges	On licenses issued and services rendered by the organs of FG	On licenses issued and services rendered by the organs of Regional States
Stamp duties	-----	On transfer of certain investment properties(capital
Agricultural income tax	-	On income of private farmers and farmers incorporated in cooperative associations
Taxes on Land Use	- -----	Fees for rural land use rights

Source: author, constructed based on the Federal Constitution taxation power

From the table 4.6 above, the FDRE Constitution allotted all revenue sources with the exception of custom duties and monopoly taxes between the Federal Government and Regional States not on the basis of tax base but based on category of taxpayers, transactions and other things. Such tax assignment practice is generally unique in nature since many federations around a globe allocate taxation power among different levels of government on the basis of tax bases. For example, taxation power on PIT and CIT are either exclusively assigned for federal government (like in India) or regional states (like Canada) or shared taxes (like in Germany, Australia and Nigeria). In addition, it is not in compliance with the general principles of tax assignment under

traditional approach, which argue income taxes on mobile factors should be imposed only by central government only. The rationale behind it is that if the taxation power on these taxes is decentralized, it might cause unintended results such as distortion of efficiency of resource allocation, high fiscal capacity disparities and unhealthy tax competition between the regional States leads to ‘race-to-bottom’ (Musgrave, 1999).

Thus, the existing tax assignment system in Ethiopia further limits the role of Federal Government in stabilizing macroeconomic and redistributive income in the federation by using taxes as instrument. The reason is that the constitution does not endow full power for federal government to levy and collect taxes on all income taxes including PIT and BPT, which have predominant effects on stabilization and redistributive policy. This indicates, therefore, the need of reassignment of the taxation power over all progressive income taxes to federal government in Ethiopia to improve the effectiveness of fiscal and redistributive policies at national level. The rationale is that if a non-benefit mobile tax base is decentralized; it would cause challenges of implementing the fiscal and income redistributive policies in effective manner due to the mobility of production factors between regions for tax reason.

However, such theoretical argument may not be practical in Ethiopia for several reasons. First, allocation of production factors like labor and capital in the country are often done on the basis of other factors rather than tax rates such as social attachment, favoritism towards birth places, institutional quality and the required infrastructure. Second, regional tax bases require harmonizing with federal tax bases so that all income tax bases are uniformly applied across all regional states in Ethiopia. This indicates that, macroeconomic stabilization and income redistributive functions should be carry out jointly by both levels of government. But, it requires both vertical (between federal and regional states) and horizontal (among regional states) coordination of policies to implement effectively the stabilization and redistributive policies at national level.

4.3.4. Concurrent Power of Taxation

Conventionally, the concept of “concurrent” implies that both the Federal Government and Regional States have legislative power to enact laws regarding to the subject of matter under their jurisdiction. This occurs when a general power of taxation is conferred on each jurisdiction

where the actual assignment of a given tax sources is left to each jurisdiction to be levied and collected separately without the approval of the other level of government. However, the practice of concurrent taxation varies from country to country. For instance, in USA, both the Federal government and the States have independent autonomy to levy and collect taxes from the same tax bases such as personal and corporate income taxes, payroll, and excise taxes on such items as motor fuel, alcohol, and tobacco products (Legesse, 2006).

The FDRE Constitution under Article 98 has assigned taxation power for both federal government and regional states jointly to levy and collect taxes on certain tax bases. Accordingly, the tax bases which are subjected to levy and collect concurrently by both levels of governments are profit, sales, excise, and personal income taxes on enterprises jointly owned by both levels of governments; taxes on profits of companies and on dividends due to shareholders; on incomes from large scale mining, all petroleum and gas operations, and on royalties from such operations (under Art.98). The constitutional stipulation of concurrent taxation power in Ethiopia raises a question like “how both the Federal Government and regional States can jointly (not separately) levy and collect taxes at the same time? Unlike USA, the implication of FDRE Constitution with regard to determination of tax base and rate on the concurrent tax revenues is that the authorities of the two levels of government jointly decide through negotiation and discussion.

The practice, however, shows the Federal Government is empowered to decide tax bases and rates on concurrent taxes as well as tax administrator by both federal houses (HoF and HoPRs) (FDRE Constitution, Art. 105(2)). Thus, unlike the practice in USA, concurrent taxes are levied and collected solely by federal government in Ethiopia while the regional states are empowered only to receive a share of the proceeds from these taxes in the form of revenue sharing. This, in turn, limits the regional states to generate more tax revenue from their jurisdictions by altering tax bases/rates on concurrent taxes.

4.3.5. Degree of Revenue Decentralization in Ethiopia

Prior to examining the degree of revenue decentralization, it is important to assess the overall domestic revenue structure and revenue collection efficiency in Ethiopia. The study measures the revenue collection efficiency in Ethiopia by using the share of total domestic revenue (both tax

and non-tax) to Gross Domestic Product (GDP) (Smoke, 2004). As it is shown in Table 4.4, the share of total domestic revenue to GDP in Ethiopia was about 14% on average during 1998-2012/13, which is lower when compared to other African countries and even the Sub-Saharan African (SSA) standard. For instance, revenue collection efficiency was on average about 20.2% in Kenya, 22% in Ghana and 24% in the Sub-Sahara African countries during 2010 (World Bank, 2012). Thus, the domestic revenue collection efficiency in Ethiopia is lower from Kenya, Ghana and the Sub-Sahara African countries by 6%, 8% and 10% respectively during the same period. The major factors contributed for the poor domestic revenue collection efficiency in Ethiopia include weak tax administration capacity due to lack of competent and professional human resource; and highly skewed of domestic revenue structure to indirect taxes, particularly on custom duties which are imposed on import and export trades (accounted about 80% to the total national revenue during 2012/13 FY). Besides, high tax evasion due to lack of an effective tax enforcement mechanism and awareness of taxpayers; and high corruption practices are also contributed for low revenue performance of the country.

As table 4.7 shows, own revenue share of regional States including the two Administration cities to the total aggregate national revenue is extremely low, which accounted in average about 22.12% during 1998/99-2012/13 FYs. This indicates the existence of high revenue centralization in Ethiopia and has shown a slightly improvement over time during the selected periods. Moreover, the share of total regional revenue to GDP is very low, which accounted about 3% on average during the same period, an indication of less revenue collection efficiency. This shows that although the regional States are accessing to several tax bases including that have mobile nature like PIT, BPT, VAT, they contributed a very low share (only 20%) to the total national revenue. This, in turn, makes regional states heavily dependent on federal subsidy/grants for financing larger portion (about 78%) of the costs of functions. As the result, it limits their fiscal autonomy and leads to less efficiency of public services delivery and accountability at sub-national levels.

**Table 4.7: Revenue Share of the Federal Government and Regional States during 1998/99
2012/13 FYs**

Fiscal year	Share of Regional States			Share of				
	Federal Gov't	Regional States	National	GDP	FG' Rev.	RS' Revenue	National Rev. to GDP	Regional Rev. to GDP
	A	B	C(A+B)	D	E(A/C)	F(B/C)	G(C/D)	H(B/D)
1998/99	7,163	1,539	8,702	60,975.20	0.8231	0.1769	0.1427	0.0252
1999/00	7,186	1,768	8,954	61,817.10	0.8026	0.1975	0.1449	0.0286
2000/01	8,075	1,874	9,949	62,564.00	0.8116	0.1884	0.1590	0.030
2001/02	10,184	1,875	12,059	61,075.30	0.8445	0.1555	0.1975	0.0307
2002/03	8,935	2,119	11,054	67,521.80	0.8083	0.1917	0.1637	0.0314
2003/04	10,849	3,088	13,937	78,396.20	0.7784	0.2216	0.1778	0.0394
2004/05	19,346	3,221	22,567	96,977.60	0.8573	0.1427	0.2327	0.0332
2005/06	13,968	4,386	18,354	120,818.5 0	0.7610	0.2390	0.1519	0.0363
2006/07	17,404	4,385	21,789	158,211.9 0	0.7988	0.2013	0.1377	0.0277
2007/08	15,836	5,478.4	21,314	229,132.5 0	0.7430	0.2570	0.0930	0.0239
2008/09	24,307	8,250	32,557	313,270.2 0	0.7466	0.2534	0.1039	0.0263
2009/10	31,923	9,835	41,758	351,144.6 0	0.7645	0.2355	0.1189	0.0280
2010/11	40,764	12751	53,515.1	469,434.1 0	0.7617	0.2383	0.1140	0.0272
2011/12	48,364	20132	68,496	685,586.8 0	0.7061	0.2939	0.10	0.0294
2012/13	59,095	28579	87,674	787,302.8 0	0.6740	0.3260	0.1114	0.0363
Average	21559.93	7285.36	28845.2	240281.91	0.7788	0.2212	0.1433	0.0302

7

Source: Computed based on data from MoFED annual report

There major factors contributed for the high revenue centralization in Ethiopia. First, an assignment of tax bases which have higher yield rates such as all foreign indirect taxes like tax

on import and export trades (accounted about 80% to the total national revenue) to the Federal Government second, regional states have weak tax administration capacity, lack of an appropriate tax enforcement mechanisms and awareness of taxpayers; as well as high corruption practices by tax authorities at sub-national levels. Thus, it requires intensive reforms to improve further the own revenue collection capacity of regional states and enhance their financial autonomy for the betterment of the efficiency of public service delivery and ensuring accountability at sub-national levels in Ethiopia.

4.3.6. Trend and Composition of Own Revenue Sources in Ethiopia

Table 4.8 below presents the share and trend of the main revenue sources of regional states in Ethiopia such as tax, non-tax revenue and federal blocked grants to the total regional revenue during 2007/08 - 2012/13 FYs. The tax revenues are the major own revenues and play important role for regional States in Ethiopia, which accounts on average 77.86% of the total own regional states revenue during the same periods. On the other hand, the share of non-tax revenues to total regional own revenue is lower, which contributed about 16.18 % on average during the same fiscal periods. Moreover, the share of tax revenue was increased from 74.57% to 83.03% while the share of non-tax was declined from 25.43% to 9% during the selected periods.

Concerning the tax revenue structure, direct taxes are the dominant tax revenue of regional states in Ethiopia, which accounted about 74% to the total tax revenue of regional states during 2007/08-2012/13 FYs. Of the total direct taxes, PIT and BPT were contributed large share (about 58% and 18% on average) to the total direct tax revenue of regional states during the same FYs. While agricultural income tax, tax on Chat, and rural land use fee were contributed least share, about 4%, 2% and 4% on average respectively to the total direct tax revenue of regional states during the selected FYs. The factors contributed for poor performance of regional states in collecting revenue from agricultural income tax and rural land use fee are identified as follows: (i) recently, the federal government exercises the taxation power on agricultural income and land use fee through recentralization of rural-land administration and (iii) the agricultural sector in Ethiopia is highly affected by drought and have negative impact on collection of agricultural income tax and livestock tax at local level. Besides, the regional states, especially emerging

regions, have no an effective tax collection systems and enforcement procedures which are suitable with the life style of pastoralist communities.

Table 4.8: Revenue Sources Share of Regional States, during 2007/08 and 2012/13 FYs (in %)

Revenue Sources	2007/0 8	2008/0 9	2009/1 0	2010/1 1	2011/1 2	2012/1 3	Average
A. Tax revenue	0.75	0.70	0.81	0.80	0.79	0.83	0.79
1. Direct Taxes	0.79	0.77	0.76	0.73	0.72	0.67	0.74
PIT	0.58	0.57	0.52	0.55	0.58	0.56	0.56
Rental income tax	0.02	0.02	0.02	0.04	0.03	0.04	0.03
BIT	0.11	0.12	0.14	0.19	0.22	0.27	0.18
Agricultural Income Tax	0.04	0.06	0.06	0.04	0.03	0.02	0.04
Chat Tax	0.05	0.03	0.02	0.02	0.02	0.02	0.02
Rural Land use Fee	0.05	0.05	0.04	0.04	0.03	0.02	0.04
Urban Land Lease	0.07	0.07	0.10	0.06	0.06	0.04	0.07
2. Indirect Taxes	0.21	0.24	0.24	0.27	0.28	0.33	0.26
Value Added Tax	0.39	0.61	0.65	0.55	0.71	0.78	0.61
Excise Tax on Local Goods	0.02	0.03	0.01	0.10	0.02	0.01	0.03
TOT on goods & services	0.34	0.28	0.25	0.28	0.21	0.16	0.26
3. Non tax Revenue	0.25	0.30	0.10	0.12	0.11	0.09	0.16
Charges & Fee	0.08	0.07	0.19	0.17	0.14	0.17	0.14
Sales of Goods Services	0.10	0.11	0.43	0.41	0.53	0.48	0.35
Government Investment Income	0.02	0.01	0.03	0.05	0.02	0.02	0.03
4. Share of TOR to TR	0.24	0.28	0.29	0.29	0.36	0.40	0.31
5. Share of Grant to TR	0.76	0.72	0.71	0.71	0.64	0.60	0.69

Source: MoFED Data Base

On the other hand, indirect taxes such as VAT, TOT and excise taxes had contributed only 26% to the total tax revenue of the regional states during the same periods. Of indirect taxes, VAT on goods and services has contributed significant share (about 78%) while excise tax on local goods and TOT had contributed the least share to the total indirect tax revenue of the regional states during the selected periods. Moreover, the contribution of direct taxes to total tax revenue of regional states was declined from 78.86% in 2007/08 to 67.01% in 2012/13; while increment

trend (from 21% to 33%) for the indirect taxes during the same periods. This shows that, the indirect taxes base has become an important source of revenue for regional states in Ethiopia. But, these tax bases have regressive nature when applied to all tax payers.

4.3.7. Tax Autonomy of Regional States in Ethiopia

The term “tax autonomy” refers to the freedom that SNGs have over own taxes such as the right to introduce or abolish taxes, set tax rates, define the tax base and administrate the tax bases. (Bahil, R, 2009). Recently, many scholars has been measured the degree of tax autonomy using a model developed by the Organization for Economic Co-operation and Development (OECD) (refer table 2.1 in literature review part). Thus, the study applied the OECD’ model to classify revenue of regional states based on the degree of tax autonomy they exercised over own revenue sources in practice in Ethiopia.

The FDRE Constitution (Art. 97) empowered both the levels of government to decide independently tax base, set rate as well as administrator taxes on the same tax bases. Because, unlike other federations, in Ethiopia a single tax base is split between federal government and regional states on the basis of various principles. Theoretical and empirical literatures, however, suggest that if legislative power over the same tax bases is endowed for two or more levels of government, it may create several problems such as unhealthy competition (vertical and horizontal), high administration and compliance costs. Thus, regional states required by Federal Government to harmonize their tax bases with federal tax bases to avoid the problems mentioned previously (Proclamation No 648/2009). As the result, regional states in the federation have no autonomy to decide the tax bases on most of own revenue sources including BPT, PIT and excise taxes. Hence, such own revenue sources of regional states fall under (b) category in the OECD model.

In contrast, regional states have full power to decide tax base, rate and tax administration on agricultural income tax and rural land use fees. Consequently, it enables them to engage in tax competition for attracting domestic and foreign investors into their jurisdictions. Thus, these tax sources fall under (a) category in the OECD model. However, the amount of revenue generated from these sources is insignificant. Hence, the full tax powers over these sources have no significant effect on the fiscal capacity and spending autonomy of the regional States. Moreover,

the FDRE Constitution also endowed power for both levels of Government jointly to levy and collect taxes on concurrent tax bases (Art. 98). The practice shows that federal government empowered to levy and collect taxes from concurrent taxes leaving power for regional states only in receiving a share of proceeds from these taxes in the form of sharing revenue. Thus, such regional revenue source falls under “f” category in OECD model since regional states are not involving in setting shared revenue arrangement. Overall, despite regional states access to various tax bases including mobile nature, the practice shows that they exercised tax autonomy over a few tax sources which accounted a very low share to their total own revenues. As the consequence, it further limits the capability of regional states to generate sufficient own revenue by altering tax bases and leads to high vertical fiscal imbalance and low fiscal autonomy.

4.4. Fiscal Imbalances in Ethiopian Federation

4.4.1. Vertical Fiscal Imbalance

In this sub-section, the study attempted to examine the extent of vertical fiscal imbalance in Ethiopia by using the following formula

$$I = [(R^s / R) / (E^s / E)]$$

Where: R^s = Regional State own revenues; R = Aggregate national revenues (federal plus regional states); E^s = Regional State total expenditures; and E = Total expenditure (federal plus regional states).

From table 4.9, the regional States in Ethiopia have a combined expenditure share of 44.46% on average and revenue share of 22.08% on average during 1995-2013 FYs. This indicates that the regional states have higher expenditure responsibility compared to their revenue sources during the selected periods. It implies that the expenditure decentralization is by far larger than the revenue decentralization in practice in Ethiopia. Consequently, it creates a high vertical fiscal imbalance, which accounted on average about 0.53 during the selected periods. This shows that all regional states with the exception of Addis Ababa have no fiscal capacity that can enable them even to finance their recurrent expenditures. As a result, they are heavily depend on federal subsidy to finance some portion of their recurrent expenditure and full of capital expenditures.

Table 4.9: Vertical Fiscal Imbalances in Ethiopia, [1995/96 – 2012/13] FYs

Fiscal year	Revenue Share			Expenditure share			Vertical fiscal imbalance
	Regiona l States	Nationa l	States' share	Regional States	Nationa l	States' share	
	A	B	C(A/B)	D	E	F(D/F)	
1995/06	1,129	6,823	0.17	3,797	9,457	0.40	0.59
1996/07	1,361	7,477	0.18	4,324	10,429	0.41	0.56
1997/08	1,593	7,857	0.20	4,633	11,373	0.41	0.50
1998/99	1,539	8,702	0.18	4,763	14,262	0.33	0.47
1999/00	1,768	8,954	0.20	4,535	16,952	0.27	0.26
2000/01	1,874	9,949	0.19	5,531	16,295	0.34	0.45
2001/02	1,875	12,059	0.16	5,935	18,175	0.33	0.52
2002/03	2,119	11,054	0.19	6,226	16,682	0.37	0.49
2003/04	3,088	13,937	0.22	7,515	19,713	0.38	0.42
2004/05	3,221	22,567	0.14	17,317	30,073	0.58	0.75
2005/06	4,386	18,354	0.24	21,246	36,031	0.59	0.59
2006/07	4,385	21,789	0.20	23,348	39,305	0.59	0.66
2007/08	5,478.4	21,314	0.26	25,030	50,485	0.50	0.48
2008/09	8,250	32,557	0.25	34,115	55,300	0.62	0.59
2009/10	9,835	41,758	0.24	29,908	54,407	0.55	0.57
2010/11	12751	53,515.1	0.24	16605	53,564	0.31	0.78
2011/12	20132	68,496	0.29	30755	68,496	0.45	0.54
2012/13	28579	87,674	0.33	41086	87,979	0.47	0.54
Average	15926.1	33832.1	22.08	6298	25268.7	44.46	0.53

Note: *-The Vertical Imbalance index is computed as: $VI = \{1 - [(RR/R)/(ER/E)]\}$ where RR is combined revenue of regions and R is the consolidated revenue of the government, ER measures the amount of combined expenditure of regions whereas E measures the total (federal plus regional governments) expenditure.

Source: Computed based on data from MoFED

The degree of vertical fiscal imbalance in Ethiopia is relatively higher compared to those countries whose experiences were previously reviewed in chapter-four. For instance, Australia, Brazil, India and Germany have a vertical imbalance coefficient of 0.33, 0.33, 0.23 and 0.45 respectively during 2010 (refer table 4.10 below). This indicates that the fiscal system of Ethiopia is characterized by a higher level of vertical fiscal imbalance compared to the selected federal countries which means the regional states in Ethiopia have no autonomy in allocating their budget resources in areas which are highly demanded by the people living in their jurisdictions because the federal government highly influenced the expenditure decisions of the regional states through its fiscal power compared to other selected federal countries. This, in

turn, undermines the accountability of sub-national authorities to local residents because it reduces the need of regional and local authorities to explain their decisions for local residents who elected them.

Table 4.10: Vertical Imbalance in selected countries, during 2010 FY

Country	Sub-national Revenue share	Sub-national Expenditure Share	Coefficient of Vertical Imbalance
Australia	31	46	0.33
Germany	35	63	0.45
Brazil	31	46	0.33
India	34	55	0.38
Ethiopia	24	55	0.53

Adapted from Watts (2005), cited in Beacon house National University (2010).

Two major factors contribute for the existence of a high vertical fiscal imbalance in Ethiopia. First, the federal constitution endowed taxation power on revenue sources that have lower yield rates for the regional states. Second, the regional states have no legislative power over the revenue bases under their domain due to the harmonization tax bases and rate by the federal government. However, the study argues that low yield rate revenue sources and limited tax autonomy are not the only factors for the existence of a high vertical fiscal imbalance in Ethiopia. The key informants at federal level claim that the poor tax administration and enforcement capacity of the regional States as well as unwillingness of taxpayers to pay taxes are also the major attributable factors for such vertical fiscal imbalance in Ethiopia. As they also explained the low-level development of regional states increased salary and wages of the SNG employees and high corruption practices at the sub-national levels also contributed to the high coefficient of vertical fiscal imbalance in Ethiopia.

4.4.2. Horizontal Fiscal Disparities

The study has measured the HFI in Ethiopia by comparing the actual total own revenue with the total expenditure needs of each regional States. However, there are some problems in using the actual total own revenue collections of regional States to measure the fiscal mobilization capacity of each regional state from their jurisdictions. This is due to the fact that the collected actual revenue is not often equal to the real fiscal capacity to generate revenue from own revenue sources (Bahl, et al, 2001:16-19). It is because the regional states vary in terms of administrative and enforcement capacity in mobilizing revenues from their jurisdictions. Even if such approach

has this limitation, the study used it to measure the fiscal capacity gaps between regional states in Ethiopia due to the absence of data related to the potential of each regional state in generating revenues from the revenue bases under their domain.

Table 4.11: Own Revenues Share of Regional States to Their Total Expenditures during 2005/06 and 2011/12 FYs (in %)

Regional States	2005/06				2011/12			
	Total own revenue	Total expenditure	HF I	Ran k	Total own revenue	Total expenditure	HF I	Ran k
<i>Tigrai</i>	194.9	695.7	0.28	2	2222.6	5991.1	0.37	2
<i>Afar</i>	38.0	332.0	0.11	7	215.3	1924.1	0.11	10
<i>Amhara</i>	380.3	1899.7	0.20	4	3334.1	14423.1	0.23	6
<i>Oromia</i>	624.3	2958.3	0.21	3	5455.1	21042.6	0.26	4
<i>Somale</i>	31.0	506.2	0.06	10	627.4	5165	0.12	9
<i>Benishangul</i>	22.1	229.0	0.1	8	268.1	1204.3	0.22	7
<i>SNNP</i>	262.8	1624.4	0.16	5	3066.6	12535.4	0.25	5
<i>Gambella</i>	12.4	156.2	0.08	9	140.8	750.61	0.19	8
<i>Harari</i>	20.5	119.2	0.17	6	142.5	542.3	0.26	3
<i>Dire Dawa</i>	34.3	153.9	0.22		331.2	810.5	0.41	1
<i>A.A</i>	41.2	29.9			12781	12413	1.03	
<i>Averages</i>			0.16		28584.5	76802	0.22	

Data Source: MoFED annual report, 2007 & 2014

From the table 4.11 one can observe that the existence of a wide variations regarding fiscal capacity between the regional states in Ethiopia during the selected periods. It ranges from 10% for Afar region to 41% for Dire-Dawa city Administration and in between it ranges from 37% for Tigrai region, followed by Harari, Oromia regions and SNNPRs with 26.2%, 26% and 25% fiscal imbalance respectively during 2012/13 fiscal year. Moreover, although Oromia and Amhara regions generated larger amount of own revenue (about 5455.1 million and 3334.1million Birr respectively), they have fiscal capacity to finance only 26% and 23%

respectively of their total expenditure needs. On contrast, although Tigray region generated only birr 2222.6 million own revenue, it had fiscal capacity about 38% to finance its expenditure need. This shows that the fiscal capacity of each region is not only dependent on the amount of own revenue it collected, but also on the total amount of the expenditure it requires to finance the costs of its functions. Thus, a horizontal fiscal capacity gaps exist in Ethiopia mainly due to a significant variation in terms of per-capital revenue and per-capital expenditure needs between regional states.

There are several factors that attributed for the existing horizontal fiscal capacity gaps among the regional States in Ethiopia. The first is the existence of a significant variation in per capital revenue raising capacity among the regional States due to differences in terms of level of economic activity and infrastructure development. This is due to the fact that, other things being constant, the higher economic activity and infrastructure development leads to a higher revenue raising capacity. The economic activity and infrastructure development are highly concentrated in few regions of Ethiopia such as Addis Ababa, Oromia, Amhara and Tigray while emerging regions such as Afar, Benishangul-Gumuz, Gambela and Somali are in worst position with regard to level of economic activity and infrastructure development due to several factors(i) they are still suffering from the marginalized overall state-led development policies of the previous central governments; (ii) they located on the national boundary and have lack of social and political stability (as the result they are less attractive for domestic and foreign investments), and (iii) they have poor tax administrative capacity due to lack of skill, professional staffs and experienced experts in their public sectors.

Second, existence of a significant variation in per capital expenditure needs across the regional States due to differences in terms of socio-demographic characteristics (such as population dispersion, urbanization rate, and social composition) between regional states. Moreover, there is variation in unit cost of public services provision across regional states due to differences in cost of raw material, economics of scale, and physical feature (climate, topography) among the regional States. For example, the regional states located in mountain topography such as Tigray, Amhara and some parts of Oromia regions required larger amount of resources to provide certain public services like road compared to regions located in lowlands. Moreover, the regional States with lower density and less population size required to spend larger amount of resources to

provide comparable quantity and quality of public services due to lack of economies of scales. Thus, it can be easily observed that the emerging regional states have lower revenue raising capacity and higher per capita expenditure needs compared to other regional states in Ethiopia. Consequently, they highly depend on the federal transfer programs to finance larger part of their expenditure needs.

4.5. Intergovernmental Fiscal Transfer Systems in Ethiopia: The Practice and the Challenges

Intergovernmental fiscal transfer is the major revenue sources of sub-national governments in Ethiopia which accounted about 80% of total regional revenues. Consequently, they are not able to carry out their functions assigned by laws properly without federal transfers. Thus, the design of federal transfers and their allocation among regional states are very essential for the efficiency and equity of public service delivery and are also become an important policy issue in Ethiopia currently.

In this section, therefore, the study has attempted to assess the practice of various forms of intergovernmental transfer system of Ethiopia together with their challenges. Prior to directly dealing with the federal fiscal transfer, in the first sub-section, the researcher has attempted to discuss the legal framework of intergovernmental fiscal transfer system of Ethiopia. It also attempts to review and assess the practice of existing revenue sharing arraignment and fiscal equalization system (which adopted by HoF in 2012) against international norms and constitutional principles and together with its challenges.

4.5.1. The Legal Framework on Intergovernmental Fiscal Transfers in Ethiopia

The legal framework of intergovernmental transfer system in Ethiopia is derived from the 1995 Federal Constitution and the 1992 proclamation. According to Article 62 (7) of the FRDE constitution, HoF is empowered to determine the formula on which financial resources transfer from the federal government to the regional States. But, it is not clearly stipulated whether “federal transfer” refer only to unconditional grant or both unconditional and conditional grants. In practice, however, the conditional grants are transferred to the regional states directly by the

federal government through its line ministries on Ad hock basis. The FDRE Constitution has also endowed the power to HoF to determine the vertical distribution of proceeds generated from the concurrent tax bases between the federal and regional states. Thus, the HoF has responsibility to carry out the two federal transfer mechanisms in Ethiopia such as revenue sharing and unconditional grants.

According to Article 89(4) of the FDRE Constitution, on the other hand, the federal government is empowered to give special assistance directly to the regional states which have lower levels of socio-economic and infrastructure developments. The purpose of such grant is to promote social services and economic development of these regions and narrow-down the fiscal capacity gap among the regions in the federation. The grant has conditional nature because it is targeted for those regional states which have lower levels of socio-economic developments. Moreover, FDRE constitution (Art. 94(2)) also clearly stipulates that the federal government could give assistance and loans for emergency, rehabilitation, and development purposes to promote balanced development across the regional states. However, the constitution limits the power of the federal government by stating that such assistance and loan should not be a hindrance to the proportionate development of the regional states. That means, the federal government should only provide such assistance and loan to regional states if it ascertains that such action would not be a hindrance to the proportionate development of the regional states in the federation. The federal constitution also provides the power for federal government to audit and inspect the subsidies it has provided to the regional states and local governments.

Like all other systems, the Ethiopian experience in designing federal transfer allocation to regional states has been developed on the basis of four basic principles as stipulated in the FDRE Constitution Article 89 (2). These are:

- I. Every Ethiopian citizens located in any part of the country is entitled, by large, to similar range and level of public services (Art. 41 (3) and Art. 43 (4)).
- II. The annual budget distributed to regional states is free of their own revenue rising efforts or expenditure level i.e. it is effort neutral (Art. 97).
- III. Government has responsibility to ensure equal opportunities to promote their economic conditions.

- IV. Regional states that are forced to spend more resources than the average national expenditure standards, they are entitled to budgetary support to fill the gaps (Art. 89 (4)).

4.5.2. Practice of the Ethiopian Intergovernmental Fiscal Transfer Systems

The Federal Government has been transferring financial resources to the regional states by employing various fiscal transfer mechanisms (instruments) to meet various national objectives. Some of them include addressing fiscal problems (both vertical and horizontal fiscal imbalance); provision of a minimum standard of basic public services and eliminating interregional externalities. The transfer instruments in Ethiopia generally can be classified into two categories namely unconditional/General Purpose Grants (GPG) and conditional/Specific Purpose Grants (SPG). The unconditional grant consists of two forms of transfers such as Revenue-Sharing Transfer and Federal Subsidy (fiscal equalization) transfer. In this sub-section, therefore, the study has attempted to review and evaluate the effectiveness of each transfer forms against international norms and constitutional principles.

I. General Purpose (Unconditional) Grants

A. Revenue Sharing

Revenue sharing is one form of fiscal transfer in Ethiopia in which the federal government is required to share a portion of the proceeds it has collected from concurrent tax bases with regional states. However, the FDRE Constitution empowered both levels of the government jointly to levy and collect on concurrent tax bases as listed under “Concurrent Taxation Power” in Article of 98. This indicates that revenue sharing in Ethiopia is unique in nature since in many federations (like India) federal government shares a portion of revenue which it collects from its own tax bases with regional states. Thus, it is difficult to consider such transfer mechanism to serve the same purpose of revenue sharing in other federations because the tax bases are owned by both levels of government in Ethiopia. Generally, the basic issue in revenue sharing is that who determines the distribution of proceeds vertically between different levels of Government and horizontally among governments located at a particular level. In the case of Ethiopia, the power for determining the share of federal government and regional states from the proceeds

generated from each concurrent tax bases as well as the allocation of the regional share among regional states is endowed to the HoF by the FDRE Constitution (Art. 62 (7)).

Table 4.12: Distribution of Concurrent Tax Bases between Federal Government and Regional States in Ethiopia

Type of tax revenue	Ratio of FG, %	Share of RG, %
Personal income tax from enterprises jointly established	50	50
Business profit tax from enterprises jointly established, private enterprises and large-scale mining	50	50
Tax on dividend from private companies	50	50
VAT and excise tax from enterprises jointly established, and private companies	70	30
Royalties from large scale mining	60	40

*Note:*FG = Federal Government and RG = Region Government

*Source:*HoF, 2nd Regular Meeting minute, 2007:76-80.

Currently, the HoF is divided the proceeds generated from concurrent taxes as follows: revenues is generated from direct taxes on a ratio of 50:50 and from indirect taxes on the ratio of 70:30 between the Federal Government and regional states respectively. While, the revenue generated from royalties such as large scale mining, petroleum and gas operation between the Federal Government and the Regional States on a ratio of 60:40 (refer table 4.12).

From table 4.12, one can observe that the vertical distribution on indirect taxes and royalties revenue favors the Federal Government. Federal level officials claim that the Federal Government has better managerial and institutional capacity compared to the regional states. So it can administrate the concurrent taxes efficiently. However, such sharing arrangement further limits the autonomy of regional states to allocate their budget resources on various programs that are highly demanded by the people living in their jurisdictions. Thus, it is important to revise such sharing arrangement in favor of the regional states to enhance the fiscal autonomy of regional states and improve the efficiency of public service delivery at sub-national levels. But, it should be noted that revising the existing sharing arrangement in such manner may limit the capacity of the Federal Government to carry out its redistributive function effectively such as addressing horizontal fiscal disparity among the regional states.

The HoF also distributed the proceeds generated from the concurrent taxes horizontally among regional states on derivative basis. The advantage of such principle is that it incentivizes regional tax authorities to make more efforts and actively cooperate with tax authorities at Federal level to generate more revenue from the concurrent taxes in their jurisdictions. However, distributing horizontally revenue generated from CIT and VAT on basis of derivative principle would further increase fiscal capacity gaps in Ethiopia. The reason is that such principle considered only the place of incorporation of the company for distributing proceeds from these taxes for regional states. But, in practice, the companies make several transactions and operate business activities not only in the in-corporate regional state, but also in other regional states of the country. This indicates the need to revise the existing arrangement including variables such as population size (like in Germany), so as to benefit other regional states and reduce the existing fiscal capacity gaps in the country.

Moreover, the existing arrangement is set to allocate a larger share (about 40%) of the proceeds from royalties to resource endowed regions. The rationale behind such revenue share ratio is to compensate these regions for negative externalities occurred in extracting natural resources such as environment degradation and for public services they deliver to mining companies. Such arrangement, however, may be a potential source of conflict between the resource endowed regions and other regions in federation in long-run. This indicates, therefore, the needs of the revision of exiting arrangement in a manner that could address both the political unacceptable horizontal fiscal gap and the political claim of a regional state on obtaining benefits from natural resources in their jurisdictions.

B. Federal Subsidy

Federal subsidy is another form of transfer in Ethiopia provided by the federal government in the form of unconditional purpose grant for regional states. Accordingly, it enables the regional governments to spend the funds in expenditure areas which give them larger priorities. Such type of grants is dominated the transfer system of Ethiopia, which accounts the larger share of the Federal total budget (about one-third) and covers larger portion (above 80%) of the total budget of the regional states (Table 5.13).In principle, there are two important issues in the process of allocation of unconditional grants for lower levels of government. These are: who determines the

total grant divisible pool? And how the total grant pool is distributed among the lower level of government?

With regarding to the first issue, the FDRE Constitution and other laws related to fiscal policy fails to clearly specify the sources of finance and the guidelines for determining the total size of the grant pool to be distributed for regional states. But, Article 90 of FDRE Constitution requires the Federal Government to provide grant transfers for Regional States to insure equal access of basic services for all citizens. The implication is that the federal constitution empowered the federal government to determine the total grant pool discretionary. Accordingly, the federal government determined the total size of grant pool as part of its annual budget without participating regional states and approved it by the parliament. As a result, it makes the total size of grant pool inconsistent and varies across various fiscal periods in terms of share of the total grant pool to federal budget. For instance, the share of total grant pool to federal budget has shown an increased trend from 1998-2010/11 FYs and slightly declining since 2011/12 FY (see table 4.13 below). Consequently, it makes the general purpose grant less predictable and stable and further limits the capability of regional states in preparing an effective own annual budgets and planning long-term objectives for providing public services for the local people.

Table 4.13: Share of Federal Subsidy to Total Federal Budget and Regional States' Expenditure during 2001/02-2013/14 FYs

Fiscal Year	Total Federal Budget (in Million)	Federal Subsidy to Regional States	Total Regional States expenditure	Share of Subsidy to Federal Budget (%)	Share of Subsidy to Regional Expenditure (%)
2001/02	15,013	3076	5,531	20.48	55.62
2002/03	16,815	3340	5,935	21.19	56.28
2003/04	21,502	4556	6,226	23.45	73.18
2004/05	26835	5056	7,515	24.95	67.28
2005/06	30,044	7,833	8,840	26.07	88.61
2006/07	35,445	9,880	13,182	27.87	74.95
2007/08	43,948	14,261	13,386	32.45	98.07
2008/09	54,278	17,438	19,856	32.13	87.82
2009/10	64,508	20,933	28,271	32.45	74.04
2010/11	77,228	24,000	39,042	31.33	61.47
2011/12	11,781	31,394	55990	26.65	56.07
2012/13	13,701	36,001	76802	26.50	46.88
2013/14	154,903	43,516	94,614	27.80	44.57
Average	43538.54	46,791.08	28860.71	27.18	68.72

Source: Author computed from the data base of MoFED

Concerning the second issue in Ethiopia, the total grant pool is distributed horizontally among regional states on the basis of a formula adopted by the HoF since 1994/95. The grant formula has been revised several times since that period mainly due to frequent changes in the socio-economic conditions of regional states and lack of reliable data (Assefa, 2007). Before 2007, HoF had adopted a grant formula which considered certain socio-economic variables (such as population, i-distance, internal revenue effort, sector output performance, area size and poverty level) and assigned weights for each variable subjectively.

Table 4.14: The Allocation Formulas of General Purpose (Unconditional) Grant during 1994/95 -2003/04 FYs

Fiscal Year	Variables (Criteria)	Weigh(percent)
1994/95	Population	30
	I-distance	25
	Internal Revenue effort	20
	1986 capital budget	15
	Area size	10
1997/98	Population	33.3
	Level of development	33.3
	Internal revenue effort	33.3
1998/99	Size of population	65
	Level of development	10
	Ratio of regional revenue collection to budget	10
	Area	15
2001/02	Population	55
	Poverty	19
	Level of development/expenditure needs	14
	Internal revenue effort	4
	Sectorial output performance	
2003/04	Population	65
	Level of development/expenditure needs	20
	Internal revenue effort and sector implementation	15

Sources: FDRE, House of Federation the New Federal Grant Distribution Formula, Addis Ababa, May 2007. Population.

However, the pre-2007 grant formulas have several limitations such as: (i) it gives high emphasis for capital expenditure without taking into account the recurrent expenditure needs; (ii) it discourages regional states to generate their own revenue. Thus, the HoF has adopted new grant formulas in 2007, 2009 and 2012 with several minor revisions between those fiscal periods with the aim of improving the fairness distribution of federal resources and incentivizes regional states to generate more revenue from their sources. The house has designed the new formulas on the basis of the experience of the fiscal-gap equalization grant system of Australia. Thus, the new grant formulas focus on equalizing the revenue raising capacity and expenditure needs of regional states with the aim of filling the fiscal capacity gap. The basic principle of the fiscal equalization mechanism applied in Ethiopia is enhancing the fiscal capacity of each regional state to the national average to enable them to provide comparable public services at comparable tax efforts for all citizens regardless of their living location in equitable and fair manner as stipulated in the Article 90 (1) of federal constitution. In this sub-section, therefore, the study has attempted to assess the fiscal equalization system adopted and putted into operation by HoF during 2012.

Assessment of the 2012 Grant Formulas

The HoF has adopted a new grant formula in 2012 and approved to be operationalized for five consecutive fiscal years in order to further enhance the capability of regional states in preparing own budgets effectively and planning long term objectives in provision of public services for their residents. The main purposes of the 2012 grant formula are filling the fiscal gap and addressing the horizontal fiscal imbalance among regional states as well as correcting inter-regional spillover effects such as compensating additional expenses incurred due to security and defense related activities (HoF, 2012).

The 2012 grant formula uses the Representative Tax System (RTS) and the Representative Expenditure System (RES) to assess the revenue raising capacity and the expenditure (both recurrent and capital) needs of Regional States to fill fiscal gap by compensating (through federal grant) those regional States that have fiscal capacity below the national average.

I. Estimation of the Potential Revenue Raising Capacity of Regional States

The 2012 grant formula uses the Representative Tax System (RTS) to estimate the potential revenue raising capacity of each regional state. Thus, it takes six major tax bases into account, which constituted about 90 percent of the regional states' total tax own-revenue sources, in the last five years (2006-2011) before the formula was initially adopted. The tax bases considered and their contributions to total revenue are employment income tax (39.4%), agricultural income tax (4.2%), land use fee (5.7%), livestock tax (2.4), Business Profit Tax (19.1%), turn over tax and Value added tax (VAT) (20.8%). This shows that the 2012 grant formula has included TOT, but excluded the 'Chat' tax base when we compared with the 2009 grant formulas. The budget experts at MoFED claimed that consideration of TOT in the 2012 grant formula is appropriate due to the fact that the amount of revenue collected from such tax base is growing consistently across regional states recently in the country. In the meantime, they claimed that the exclusion of 'Chat' tax from the grant formula is not appropriate because it is not only a major source of revenue for some Regional States like Oromia, SNNP and Harari, but it is also a potential revenue source for some Regional States like Dire Dawa, Somali, Afar, and Amhara regions if properly administrated.

Moreover, the new grant formula uses to raise the potential revenue rather than their actual collected revenues to measure the revenue raising capacity of each regional state. As the result, it pursues the principle of effort neutral approach in more effective manner than the previous grant formulas and incentive Regional Revenue Offices to make significant effort to generate more own revenues and close the gap between their potential revenue and actual revenue collection. The 2012 grant formula computed the potential revenue raising capacity of each regional state by summing-up the potential revenues from each revenue sources included in the formula. The potential revenue is adjusted by deducting the federal VAT and business profit from each region. This indicates that the 2012 grant formula is relatively effective in assessing the revenue capacity of regional states as we compared with the previous grant formulas.

II. Estimation of Expenditure needs of Regional States

The 2012 grant formula also uses Expenditure Representative System (ERS) to estimate the expenditure needs of each regional states and considered six biggest sectors or functional areas

that cover more than 95% of the total public expenditures of regional states'. The functional areas with the weight attached in each functional areas are general administration(29%); primary and secondary education and public health (26%); agriculture and rural development (14%), drinking water development (5%), rural road construction and maintenance (5%), work and urban development (3%) and micro and small scale enterprise development (3%) (HoF, 2012). This shows that the 2012 grant formula has not only made some modification in the 2007 formula, but it also added a new functional area such as environmental protection and micro and small-scale enterprise development. Budget experts of MoFED claimed that it included the urban development and micro and small scale enterprise development and which is appropriate because they are essential to address urban problems such as unemployment and poverty. Moreover, the 2012 formula has also considered the expenditure disabilities of regional states such as expenditure needs for administration and general services include special fund for ethnic diversities, cross-border conflict, hardship allowances, air-conditioning and refrigeration (HoF, 2012).

In this formula, the estimated amount of total expenditure needs of each regional state was computed by summing up the expenditure needs of each regional state on the expenditure factors mentioned earlier. All expenditure needs are then multiplied by the spatial price index to adjust the price differences and remoteness and thereby compute regional budgets in real terms. Then after, the estimated expenditure need of each regional state was deducted from its corresponding revenue raising capacity to calculate the fiscal gap of each regional state. The result may give positive sign or negative sign. If a regional state has a positive sign, the regional state has lower than average capacity to generate own revenues compared to its expenditure needs, and the gap will be filled through federal subsidy. In contrast, if the result produces negative sign meaning the regional state has higher than average capacity to raise own revenues as compared to its expenditure needs and will not receive any federal subsidy. Finally, the budget grant share of each region was determined as a ratio of fiscal gap of each region with its average population size. The percentage share of each region from the total budget grant pool was decided and approved by HoF for next five consecutive fiscal years (2011/12-2015/16) as follows.

Table 4.15: Budget Grant Shares of Regional States in Ethiopia during 2009/10-2011/12 FYs

Regional States	Budget subsidy Share (x10 ⁶ Birr)	Share from total Grant (%)	Share of population to total population (%)	Share of B to C
	A	B	C	4 = B/C
Tigray	2407	7.18	6.04	1.17
Afar	1102	3.15	1.96	1.71
Amhara	7978	23.17	26.56	0.88
Oromia	11125	32.50	36.72	0.89
Somali	2883	8.14	6.02	1.40
Benshangul-Gumuz	670	2.10	0.87	2.25
SNNPR	6806	20.10	20.60	0.97
Gembella	534	1.50	0.34	4.62
Harari	304	1.00	0.27	3.30
Dire-Dawa	345	1.16	0.54	1.87
Total	342	100	100	100

Source: data computed by the Author from data base of MoFED

From the table 4.15 above, the regional states with less population size such as Gambela, Harari, Benishangul-Gumuz and Afar have 57, 0.9, 1.96 and 3.34 respectively in the 2012 grant formula. But they had a budget grant share of 0.92, 0.50, 1.42, and 2.51 respectively in the 2007 grant formula (see Appendix-G). This shows that the budget grant share of these regional states was increased in the new grant formula. In contrast, the regional states with larger population size such as Oromia and Amhara had a budget grant share of 33.7 and 26.49 in the 2007 grant formula (see Appendix-H), but it declined to 32.53 and 23.33 respectively in the 2012 formula (see table 4.15). Particularly, the budget grant per capital of the regional states with larger population like Oromia and Amhara have birr 0.88 and birr 0.89 respectively, which is less than the per-capital grant by the 2007 grant formula (which had Birr 0.92 and birr 1.00 respectively). While, regional States with less population size such as Gambela, Harari, Benishangul-Gumuz and Afar have budget grant per capital of Birr 4.62, Birr 3.30, Birr 2.25, and Birr 1.71 respectively by the 2012 grant formula. But, they had a budget grant per capital of Birr 2.11, Birr 2.67, Birr 1.63 and Birr 1.28 respectively by the 2007 grant formula, which has shown an incensement trend as compares with the 2012 grant formula.

Thus, it can be argued that the 2012 formula is relatively more effective in addressing the fiscal gaps between regional states in the federation compared with the previously grant formulas. As the result, it is effective in pursues the principle of ensuring all Ethiopian access to similar range and levels of basic public service. In addition, it is effective in pursue the principle of effort neutral as the result it would not be affected by the tax efforts and policies of regional states. This, in turn, enables to control disincentive behavior and ensure fiscal discipline of authorities at regional level. Like the previous grant formula, however, there are challenges to implement the grant formula in effective manner such as lack of adequate and quality data related to the variables included in the grant formula at regional level.

Conditional (specific purpose) grants

Conditional (Specific purpose) grant is the second category of transfer mechanism in Ethiopia, and its importance and role has shown increment over time. For instance, it accounted about 12.73 % and 14.51% of federal total budget in 2013/14 (MoFED annual report, 2014). The conditional grants are allocated for regional and local governments through federal line ministries to meet the Millennium Development Goals (MDGs). The federal ministries are selected beneficiary regional states on the basis of political factors and willingness of foreign donors. The MoFDE is empowered to approve and supervise the specific projects/programs financed through conditional grants as well as to audit the spending of such grants.

The total grant divisible pool of conditional grants is determined solely by the MoFED and the foreign grantors. The conditional grants has been financed from two sources: external loans and/or assistances (which accounted 80% of total grant) and contributions from federal government and beneficiary regional states (accounted 20% of the total grants). This indicates that conditional grants highly depend up on external loans and/or assistances. As the result, it makes such grants less predictable and further limits the capability of regional and local governments to prepare an effective own budgets. Once the grant pool is determined, it allocates among selected beneficiary regional states. In Ethiopia, conditional grants are provided in from of closed-end matching grants. Because the beneficiary regional states are expected to contribute resources (often paid in kinds like materials and labor) that covers about 20% of total project costs. This indicates, unlike the practices of other countries, it is not required that the regional

and local governments to scarify their scares budget resources for meeting the national objectives such as meeting the MDGs. Thus, it attributes not only in addressing horizontal fiscal gaps but also achieving minimum provision of public services.

In Ethiopia, conditional grants are allocated to finance specific projects and programs which the federal government gives higher priority, but the design of projects and programs are undertaken by regional governments. Many of the conditional grants are allocated to finance the costs of capital projects/programs in emerging regions to promote their administrative capacity and infrastructure developments. The federal line-ministries also allocated a few conditional grants to cover the costs of specific programs such as Health Sector Development Program (HSDP), and Education Quality Improvement Program (GEQIP) in all regions to promote the administrative capacity and achieve the provisions of basic services like education and health-care (MoE annual report, 2014). Moreover, the federal government allocates specific purpose grants to finance the costs of a specific program in urban areas such as Urban Safety-net to meet MDGs.

4.6. Access of Regional States to Financial Market (Borrowing) in Ethiopia

Sub-national borrowing is the last pillar of fiscal decentralization and an important source of revenue for SNGs to finance their capital projects because it improves resource allocation efficiency and ensure intergenerational equity. In this section, therefore, the study has attempted to examine the constitutional provision of regional states borrowing power in relation to the practice on ground in the country.

In addition to own revenue sources and federal transfers, Regional states in Ethiopia endowed right by the FDRE Constitution (Art. 51 (7))to borrow funds from domestic financial institutions (like MoFED, NBE and CBE) to finance their short-term budget deficit and capital projects. However, the domestic borrowing of regional states is subjected to direct control of the Federal Government. The main reason behind the participation and control of sub-national borrowing by the center is that the monetary and fiscal policies are the primary responsibility of the Federal government. This is due to the fact that sub-national borrowing has a potential risk to destabilize the macro-economy of the nation as a whole because they may borrow funds irresponsibly to

finance their expenditure needs. Hence, it would increase the public debt and negatively affect the macro-economy stability of the federation as a whole.

The FDRE Constitution (Art. 77 (4)) empowered the federal government to determine the conditions and terms under which regional states can borrow funds from domestic financial institutions. Hence, each regional state are expected to follow some procedures to borrow funds from domestic credit sources. First, they should submit to MoFED the amount of loan they wanted to borrow along with statements showing the relation of the requested amount to their revenue forecast and economic indicators of their regional state. Second, they should submit their consolidated budget and feasibility study of the project for which the loan is required. Third, the MoFED evaluates the requested amount of loan based on debt repayment capacity of the Regional States and the impact of the loan on the national budget, if the loan is provided. Finally, the minister to whom the request submitted recommends the amount of funds each regional states can borrow for the federal legislative body and then communicates the decision to the National Bank of Ethiopia (NBE) for authorization of the credit on request (proclamation No. 33/1992).

4.6.1. The Practice of Borrowing of Regional States in Ethiopia

According to the Federal Finance Administration Law, regional governments may borrow funds from domestic institutions such as MoFED, National Bank of Ethiopia (NBE) and/or other commercial banks (like CBE) to finance their recurrent and capital expenditures. Accordingly, regional government scan borrow funds from MoFED to finance their immediate recurrent expenditure requirements of the current period such as salary payment for civil servants. The minister gives the loan for regional states by using the federal subsidy entitlement as collateral. For instance, if a regional government is borrowed funds to fill its current year budget deficit, the MoFED would deduct an equal amount from the federal subsidy entitlement of the regional state in the next year.

Furthermore, they can also borrow funds from domestic commercial banks owned by the federal government using their annual budgets as collateral. The key-informants at federal level reported that the regional states have been borrowing funds from CBE to provide lending service for urban and rural residents to achieve several objectives. For instance, they provide loan to farmers

for purchasing agricultural inputs such as fertilizer to promote agricultural productivity and ensure food security at family level. They also provide loans to urban residents for building houses such as condominium to reduce the urban house problems and create job opportunity for urban residents.

In the borrowing process, the MoEFD acts as an intermediary agency between the borrower (i.e. Regional State) and the lender bank (i.e. CBE) and issues undertaking letter to both parties. Thus, the individuals (e.g. farmers and urban residents) who took loan from respective Woreda Administrations in a given region are expected to return the loan amount with interest to the lender Woreda Administrations immediately after next harvest period. But, if the Woreda Administrations that had given lending service for farmers are failed to collect the loans from the beneficiaries and repay the debt to the lender bank (i.e. CBE) on the specific due date, the MoFED will deduct an equal amount of funds from the respective federal subsidy entitlements of regional states. Then after, the Regional governments will also deduct an equal amount of funds from the share of blocked grant of the Woredas. This shows that the federal initiative borrowing schemes are designed to avoid bailout problem since it could not cause overspending of regional states. Thus, it can be argued that unlike other federation in globe, the problem of bailout requests is not a series problem in Ethiopia currently and in near future. The reason is that presently almost all regional states have weak institutional capacity in utilizing the budget resources allocated to them effectively mainly due to lack of trained and experienced manpower.

Overall, despite the regional governments in Ethiopia grants the rights to borrow funds from domestic credit sources to finance their capital expenditures, in practice, all regional governments with exception of few regions did not exercised their borrowing power particularly on long-term loans, so far. The reason is that regional borrowing from long-term loans is subjected to the direct control of Federal Government in Ethiopia. This is due to the fact that public debts have direct effect on the monetary and fiscal policies which are the responsibility of central government. Key-informants at federal level believes that if regional governments are allowed to exercises their borrowing rights, particularly on long term loans, without any restriction, it might cause macroeconomic instability in the nation as a whole. As the result, they are forced to cover the costs of capital projects by own revenue and federal transfers, which limits them to ensure intergenerational equity through debts.

This indicates the need of introducing other debt control mechanism such as market-based approach to avoid the potential risk related to sub-national borrowing mentioned earlier and enhance the role of the regional states in the provision of public service and ensure intergenerational equity in Ethiopia. This is due to the fact that lenders in a market-based system have capacity to control effectively the sub-national borrowing by charging higher interest rates for excessive or irresponsible regional governments. However, the control of the regional borrowing by market-based approach is not currently feasible in Ethiopia due to two reasons. First, the development of capital market in Ethiopia is very weak. Second, the financial institution is highly monopolized by commercial banks owned by government (like CBE and Cooperative Bank of Oromia). In such situation, therefore, the market-based approach is not an effective mechanism to control the borrowing activity of the regional governments. Thus, it is important to control the borrowing of regional states in Ethiopia through either the rule-based approach or the cooperative approach.

4.7. Discussion

The FDRE Constitution had taken into account various principles of fiscal federalism such as subsidiary principle, economies of scale, spillover effects as well as cost of information and decision-making as well as macro-economic and redistributive factors in allocating power and functions between the Federal Government and Regional States. Thus, the existing expenditure assignment system in Ethiopia is more or less complies with the general principles of fiscal federalism and agree with the practice of other federal countries around the globe. However, there is lack of clarity with regard to assignment of power and functions between federal and regional states, particularly on *shared functions*. For instance, the FDRE Constitution fail to clearly rationalize the relevance of assigning power on similar policies for the Federal and Regional Governments at the same time, and also does not indicate any restriction imposed upon the regional governments to act in areas left by the Federal Government like that of the German basic law. As the result, it creates overlapping and duplications of responsibilities and thereby would breed conflicts between both levels of government. This indicates, therefore, the need of more clarity on shared responsibilities in each aspects of the functions, so as to improve public services delivery and ensure accountability at all government levels.

In terms of revenue assignment, the FDRE Constitution divided all tax bases except custom duties and monopoly taxes between the Federal Government and Regional States on the basis of several principles. As the result, it enables the regional states access to various tax bases including mobile natures like BPT, PIT, VAT and excise taxes. This makes the existing revenue assignment system of Ethiopia more decentralized and detailed as compared to the theoretical arguments and practices of other federal countries around the globe. However, such revenue assignment is against the argument of traditional approach of fiscal federalism and contradicts with the practices of other federal countries. The implication is that the existing assignment of taxation power in Ethiopia takes both economic factors (efficiency and equity) and non-economic factors (such as historical and socio-cultural context as well as political system) into account in allocating taxing power between the federal government and regional states. Moreover, although regional states endowed full power to determine tax base and set tax rate on revenue bases under their domain, the practice shows that they have tax autonomy only on few revenue sources that contribute very low share to their total own revenue. The reason is that most of regional tax bases are harmonized with federal tax bases by the Federal Government and applied uniformly across all regional states in Ethiopia. Hence, it further limits the regional states to generate sufficient own revenues from their jurisdictions by altering the tax bases and/or taxes on tax bases under domain and thereby limit their fiscal autonomy.

The Findings of this study have also shown that the revenue collection function by far is highly dominated by federal government compare to expenditure responsibility in Ethiopia. The share of the regional states to the total national revenue and expenditure were on average about 22% and 37% respectively while the share of Federal Government to the total national revenue and expenditure were on average about 78% and 63% respectively during 1995-2012/13 fiscal years. This, in turn, creates a vertical fiscal imbalance with a coefficient of 0.53 on average in Ethiopia, which is relatively higher than other federal countries. The factor contributed for the existence of high vertical fiscal imbalance in Ethiopia is that tax bases that have high yield rates concentrated by the Federal Government while the responsibility for provision of public services that require high costs to delivery assigned for regional states. Consequently, it makes the regional states heavily dependent on federal transfer to finance the costs of functions that they are responsible for. This, in turn, further limits the autonomy of regional governments to develop own policies and allocate budget resources in accordance with the need and preferences of their respective

residents. Thereby, reduce the efficiency of public service delivery and accountability at sub-national levels mainly due to lack of a strong linkage between revenue raising and spending decisions. In addition, there is a wide fiscal capacity gaps in Ethiopia due to significant variation in revenue raising potential and expenditure needs between regional states.

Thus, the Federal Government employed various transfer mechanisms such as general purpose grants (revenue sharing and federal subsidy) and specific purpose grants to address the fiscal problems (both vertical and horizontal), correct interregional externalities and ensure the provision of a minimum standard of public services. The transfer system of Ethiopia, however, is dominated by federal subsidy, which accounts about one-third of federal total budget and 80% of regional states' total budgets. This transfer mechanism has provided autonomy for regional states to spend the transfer funds in areas that give them higher priorities. The total size of such grant pool is determined by federal government on Ad-hock basis, and it is approved by the federal legislative body (the Parliament). As a result, it further limits the capability of regional states to estimate their total revenue accurately and in planning medium and long-term objectives to provide public service for citizens. The grant divisible pool has been allocated among regional states by the formula adopted by HoF in 1994/95. Currently, the federal subsidy is allocated among regional states by a grant formula that considers both the revenue raising capacity and expenditure needs of each region. It has used Representative Tax System (RTS) and Representative Expenditure System (RES) to calculate the fiscal gap of each regional state and attempt to equalize about 90% of revenue raising capacity and 95% of expenditure needs of regional states. Thus, it is more effective in addressing the horizontal fiscal disparity among the regional states as compared to the previous grant formulas.

In addition to federal subsidy, conditional grants are also allocated for regional and local governments through federal line of ministries to achieve MDGs. The conditional grants are allocated in the form of closed-end matching grant since it requires the beneficiary regional states to contribute less than 20% of total costs of the projects (often made in form of kinds like labor and material). Thus, such practice does not require regional governments to sacrifice their scarce resources to meet the national goals. As a result, it is effective in addressing horizontal fiscal disparities and achieving national goals like MDGs. Overall, although the transfer system of Ethiopia is to the large extent effective in addressing vertical and horizontal fiscal imbalances,

there is lack of administrative capacity and willingness at sub-national levels in utilizing efficiently the transfer funds in programs and projects that have potential for promoting the living standards of people at local levels. This indicates that the fiscal transfer remains a necessary condition, but it is not sufficient for realizing the potential benefits of fiscal decentralization such as promoting socio-economic developments in Ethiopia.

In addition to own revenue and federal transfers, regional states also granted right by the FDRE Constitution to borrow funds from domestic financial institutions (CBE, MoFDE and NBE) for financing recurrent and capital expenditures. The practice, however, shows that all regional states with the exception of few have limited access to domestic long-term credit sources until today. The main reason is that regional borrowing from long-term loans is subjected to the direct control of the Central Government mainly due to the monetary and fiscal policies are the responsibility of a center in Ethiopia. This indicates that the existence of a gap between the constitutional provision and the actual practice on the ground regarding regional access to borrowing in Ethiopia. Furthermore, despite fiscal discipline such as bailout problem is the main concern of all federal governments in many countries around the world, it is not a serious problem currently in Ethiopia. The reason is that the federal initiative borrowing schemes are designed in a manner to avoid bailout problem and sub-national governments in Ethiopia have limited capacity in utilizing the financial resources transferred to them by federal government.

5.0. CHAPTER FIVE: FISCAL DECENTRALIZATION AT WOREDA (DISTRICT) LEVEL OF GOVERNMENT IN OROMIA AND AFAR REGIONAL STATES

5.1. Introduction

Ethiopia has been exercising fiscal decentralization at local, particularly at Woreda (district), level of government by adopting DLDP since 2002 with the aim of enhancing local communities' participation in political and development affairs to promote good governance through inspiring transparency and accountability as well as to improve the efficiency of public service delivery to the local people and promote local economic development (Kumera, 2006; Dickovick and Tegegne, 2010). Following the implementation DLDP, regional governments in Ethiopia have been devolving more power and fiscal responsibilities for their respective Woreda (district) level of government. Therefore this chapter aims to assess the practice and the associated challenges of fiscal decentralization at Woreda (district) level of government in Ethiopia since 1995 by selecting two regional states, namely: Oromia and Afar regional states.

5.2. Description of the General Profiles of the Study Areas

5.2.1. Oromia Regional State

The Oromia Regional State was established in July 1992 as a member of the nine federal states of the country that has given power of autonomy under the Federal Government of Ethiopia. Oromia Regional State has the largest geographical area coverage with a total land area of 359,620 square kilometers and has a very varied topography. It is located in the central part of Ethiopia and has borders with all of the regional states of the country except Tigray region. In terms of population size and urbanization rate, Oromia region is the most populous region with population size of 31,179,949 (about 35% of total national population), of which around 82% lives in rural areas. In terms of sex composition, females (51.43%) are a little higher than their male counterparts (48.57%) (CSA, 2007).

The Oromia region is considered as a mirror image of the Ethiopian people realities in terms of its vast territories and diverse population with varied livelihood conditions such as pastoralism, agriculture and relative developed urban centers. In terms of ethnic composition, majority of the

region's population (about 85%) belong to Oromo ethnic group while the rest 15% belong to non-Oromo ethnic groups that comprise mainly Amhara, Gurage and other mixed groups. Considering the ethnic composition in urban areas, the population rate comprises Oromo (55%), Amhara (30%), Gurage (8%) and other ethnic groups (7%) respectively (Population and Housing Census, 2007).

In terms of economic activity, Oromia's economy is based on agriculture (rain-fed, subsistence), contributing about 45% of the region's GDP and supports 83% livelihood of the population. The Oromia region is contribute a larger share for Ethiopia' agricultural export: coffee, hides and skins, pulses and oil seeds. The region is also rich in water (lakes and rivers) resources and contribute for about 90% the Country' hydro power generation. Next to agriculture, manufacturing and small-scale trade are the major economic activities in the region, which provide livelihoods for more than 17% of the regional population (Oromia Regional State Strategic Plan, 2014).

The Oromia regional state is in better position in terms of socio-economic infrastructural development compare with emerging regions such as Afar, Somali, Gambella and Benshangul-Gumuz. With regarding to educational service coverage, for instance, at the end of 2011/12 fiscal year, in Ormia region, there were only 25 kindergartens, 442 Alternative Basic Education Centers, 477 primary schools and 18 secondary schools, two Technical and Vocational Colleges (TVET) and one Teachers Training College. With regard to health services coverage, there were only 7 hospitals, 62 functional health centers, 314 health posts and 36 drug shops during the same FY (Afar Regional Government Annual Report, 2014). With regard to the coverage of electricity and road network, during the 2012/13 FY, the households with electricity and road network were 79.8% and 67.6%, respectively, in Oromia regional state.

5.2.2. Afar Regional State

Afar Regional State is located in the North-Eastern part of the country and has boarders with four national Regional States: in the Northwest with Tigray, in the West and Southwest with Amhara, in the South with Oromia and in Southwest with Somali. The region shares international boundaries with two neighboring countries, Djibouti in the East and Eritrea in the North-East. Afar region is about one-fourth a size of Oromia with a total land area of 92,000 square

kilometers. It is one of the regions with a very low population density of 14.9 people per square kilometers (Afar Regional State Council, 2014). In terms of population size and urbanization rate, Afar region is less populous region in Ethiopia with 1,800,000 number of population (about 1.9% of country's total population) (CSA, 2007). Of the region's total population, it is estimated that about 90% live in rural, mostly remote and inaccessible areas.

In terms of economic activity, the Afar region' economy is based on livestock production (subsistence) and it supports for about 90% of livelihoods of the population. Nevertheless, the number of agro-pastoralists has shown an increment trend over recent periods due to the development of irrigation infrastructures in the region. Accordingly, the region has started producing some agricultural commodities such as food crops, cotton and honey production. Following to agriculture, manufacture and small-scale trades are major economic activity in the region, which provides livelihood for less than 10 percent of the region's total population (Afar Regional State Strategic Plan, 2010). Although, the region has great potential for agricultural development and cattle rearing, agricultural production is very low due to several factors which include: utilization of weakly modernized agricultural technologies and inputs, erratic and unreliable rainfall pattern, lack of adequate and efficient extension service and animal diseases such as tsetse fly. As the result, the region is suffering from severe poverty and food shortage. In 2016, for instance, 23.6% of the region's population was below the nationally defined poverty line as compared with 23.5% of national rate (Household Income and Consumption Expenditure Survey, 2016).

5.3. Administrative Structure of Oromia and Afar Regional States

Following the proclamation of the transitional charter, Oromia and Afar regional states were established as autonomous administrative units in 1991. The government endowed some political, administrative and fiscal power for the regional states by enacting FDRE Constitution in 1995, with the aim of ensuring self-administration at grass roots by empowering local people to participate directly on their political affairs and developmental activities and making local authorities responsive with their real needs and preferences (Dickovick and Tegegne, 2010:5). Moreover, the FDRE constitution (Art (50)) endowed discretionary power for the regional governments to establish various government units which are closer to local people.

Accordingly, Oromia and Afar regional states have established different levels of government below the regional government by taking various factors into account such as administrative convenience, population size and settlement patterns. Afar region, for instance, established four tiers of local governments, namely: Zones, Special Woredas, Woredas and Kebele Administrations while Oromia established a three level of local government: Zone, Woreda, and Kebele Administrations (refer Revised Constitutions of Oromia and Afar Regional States). Of the local government units, Zone administrations are organized as an executive sub-body (like branch offices) of the regional sector bureaus without having any legislative power (elected councils) in both regional states. Thus, they are considered as an intermediary government unit between the Woredas and the Regional sector bureaus. The Zones' administrations are directly accountable not only to the president of regional state but also to regional council (see the revised Constitutions ORG and ARG).

On the other hand, the *Woreda* and *Kebelle* Administrations are organized to act as autonomous government units with having legislative and executive councils as well as judicial bodies in both regional states. Each Woreda directly elects council members and appoints the elected executive and judicial bodies. They are recognized by constitutions of regional states and endowed with a power to prepare own plan concerning socio-economic development policies and implement policies and directives which issued by the higher levels of government. Thus, they are considered as a key local unit of government in both of the regional states because they are central in prioritizing and provision of public services at the local level. Each Woreda Administration is further sub-divided in lowest unit of government known as “Kebelle”, which is very close to the local residents. Each Kebele has an elected legislative council, executive administration committee, social courts, a manager and a pool of civil servants. Their major functions include providing public services like primary school, health posts, extension services, social courts, and community policing. In addition, they are also operating consumer cooperative shops through which the Government distributes subsidized food items and other necessities to poor people. In general, the Administrative structures of Oromia and Afar Regional States are summarized as follows.

Table 5.1: Local Administrative Structures of Afar and Oromia Regional States, 2015

Levels of Local Governments	Regional State		Total
	<i>Afar</i>	<i>Oromia</i>	
No. of Zones	5	22	27
No. of Special Woredas	1	None	1
No. of rural Woredas	31	265	296
No. of Urban Woredas	3	39	42
No. of Rural Kebeles	NA	6,324	NA
No. of Urban Kebeles	NA	482	NA

Source: Central Statistics Agency (CSA) report, 2007

5.4. Expenditure Responsibility Assignment for Woreda (District) Governments

The powers and functions of regional and local governments are not defined in FDRE Constitution since the federal constitution has explicitly specified the powers and functions of federal government and regional states only under articles of 51 and 52 respectively. Article 50(4) of FDRE constitution, however, requires the regional governments to devolve significant power and fiscal responsibilities to their respective local governments that enable them to function as institutions of self-governance. The implication is that the devolution of powers and fiscal responsibilities to local governments are made discretionarily by regional governments in Ethiopia.

In the case of Oromia and Afar regions, the process of powers and functions assignment between regional and local governments has been done through a top-down approach (i.e. without involving local communities and local authorities). As the result, there is lack of clarity with regard to the assignment of power and functional responsibilities between regional and local governments. This, in turn, creates overlapping responsibilities, particularly on shared responsibilities and would breed conflict between the two levels of governments. Moreover, the revised regional constitutions fail to provide guidance for resolving potential conflicts that could occur between regional and local governments regarding the shared responsibilities. Consequently, it reduces the efficiency of public service delivery and difficulty to ensure accountability at regional and district levels of government.

The practice shows that regional governments in the regions under study devolved power and functional responsibility for administration and provision of public services that have local benefit effects such as primary education and health-care services, water and sanitation, agriculture and rural development, inter-district roads and natural resources conservation to their respective local governments (particularly districts). Moreover, the regional governments are also delegated certain functions that may produce inter-jurisdictional externalities and have redistribution implications such as provision of secondary schools, TVET and hospital level health services to the respective Woreda (district) governments. This indicates that Woreda governments in the regions have responsibility for provision of public services that promote the local socio-economic development and improve the living-standard of local people. The practice, however, shows that the Woreda governments are ineffective in carrying out some functions that are delegated to them by regional governments due to weak managerial and technical capacity and lack financial, material and human resources. In Afar, for instance, key-informants claimed that although Woredas (districts) in the region have responsibility for providing water supply and major roads, these services are actually provided by regional sector bureaus rather than the districts.

Following the implementation of the DLDP in Ethiopia, the regional governments in Oromia and Afar regions devolved some powers to their respective Woreda Councils with the goal of ensuring self-administration at the local level. As the result, Woreda governments empowered to make decisions on political, socio-economic, administrative and fiscal matters that directly affect their internal affairs without the influences of zonal administrations. According to the interview made with key informants at regional level, Woredas in the regions currently make budget decisions on Woreda blocked grants independently and are not required to submit their annual budgets and expenditure plans to zone administrations for approval. The practice, however, shows that the elected council members of some Woredas in the Afar region are not yet exercised the powers devolved to them by the regional government. They often meet regularly only to approve the annual plans and budgets which have been formulated by the higher levels of government. Moreover, some of the powers and functions devolved for local governments are still carried out by regional sector bureaus. This, in turn, reduces role of the Woreda to act as de-concentrated administrative units of the regional government without having decision making power.

Generally, the Woredas in Oromia region are in better position in term of administrative and technical capacity; and availability of financial and human resources as compared with Woredas in Afar region. As the result, most of the Woredas in Afar region, are highly vulnerable to the interference and manipulation of regional organs and authorities. Thus, it can be argue that there is a gap between the constitutional provisions and the reality on ground in the regions under study.

5.4.1. Degree of Expenditure Decentralization in Oromia and Afar Regional States

This study used the ratio of Woreda governments' expenditure to the total regional state expenditure to measure the extent of expenditure (de)centralization in Oromia and Afar regional states. As shown in table 5.2, the expenditure share of Woredas to the total regional states expenditure is low in both regions under study, which account on average about 40% and 33% in Afar and Oromia regions respectively during 2007/08 – 2015/16 fiscal years. This indicates that expenditure decisions are highly dominated by regional government in both regions over the study periods. Moreover, the expenditure share of Woredas has shown an increment trend over time (from 8% in 2007 to 38% in 2015/16) in Oromia region, but it has shown a decline trend (from 51% to 32%) in Afar region. The implication is that, the role and performances of the Woredas in the provision of public service delivery in Oromia region has been shown an improvement over recent periods.

Table 5.2: The Expenditure ratios of Woredas in Oromia and Afar Regions during 2007/08 2015/16 FYs (in Million Birr)

FY	Afar Regional State				Oromia Regional State			
	WE A	RE. B	Total C(A+B)	Share D(A/C)	WE A	RE. B	Total C(A+B)	RWT D(A/C)
2007/08	190.3	201.1	391.4	0.51	482.5	5778.2	6260.7	0.08
2008/09	286.9	276.2	563.1	0.49	4746.5	7191.1	11937.5	0.40
2009/10	421.8	370.6	792.4	0.47	4977.8	7938	12896.6	0.39
2010/11	843.4	842.9	1686.3	0.50	6660.6	10,518.5	17179	0.39
2011/12	982.5	458.0	1440.5	0.32	7489.3	14556	22045.7	0.34
2012/13	1368.7	555.4	1924.1	0.29	9709.3	19033	28742.3	0.34
2013/14	1328.6	661.4	1990.0	0.33	11650.9	24742.9	36393.8	0.32
2014/15	1913.3	1032.2	2945.4	0.35	15146.2	27216.1	42362.3	0.36
2015/16	1981.8	1154.6	3136.5	0.37	18175.1	29937.6	48112.7	0.38
Average				0.40				0.33

Note: WE = Woreda Expenditure, RE = Regional Expenditure and RWT = Ratio of Woreda to Total Regional Expenditure.

Source: Data from BoFED; IBEX Data Base of Oromia & Afar Regional States

From the discussion above, the Woredas in Oromia region have shown an improvement in delivery of basic public services (like education, health, agriculture, water and rural road) in terms of quality and quantity after the implementation of fiscal decentralization at local government units. Thus, it can be argued that such finding match with the theoretical argument that suggests that fiscal decentralization can improve the efficiency of public services at local level by enabling the local authorities to supply public services as per the needs and preferences of local people. According to the FGD, however, the real contribution of local governments for the improvement in basic public services delivery is very limited in reality. The reason is that most of basic public services facilities constructed (like primary school, health posts and clinics, shallow wells) in the Woredas of Oromia region are built by regional and zonal sector bureaus as well as international and local NGOs supported by foreign donors (like World Bank, UNDP, UNICEF etc.). Thus, when we take actors outside the Woreda institutions into account, the role and performances of local governments in the delivery of basic public services is very weak.

It is found out that numerous factors are contributing to the existence of a high degree of expenditure centralization in both regions. The first one is the poor political and leadership commitment on the part of regional authorities to decentralize the expenditure responsibilities. The regional sector bureaucracies have been hesitant to decentralize the public services provisions to the Woreda by the regional constitutions. Regional authorities explain that they are concerned about losing their prestige and resources to Woreda authorities. Regional authorities frequently regard local authorities as competitors rather than collaborators in the administrative hierarchy. Such a perception stifles regional decentralization processes. Second, the regional sector offices believe that the Woreda governments lack administrative and institutional capacity to handle all of the expenditure responsibilities that are legally devolved to them. As a result, they use the limited capacity of the Woredas to justify keeping public functions centralized at the regional bureau levels (World Bank, 2004). In addition to that, the Woredas in both regions still suffering from various serious problems includes; weak managerial and technical capacity due to lack of availability of competent human power and lack of availability of sufficient financial and material resources

In general, fiscal systems of the two regions are characterized by high degree of expenditure centralization. Hence, it reduces the efficiency of public services delivery because of the existence of a large disparity in location between the local beneficiaries and the public service provider i.e. the regional sector bureaus. Thus, the regional sector bureaus should demonstrate commitments to decentralize more expenditure responsibility by strengthening administrative and institutional capacity at local (district) levels in order to improve the efficiency of local public service delivery and promote local socio-economic development. Furthermore, the regional governments should devolve proportional revenue raising authority to the respective Woredas to enable them to finance the devolved functions through their own local revenue sources. In this regard, this paper contends that the local level of governments remain dependent on intergovernmental grants to finance their functions that would mean they show a disincentive behavior to mobilize own resources and compromise transparency in budget making and accountability in expenditure management.

5.4.2. Trend and Performance of Woreda Administrations in Budget Allocations

Table 5.3 shows the trend of recurrent expenditure at both Regional and Woreda (district) levels in Oromia and Afar regions for nine fiscal periods (from 2007/08 to 2012/13). The trend of recurrent expenditure is higher at the Woreda level than at the regional level in both regions under study during the selected periods. Averagely, the Woredas were spent about 45% and 52% share of total regional recurrent expenditure in Oromia and Afar respectively during the same time periods. Moreover, the trend of recurrent expenditure at the Woreda level remained stagnant in both regional states over the nine fiscal year period.

With regard to the trend of allocating total recurrent expenditure to each component of recurrent expenditure, the Woredas in the Oromia region allocated a relatively large portion of their recurrent expenditure to general administrative and social services that accounted 42 percent on average. In contrast, the Woredas of the Afar region allocated a large portion of their recurrent expenditure to social services, which accounted for 56 percent on average during the same periods followed by administrative and general services, which accounted for 26 percent on average. This demonstrates that during the selected fiscal years, the Woreda governments in both regions allocated a significant portion of their recurrent expenditure to social, administrative and general services. The main reason is that Woredas in the regions under study (especially in Afar region) give more emphasis on building constructions for key Woreda sector bureaus and offices followed by unnecessary staffing and filling of these sector bureaus by the regional civil service bureaus. As a result, it created duplication of support staffs that consume a significant portion of Woredas' budgets in the form of wage and salary but provide little or no service to Woredas. Generally, the Woredas in the two regions spent the majority of their recurrent budgets on salary and wage payments to teachers, health workers and personnel working in various Woreda sector offices.

Table 5.3: Recurrent Expenditure Share at Woreda and Regional Level in Oromia and Afar Regional States (2007-2016 FYs) (in Million Birr)

FY	<i>Afar Regional State</i>				<i>Oromia Regional State</i>			
	WE	RE.	Total	SWRE to TRE	WE	RE.	Total	SWRE to TRE
	A	B	C(A+B)	D(A/C)	A	B	C(A+B)	D(A/C)
2007/08	191.1	119.6	310.6	0.62	3107	4575	6260.7	0.40
2008/09	248.1	165.4	413.4	0.60	4313	5771.0	4886.1	0.43
2009/10	327.7	240.2	567.9	0.58	4366.3	6048.7	10084	0.42
2010/11	371.2	244.4	615.6	0.60	5866.4	8014.6	10415	0.42
2011/12	405.5	302.2	707.7	0.57	6957	9672.9	13881	0.42
2012/13	481.5	384.5	866.0	0.56	8887.9	10073	16630	0.47
2013/14	558.5	444.2	1002.7	0.56	9776.9	11080.3	20857.1	0.47
2014/15	1195.9	660.2	1856.	0.58	11243	12188.6	23432.1	0.48
2015/16	1052.8	716.6	1769.4	0.60	13492	13014	26506.5	0.51
Average				0.52				0.45

Note: WE= Woreda Expenditure; RE= Regional Sector Expenditure; and SRETE = Share of Recurrent Expenditure to total regional total.

Source: Data from BoFED; IBEX Data Base of Oromia & Afar Regional States.

With regarding to the allocation of capital expenditure, share of Woredas from the total regional capital expenditure is very low in both regional states during the selected fiscal years. Woredas sector bureaus in Oromia and Afar regions in average spent approximately 14 percent and 15 percent of the total regional capital expenditure, respectively during the selected periods (refer table 5.4 below). Furthermore, the share of Woreda sectors' bureaus from the total regional capital expenditure was declined from 19 percent in 2007 to 7 percent in 2016 in the Afar region and from 24 percent in 2009 to 6 percent in 2016 in Oromia region. This shows that capital expenditure decisions in both regions are carried out largely by regional sector bureaus and an indication of centralization of allocation decision of capital budgets in various sectors and implementation of capital projects in both regions. Consequently, the role and performances of local governments in delivering public goods that have potential to provide benefits for more than one fiscal year for residents (e.g., school, health center and roads constructions, water supply projects, and irrigation schemes) is minimum. This could be due to the devolution of limited power and functions for their local governments, insufficient financial resources and

weak managerial and institutional capacity at local level. This, in turn, undermine the efficiency of public service delivery and economic development at local levels.

Table 5.4: Capital Expenditure Share at Woreda and Regional Level in Oromia and Afar Regional States (2007-2016 FYs)

FY	Afar Regional State				Oromia Regional State			
	WCE	RCE.	Total CE	SWCE to TRCE	WCE	RCE.	Total CE	SWCRto RCET
	A	B	C(A+B)	D(A/C)	A	B	C(A+B)	D(A/C)
2007/08	10.0	70.8	80.8	.123	171.8	1202.8	1374.6	0.125
2008/09	28.3	121.4	149.7	.19	433.5	1420.1	1853.6	0.23
2009/10	43.2	181.4	224.6	.19	591.5	1890.1	2481	0.24
2010/11	52.5	599.1	1070.7	.44	794.2	2503.9	3298.1	0.24
2011/12	74.0	680.3	732.8	.072	532.3	4883.4	5415.7	0.10
2012/13	102.5	984.1	1058.1	.07	821.4	8959.9	9781.3	0.084
2013/14	119.8	884.1	987.3	.104	903.1	10752	11655.1	0.08
2014/15	91172.	1254	1373.3	.087	1038.5	13440	14478.5	0.072
2015/16	102.1	1265	1367	0.07	1162.6	16934.4	18097	0.064
Average				0.15				0.14

Note: WRE= Woredas Capital Expenditure RCE= Regional Sector Bureau Capital Expenditure; and SWCR to TRCE = Share of Woredas Capital Expenditure to total regional Capital Expenditure.

Source: Data from BoFED; IBEX Data Base of Oromia & Afar Regional States

However, it is important to analyze the allocation of capital expenditures into economic and social development sectors at Woreda level to check how much the authorities at Woredas take the key socio-economic sectors into account in allocating their capital budgets. With regard to the economic sector, the Woredas in Oromia region spent on average about 32%, 33%, 11% and 7% for agricultural, rural roads, natural resource conversation and water supply respectively while the Woredas in Afar region spent about 61%, 19%, 15% and 5% in similar sub-sectors respectively during 2007-2012/12 FYs (refer table 5.5). With respect to the service sector, the Woredas in Oromia region spent on average around 65% and 31% on education and health services respectively; while Woredas in Afar region spent about 60% and 38% in similar sub-sectors respectively during the same periods (refer table 5.5).

This indicates that the Woreda governments in Oromia and Afar regions have taken into account the key sub-sectors (such as education and health services, agricultural and natural resource conversation) in allocating their capital budgets during the study periods. As compared with Oromia region, however, Woreda level in Afar region has given less emphasis for rural road

construction and water supply sub-sectors, which have potential positive effect for better interaction and economic linkage as well as improve health sector. Consequently, it might adversely affect the economic development and poverty reduction goals of the region as a whole.

Table 5.5: Allocation of Total Capital Expenditure of Woredas on Key Sectors in Oromia and Afar Regions (2007/08 –2012/13 FYs) (in %)

Exp. Categories	2007/08		2008/09		2009/10		2010/11		2011/12		2012/13		Average	
	A	O	A	O	A	O	A	O	A	O	A	O	A	O
ED	.24	.33	.41	.29	.35	.35	.32	.30	.41	.51	.37	.60	.35	.40
Agriculture	.71	.52	.66	.50	.34	.39	.84	.15	.39	.16	.60	.11	.61	.32
Natural Resources	.08	.29	.17	.20	.46	.21	.02	.21	.41	.18	.23	.18	.19	.11
Rural Road Construction	.14	.05	.08	.20	.05	.24	.00	.42	.07	.48	.10	.59	.15	.33
Water supply	.07	.10	.09	.09	.15	.10	.14	.11	.14	.11	.06	.04	.05	.07
SD	.40	.46	.38	.49	.41	.49	.45	.54	.30	.27	.41	.21	.39	.41
Education	.57	.36	.44	.50	.59	.75	.57	.87	.68	.72	.73	.72	.60	.65
Health	.43	.61	.47	.47	.41	.22	.40	.10	.30	.23	.27	.21	.38	.31
GD	.32	.21	.21	.23	.24	.16	.23	.16	.29	.22	.23	.20	.25	.20

Source: Data from BoFED; IBEX Data Base of Oromia & Afar Regional States

ED = Economic Development; SD = Social Development GD =General Development

5.4.3. Fiscal Autonomy of Woreda Governments in Oromia and Afar Regions

Local spending autonomy refers to the extent of local governments to have the right and ability to determine the nature and size of overall public expenditure and break it down into various public goods and services based on the needs and preferences of local people without being influenced by higher levels of government (Dafflon and Madiès, 2011). It is better measured by using non-financial indicators such as policy decision-making power, input autonomy, monitoring and evaluation autonomy and political decentralization to ensure the accountability

of local authorities. Thus, the qualitative indicators were also used in this study to assess the extent of fiscal autonomy of local governments in Afar and Oromia regional states.

Although the Woreda governments are established by regional governments to act as independent and autonomous local administrative units, in reality, they do not have decision making autonomy in developing own policies and strategies as well as preparing own plan and budgets in the study area. As the key informants responded, the decision with regard to the allocation of capital budgets into various sectors and the implementation of most capital projects (like construction of schools, digging wells and health units) are carried out by the regional sector bureaus in the two regions. The informants added that all Woredas with the exception of few have no decision-making autonomy to hire, promote, transfer and impose disciplinary measures on their civil servants. In most Woredas in Afar region, for instance, the decisions to hire and promote civil servants in remote areas are carried out by regional sector bureaus. In addition, Woredas in both regions lack decision-making autonomy when it comes to setting standards for local public services they responsible to deliver, mainly due to weak technical and managerial capacity. Furthermore, the Woredas do not have the autonomy to monitor and evaluate the efficiency and effectiveness of capital budget spending. This is because the monitoring and evaluation of most capital projects in the regional states have been carried out through regional sector bureaus. The regional sector bureau officials explain that local administrative levels lack an effective information system in order to gather data and reports on the performance of capital budget spending.

In general, Woreda governments in the regions under study have limited decision making autonomy with regard to political, fiscal and administrative matters that affect directly their affairs. This suggests that there is a gap between the constitutional provisions and the reality on the ground in terms of local government spending autonomy in both Afar and Oromia regional states. This, in turn, could undermine the benefits of fiscal decentralization such as efficiency in service delivery, accountability and economic growth. There are several factors that contribute to the Woredas' low decision making autonomy in the regions under study. First, there is poor political and leadership commitment on the part of regional authorities to devolve adequate power and the fiscal responsibilities to Woreda governments in real sense. The regional sector bureaucracies have been hesitant to decentralize political power and fiscal responsibilities which

devolved to the Woredas by the regional revised constitutions. This may be due to fear of Regional authorities losing of their prestige and resources to Woreda authorities; since they frequently regard local authorities as competitors rather than collaborators in the administrative hierarchy.

Second, most of the Woredas in the regions under study are facing serious challenges in mobilizing funds and utilizing the resources in projects that could improve the living standards of their local people (discussion made with key-informants and FGD). The reason is that LGs have weak administrative and technical capacity due to lack of availability of trained and experienced human resources; and lack of availability of necessary material resources and infrastructure facilities at local levels. Third, almost all Woredas in the regions have no capacity to generate sufficient own revenues that can enable them to meet the increasing demand of socio-economic development of the people in their areas. This is mainly due to several factors including the delegation of few revenue sources that have very low yielding rates, lack of tax autonomy, poor tax administrative capacity, unwillingness of taxpayers to pay taxes and the effects of corruption. Finally, the Woredas of the regions under study are often not involved the local communities in the policy formulation, planning and implementation of capital project (field observation and discussion with FGD).

5.5. The Revenue Sources Assigned to Woreda (District) Governments

The FDRE Constitution does not specify the division of revenue raising power between the regional and local governments; it only defines the taxation powers of the federal and regional governments. Nonetheless, the federal constitution (Art. 50) grants the regional states a legislative authority to devolve sufficient revenue sources to their respective local governments with the aim of enhancing their financial capacity and enabling them to function as effective institutions of self-government by improving their autonomy in planning and decision-making. This implies that regional governments in Ethiopia have full power with regard to the devolution of tax sources for their respective local governments. As the result, tax revenues at Woreda level are not only derived from tax sources assigned exclusively for regional governments, but also it varied in terms of the extent of revenue sources which devolved for Woredas among regions in Ethiopia.

In Oromia Regional States, revenue sources of Woredas are clearly listed in the revised Constitution of ORS (Art. of 72/2002), while the revenue sources of Woredas are not clearly defined legally in Afar region. Moreover, regional government in Oromia is delegated responsibility to collect revenues on relatively several revenue sources as compared with Afar region (refer Appendix H). In Afar region, for instance, the regional government is delegated the responsibility for its Woredas to collect revenues on a few tax bases including PIT on Woreda employees and private enterprises, agricultural income tax and rural land use rent, livestock resource and turnover taxes. The key-informants had responded that the regional authorities in Afar believe that the Woredas in the region have poor managerial and technical capacity to carry out revenue collection responsibility effectively. Hence, they claimed that delegating more revenue sources to them would lead to resource mismanagement or corruption. This indicates, therefore, the devolution of political and administrative powers by regional governments to Woreda governments in Oromia is accompanied by relatively sufficient financial sources compared to in Afar region. As the result, it could enables the Oromia region to realize the major objectives of Woreda decentralization policy in general and fiscal decentralization in particular as compare to Afar region.

Moreover, despite the regional governments are delegated responsibilities to their respective Woredas to levy and collect taxes on certain revenue sources, in practice the Woredas have no tax autonomy on the delegated taxes. The reason is that tax policies of the regional states including Woreda governments are decided solely by the regional councils (interview with key informants). Thus, Woreda governments in both regions have no authority to determine the tax bases and rate over revenue sources which delegated to them by regional governments. This, in return, further limits the capacity of Woreda governments to generate sufficient revenue from their jurisdictions based on the developmental needs of their residents by altering tax bases and/or rates. Consequently, it reduces the efficiency of local public services delivery and accountability at local level, due to lack of a strong linkage between revenue raising and spending decisions.

5.5.1. The Practices of Own Revenue Generating of Woreda (District) Governments

Following the implementation decentralization program at *Woreda level* in Ethiopia, regional governments in Oromia and Afar regions have been delegated responsibility to collect revenue from certain sources to their respective *Woreda* governments since 2002 and 2005 respectively. As it has been discussed previously, regional government in both regions delegated tax collection responsibilities on revenue sources with lower yield rates for their respective *Woredas*. The main reason as explained by key-informants for centralization of revenue collection in the region is that the regional authorities fear loss of their fiscal power and control over regional revenue. The regional authorities believe that *Woredas* in the regions have poor tax administrative capacity and lack appropriate enforcement mechanisms to collect revenues from major taxes with mobile nature efficiently.

According to the interview made with budget experts from Regional BoFEDs, the amount of revenues collected by *Woredas* from the delegated revenue sources are not returned to Regional governments, but they are retained and will be deducted from their share of regional-blocked grants. The key-informants also responded that the total size of *Woreda* block grants and the amount of revenues to be generated from the respective jurisdictions of each *Woredas* are determined solely by the regional' BoFED of the two regions. Accordingly, the *Woreda*' revenue office is expected to collect the targeted revenue from its jurisdiction based on the plans it receives from the revenue office of regional governments. The key informants also responded that the amount of targeted revenue of each *Woreda* is determined on the basis of the planned regional economic growth rate in both regions under study. The amount of the targeted revenue of each *Woreda* is deducted from the annual budget (block grant) of the respective *Woreda* after it approved by *Woreda* councils.

The practice, however, shows the amount of the targeted revenue is often above the actual *Woredas*' tax administrative capacity in both regions. As a result, the revenue offices of most *Woredas* in these regions often collect revenue from their jurisdictions lower than the targeted amount of revenue. The implication is that *Woredas* in the regions have less collection efficiency, often measured by comparing the actual revenue collected with the estimated

revenue. The regional BoFED data confirm that the average revenue collection rate of the Woredas in Afar is by far lower than in Oromia. In general, if the actual revenue collected from Woredas is less than the estimated revenue, the difference will be covered by regional government with Woreda block grants. On the contrast, if the Woredas collected revenue above the targeted revenue amount, they would be expected to transfer the excess revenue to the regional governments' account. But, *Woredas* could utilize the extra revenue, if and only if they obtained permission from regional government (interviews made with key-informants). Such tax system either discourage the Woredas' revenue offices to generate more own revenue by fully exploiting their tax potentials or incentive them for their under reported of actual collected revenues. This, in turn, makes the Woredas to heavily depend on regional transfers for financing larger portions of the cost of functions they are responsible for and thereby further limit their fiscal autonomy.

5.5.2. Degree of Revenue Decentralization in Oromia and Afar regions

Table 5.6 below shows that the Woredas' share of own revenue to the total regional revenue is very low, which account on average about 20.1 percent and 6.3 percent in Oromia and Afar, respectively, during the 2007/08 – 2012/13 fiscal years. This indicates that the revenue collection is highly dominated by regional governments and makes Woredas heavily dependent on regional blocked grants to cover larger portion of the cost of functions they are responsible for. The Woredas' capacity of raising revenue in Oromia region has, however, shown an improvement trend (mainly from domestic indirect taxes and non-tax revenues) and thereby reduces the level of their dependency on regional blocked grants (from 93 percent to 87 percent) during the study periods.

The practice shows that despite the Woredas in Oromia region have been made more efforts to generate more own revenues, still their level of decency on regional transfer remain unchanged during the selected periods (refer table 5.6 below). Consequently, it further limits the autonomy of Woreda authorities to allocate their budget resources in expenditure areas that are demanded highly by local residents. This, in turn, could undermine the potential benefit of fiscal decentralization such as less efficiency of local public services delivery and less accountability at local levels. The key informants explained the factors that are contributing for the centralization of high revenue collection in the two regions are delegation of few revenue sources with very

low yield rates, poor tax administrative capacity at local level due to lack of trained and experienced manpower, lack of availability of an appropriate mechanisms and procedures to assess and collect local taxes, unwillingness of tax payers due to lack of awareness, and lack of tax autonomy.

5.5.3. Own Revenue Composition of Woreda Governments

Table 5.6 presents the composition and share of the major own revenue sources (taxes and non-taxes) and regional transfers of Woredas to total budget revenues in Oromia and Afar regions for 2007/08 – 2012/13 fiscal years. Tax revenue is the major own revenue source, and it plays an important role at Woreda level, which accounted on average about 88.6 percent and 86 percent of the total own revenue of the Woredas in Afar and Oromia regions respectively. However, the share of tax revenue from the total own revenue has shown a declining trend (from 90 percent to 85 percent) in Afar region and (from 93 percent to 83 percent) in Oromia region during the selected periods.

Table 5.6: Composition of Own Revenue and Fiscal Capacity of Woredas in Oromia and Afar Regional States during 2007/08 – 2012/13FYs

Revenue Sources	ARS	ORS	ARS	ORS	A	OS	ARS	ORS	ARS	ORS	Average ARS ORS	
Tax revenue	31.62	868.24	41.30	1074.3	6.07	237.5	100.1	1715	91.53	2778.5	54.13	1335
Direct Taxes	23.05	768.32	24.50	934.84	5.80	190.5	80.61	1491	88.02	2474.9	44.4	1172
Indirect Taxes	8.6	100	16.8	140	0.27	0.46	19.53	224.4	3.51	303.4	9.74	153.6
Non-tax Revenue	3.7	111	4.3	173	1.30	39.54	13.29	305.6	12.05	530.07	6.93	231.9
Total own revenue (A+B)	89.35	979.17	45.6	1247.3	73.4	277.	114.5	2021	107.9	3308.6	86.15	1567
Regional Block Grant	232.3	14,108	251.1	17,070	330	20,824	415.0	25,614	511.5	31,761	348.1	21875
Total Revenue (C+D)	321.7	15087	296.7	18317	404	21101	529.5	27634	619.5	35069	434.2	23442
Share of tax to TOR	0.90	0.87	0.90	0.86	0.89	0.85	0.87	0.84	0.85	0.83	0.88	0.85
Share of Direct tax to tax	0.73	0.88	0.59	0.87	0.88	0.80	0.80	0.87	0.96	0.89	0.79	0.862
Share of Indirect tax to tax	0.27	0.12	0.41	0.13	0.12	0.20	0.20	0.13	0.04	0.11	0.21	0.14
Share of Non- tax to tax	0.10	0.13	0.10	0.14	0.11	0.16	0.13	0.17	0.13	0.19	0.15	0.16
Share of TOR to TR	0.28	0.07	0.15	0.07	0.18	0.013	0.22	0.07	0.17	0.09	0.2	0.063
Share of Grant to TR	0.72	0.93	0.85	0.93	0.82	0.986	0.78	0.93	0.83	0.91	0.8	0.94

Note: TOR = Total Own Revenue, TR = Total Revenue

Source: computed based on data from BoFED of Oromia & Afar Regional States

In terms of tax structure, direct tax revenue is the dominant tax revenue source of the Woreda governments in the two regions, which accounted about 79.4 percent and 90.5 percent of the from the total tax revenue of Woredas in Afar and Oromia regions, respectively. Moreover, the contribution of direct tax to total tax revenue of the Woredas has shown an increment trend (from 73 percent in 2007/08 to 96 percent in 2012/13) in Afar region while it remains unchanged in Oromia. Out of the total direct tax, the Woredas generated more tax revenue from employment income tax followed by enterprise business profit tax and ‘Chat tax’ during the selected periods. Although Afar’s economy is based on agriculture (mainly on livestock production), the Woredas in the region generated little taxes (not more than 3 percent of their total direct tax) from livestock income tax and rural land use fees during the selected periods. Key-informants from the Woreda revenue offices in Afar region explained the factors contributed for the low revenue collection performance from these taxes includes late implementation of the region land use policy by the revenue authorities of the Woreda and lack of appropriate revenue collection mechanism that suits with the life style of the pastoral community at local level.

In contrast, the share of indirect taxes to total tax revenue of the Woredas is low, which accounted about on average 20.6 percent and 9.7 percent in Afar and Oromia regions respectively during the study periods. The reason is that most of the indirect tax bases are levied and collected by regional governments in the two regions. The Woreda shave been collecting indirect tax revenue mainly from value added tax (VAT), turn over tax (ToT) and excise tax on locally produced goods and services (refers table 5.6). Finally, the share of non-tax revenue to total own revenue of Woredas in the regions is very low, which accounted on average only 11.4 percent and 14.2 percent in Afar and Oromia regions, respectively. The Woredas in the regions have been collecting non-tax revenues mainly from charges and fees and sales of public goods and services.

5.6. Fiscal Imbalances (Vertical and Horizontal) in Oromia and Afar Regions

5.6.1. Vertical Fiscal Imbalance

The study used the share of Woredas’ expenditure needs that are financed through their own revenue to measure the extent of vertical fiscal imbalance in both the regions. On average, the

share of the Woredas' own revenue to their total expenditures was about 10.57% and 20.36% in Afar and Oromia regions respectively during the 2007/2008, 2015/2016, and 2017/2018 fiscal years (refer table 5.7). This indicates that the devolution of power and functions for Woredas to regional governments in both regions is not accompanied by the devolution of sufficient financial resources. As a result, it created a high vertical fiscal imbalance, which accounted for on average about 0.89 and 0.79 during the selected periods. This shows that the districts in the regions have no fiscal capacity that can enable them to even finance their recurrent expenditures, and thereby they heavily depend on regional transfers to finance some portion of their recurrent and full capital expenditures. Thus, it can be argue that the fiscal relation between the regional and local levels of government in both regions is characterized by high vertical fiscal imbalance. As the result, it limits the fiscal autonomy of local authorities and thereby undermine the efficiency of public service delivery and accountability at grass-roots levels due to a lack of strong linkage between revenue raising and spending decisions. Moreover, although the fiscal capacity of Woredas has shown an improvement (from 1.8 percent to 19 percent in the Afar region and from 5.6 percent to 28 percent in the Oromia region), the level of dependency on regional transfers has remained unchanged in the selected periods.

The factors that contributed to the existence of a high vertical fiscal imbalance in the regions under study are the devolution of revenue sources that have very low yielding rates and a lack of tax autonomy, poor tax administrative capacity, a lack of appropriate enforcement mechanisms, and the unwillingness of taxpayers to pay taxes. In addition, the key informants at the regional level also claimed that high expenditure requirements in Woredas due to low-level infrastructure development (especially in the Afar region), increased salaries and wages of civil servants and high corruption practices at local levels also contributed to the high vertical fiscal imbalance in the regions under study.

Table 5.7: Share of Woredas' Own Revenue to Its Total Revenue Expenditure in Oromia and Afar Regional State during 2007-2014 FYs (In Million Birr)

Revenue Sources	2007/08		2008/09		2009/10		2010/11		2011/12		2012/13		2013/14	
	ARS	ORS	ARS	ORS	ARS	ORS	ARS	ORS	ARS	ORS	ARS	ORS	ARS	ORS
Total Own revenue	23.8	629.32	35.30	979.17	7.38	277.03	45.61	1247.30	107.96	3308.56	16.2	410.4	251.7	564.7
Total Expenditure	190.3	4825	287	4746.5	422	4978	843.4	6661	982.5	9709.3	13.69	970.9	132.9	155.34
Imbalance	12.5%	13%	12.3%	20.6%	1.8%	5.6%	5.4%	19%	11%	24%	12%	32.3%	19%	28%

Source: Data from Oromia and Afar BoFED.

5.6.2. Horizontal Fiscal Imbalance

Horizontal fiscal imbalance refers to the fiscal capacity gap between government units presented at the same level. HFI commonly measures by comparing the potential revenue raising capacity with the total expenditure needs of local governments. However, measuring the fiscal capacity gaps between local governments within a region by using such measurement approach in developing countries including Ethiopia is a very difficult task due to lack of availability of adequate and reliable data at sub-national levels. Thus, this study used the actual data related to revenue raising capacity and expenditure needs of each Woredas in the regions under study to measure the extent of fiscal capacity gaps.

The existing data from regional BoFDE in the two regions shows the existence of wide horizontal fiscal capacity gaps between the Woredas located within each region because of two major factors. First, significant variation between the Woredas in terms of revenue-raising potential, due to differences in the level of economic and infrastructural developments as well as availability of natural and mineral resources in the regions. In the Afar region, for instance, the Woredas located in the Eastern Zone (like Afdera, Elidaar, Amibera, Aysaita, and Dubti) had higher revenue raising potential compared with those located in the Western Zone (like Kuri, Bidu, Adaar, Afambo, and Argoba) during the 2011-12 and 2012-13 FYs (refer to the 2014 BoFED annual report). The reason is that the Woredas in the Eastern part of the Afar region are in a better position with respect to economic activity, infrastructure development, urbanization

rate, and natural resources (salt, potassium and zinc). As a result, these Woredas collected more than half of the region's total PIT and BPT during the 2012/13 fiscal year (Ibid).

Second, existence of a significant variation in per capita capital expenditure needs exists between Woreda Administration within the two regions, mainly due to differences in terms of socio-demographic characteristics (such as population dispersion, urbanization rate, and social composition and age structure), level of infrastructure developments, and physical and climate conditions. For instance, Woredas located in the mountain topography of Oromia region are required to spend a larger amount of their budgets to provide certain public services like local roads as compared with those located in lowland areas. Moreover, in areas with lower densities of population, higher budgets are required to provide comparable quantities and quality of basic public services due to a lack of economic scale.

From the discussion above, the fiscal relationship between the regional and local governments in Oromia and Afar regional states is characterized by a high vertical fiscal imbalance and a wide horizontal fiscal capacity gap among the local level governments. This, in turn, requires designing and putting in place effective fiscal transfer mechanisms that fit with the specific situations of the regions in order to address the fiscal problems and ensure the provision of a minimum basic public services all citizen in the region. Additionally, in designing a fiscal equalization transfer system, it needs to take into account international norms and principles related to intergovernmental fiscal transfer, such as clarity in grant objectives, autonomy, revenue adequacy, predictability, equity, transparency, and simplicity.

5.7. Assessment of Intergovernmental Fiscal Transfer Systems of Oromia and Afar Regional States

Intergovernmental fiscal transfer is the major revenue source for sub-national governments in Ethiopia, accounted for about 70% of their total revenue. As a result, they could not carry out their functions properly without federal transfers. In Ethiopia, however, the federal government does not provide transfer funds for local governments directly but rather through its regional governments. Hence, Woreda governments in Oromia and Afar regions have been receiving funds in the form of a Woreda Block Grant from their respective regional level of government. It

accounted the larger share of the regional total budget (about 47% and 43.72%) and covers larger portion (about 79.64 % and 89.43% of the Woredas' total budget) in Oromia and Afar regions respectively during 2007/08-2012/13 FYs (see table 6.6 above). This shows that the Woreda governments in the two regions are almost unable to do any function without the regional block grant. Such a high level of dependency on regional block grant could make the Woreda governments vulnerable to the intervention and manipulation of the regional government and limits their fiscal autonomy.

As it discussed in literature review, there are two major questions that need to be addressed in designing a mechanism for transferring funds in the form of unconditional grants: How will the aggregate grant pool be determined? And how is the total grant pool to be distributed among lower levels of government? With regard to the first question, the regional BoFEDs of the two regions determine the total Woreda block grant pool as part of the annual regional budget and approve it at the regional council. The practice shows that the total size of the grant pool with respect to the share of the grant pool in the annual regional budget has had inconsistent trends over the last ten years. The size of the Woreda grant pool, for instance, has shown an increment trend over the fiscal years in nominal terms but has been inconsistent with respect to the share of the Woreda grant to the total regional budget. This, in turn, makes the current transfer systems of the regions less stable, unpredictable, and non-transparent, which further limits of the capability of local governments to prepare an effective budget and plan long-term objectives to provide local public services. This calls for the involvement of all stakeholders in determining the size of the Woreda grant in order to improve the predictability and transparency, as well as the acceptability, of the transfer system by the local authorities.

Concerning to the second question, the regional governments of the Oromia and Afar regions have been allocating the Woreda blocked grant pool among their respective Woreda and urban administrations on the basis of a grant formula that was adopted by the Regional BoFED since 2002 and 2005 respectively. The regional governments have revised the grant formula several times since then, mainly due to frequent changes in the socio-economic conditions of regional states and a lack of reliable data (Assefa, 2007). Before 2009/10, the regional governments adopted grant formulas that considered some socio-economic variables and assigned weights for each variable subjectively. However, the pre-2009/10 grant formulas have severe shortcomings,

including that they discourage Woredas from generating more revenues for their jurisdictions and undermine the efficiency of local public services.

Thus, the regional governments of Oromia and Afar regions replaced the socio-economic variable-based formula with a new grant formula (commonly known as the expenditure-need-based grant formula) in 2010/11 and 2009/10, respectively. The main aim of replacing the old grant formula with a new one is to match the real, specific circumstances of the Woreda governments located in the regions on the ground and improve the fairness of the distribution of regional block grants. However, key informants claimed that the regional governments do not make all stakeholders fully involved such as the local executive, local council, and local communities, in the process of designing the new grant formulas. Consequently, it reduces the acceptability of the new grant formulas by authorities at the local level.

In general view, the new grant formulas adopted by both regions give more emphasis on expenditure needs for allocating the Woreda block grant among Woreda governments (located in both rural and urban areas) within the regional boundaries. The new grant formulas use various expenditure indicators to estimate the capital and recurrent budget needs of each district separately.

I. Assessing the Capital Expenditure Needs of Woredas

The grant formulas use similar development indicator to estimate the need of the capital budget of each Woreda located in rural and urban areas with some exceptions. The formulas, for instance, use the level of industry and trade development to estimate the need of capital budget of each Woreda located in urban areas while extension service for agriculture and rural road density to estimate the capital budget of Woredas located in rural areas (refer BoFED annual report of Oromia and Afar, 2014:40). Accordingly, the new grant formulas are allocated more capital budget for Woredas that are in worst position in terms of level of socio-economic and infrastructure developments than other Woredas, so as to ensure equal access of basic public services to local communities regardless of their living locations. In addition, the existing grant formula adopted by the Oromia region is also considered the difference of expenditure needs of Woredas due to the variation in geographical characteristics of the Woredas. Accordingly, it allocates more regional block grant for Woredas located in high land areas and far away from the

center. It can be argued that including such factor in the formula is appropriate because the Woredas located in mountainous areas requires more resource to provide comparable quality and quantity of certain public services and infrastructures such as roads compared to the Woredas located in the low lands in the region.

Table 5.8: Indicators to Estimate Woredas' Capital Expenditure needs

<i>Expenditure Needs</i>	Indicators
<i>Health infrastructure</i>	- Population size, - Number of Health Centre and Health Post;
<i>Educational infrastructure</i>	- Number of schools, class rooms and school age population
<i>Agricultural infrastructure</i>	- Number of farming households, farmers training center, livestock in a Woreda,
<i>Rural Water-Supply</i>	- Water coverage (in%)
<i>Rural-Road infrastructure</i>	- Population, Area size (in Km ²), Road Length (Km) Road Density
<i>Cost factor</i>	- Distance from the center

Sources: Oromia and Afar Regional BoFEDs

II. Assessing the Recurrent Expenditure Needs of Woredas

The new grant formulas also use the cost of each unit of output for each basic service (like education per student, health service per patient, cost of agricultural extension service per household, etc.) to estimate the recurrent budget need of each Woreda (Ibid). Moreover, they use similar expenditure indicators to assess the recurring budget needs of Woredas which are located in rural and urban areas with some exceptions. The grant formulas, for instance, do not consider the expenditure needs for municipality services such as water supply, waste disposal, etc. to assess the recurrent budget needs of the respective urban administrations. The rationale is that municipal services are exclusively financed from local revenue sources such as service charges and fees. In this formula, the total recurrent expenditure needs of each Woreda are computed by summing up the estimated costs of each Woredas on all sectors included in the grant formula.

Table 5.9: Indicators to Estimate Woredas' Recurrent Expenditure needs

Expenditure Needs	Indicators
Administration and General Expenses	- Estimated salary and operational expenses for all sectors those are not covered in unit cost service delivery institutions
Primary Health care	- Number of health centers and health posts, - Health staff salary and standard operational expenses for the health institutions
Education	- School age population, Actual number of enrolled students - Expected number of students to be served, - Actual number of teachers, number of schools and classrooms, - Unit cost of construction, actual recurrent expenditure and operation costs for the previous year
Rural Water-Supply	- Water infrastructures, and costs of major maintenance for un-functional schemes, minor maintenance cost for functional schemes
Agricultural and Rural developments	- Number of development agents and annual salary, Number of kebeles, - Number of farmer households and standard ratio to development agent, - Operation expenses for extension service delivery; and veterinary services
Micro and Small scale enterprises	- Costs required to facilitate job opportunities for economically active unemployed population
Cost Factor	- Cost differences among Woredas due to number of kebeles, distance from the zonal and regional centers and area size of Woredas

Sources: Oromia and Afar Regional BoFEDs

Hence, the regional blocked grant share of each Woreda is determined by summing up the estimated recurrent and capital budgets of each Woreda for all expenditure indicators mentioned in grant formulas. The practice, however, shows that a larger portion of the total Woreda block grant is allocated in the form of a recurrent budget for the Woredas in both regions. Of the total Woreda blocked grant in Oromia region, for instance, about 88% and 12% are provided in the form of recurrent and capital budgets, respectively, for the Woredas in the 2013/14 FY (BoEFD annual report of Oromia, 2014:41). This indicates that the new grant formulas of both regions do not provide sufficient financial resources for the Woredas to enable them to finance larger portions of their capital expenditures.

In general, the existing grant formulas adopted by both the regions are effective in equal access of all local people for basic public services such as education, health, agricultural and natural resources and rural roads. This is because grant formulas are allocating more capital budgets for Woredas that are in worst position in terms of socio-economic and infrastructural developments. However, grant formulas discourage Woredas to mobilize more own revenues from their

jurisdictions and also further increases the fiscal capacity disparity between Woredas within the regions. The reason is that the existing grant formulas of both regions fail to take the Woredas' efforts of raising the revenue into account in distributing the total Woreda block grant pool among the respective Woredas.

5.8. Access of Woredas (Districts) to Financial Markets

In the case of Oromia and Afar Regional States, regional governments endow the right for respective Urban Administrations to borrow funds from domestic financial institutions owned either by federal government or regional governments to finance only their capital expenditures. Moreover, the revised Constitutions of the regions also empowered the regional administrative council to determine the terms and conditions under which the Urban Administrations could borrow funds from domestic sources (see the revised constitution of Oromia and Afar regions). Accordingly, the regional administrative councils in Oromia region has facilitates through designating various borrowing schemes to enable the Urban Administrations access to domestic financial institutions owned by establishing a regional owned financial institutions like Micro-Finance Institution (MFI) and Co-operative Bank of Oromia .

The practice, however, shows that the urban administrations in the two regions have no autonomy to borrow funds discretionarily from domestic credit sources so far mainly due to direct control of the regional administrative councils. The reason is that regional authorities highly believe unlimited local access to domestic financial markets may cause several unintended outcomes such as over borrowing and over spending which leads to bail-out problems. Consequently, urban administrations in the regions have been financing their capital expenditure through their own revenues and Woreda Blocked Grants. This indicates that the Urban Administrations in the region have high financial constraints to expand the production and delivery of basic public services in urban centers of the regions, and there by address the major problems of their urban residents like water supply and housing problems as well as urban unemployment. Thus, limited access of Urban Administrations to domestic financial institutions make it difficult for them to ensure intergenerational equity in their jurisdictions through financing some part of the cost of long-term infrastructure projects by borrowing. This is because

the authorities at urban centers in the region are forcing the local residents to burden the full cost of local capital projects in the region.

Therefore, it needs access the Woreda Administrations to domestic financial markets through introducing an effective borrowing control mechanism that suit the specific conditions of the regions to improve the efficiency of public services delivery and ensure intergeneration equity at grass root levels. However, the market-based approach is not appropriate mechanism to control the borrowing activity of local governments at present in Oromia and Afar Regional States for several reasons including weak development of financial markets in the regions; and the financial institutions owned by regional governments may provide lending service to local governments without any restriction. In such situations, therefore, the borrowing activities of Urban Administrations either adopt a rule-based approach or cooperative approach or the combination of the two, so as to ensure fiscal discipline and adequate access to domestic financial markets of the Urban Administrations in the regions.

5.9. Discussion

The main findings are summarized on the basis of the implementation of fiscal decentralization at the local level of government (Woredas) by considering the performances two regional states, namely Oromia and Afar. With this perspective, the analysis is made on the major pillars of fiscal decentralization which includes the extent of an enabling environment, the assignment of appropriate expenditure responsibility and revenue sources with reference to regional and local levels of government, vertical and horizontal fiscal imbalances and the design of intergovernmental transfers as well as adequate local access to capital markets.

With regard to the enabling environment, regional governments in Oromia and Afar regions have devolved more power and fiscal responsibilities to the respective Woredas (districts) following the implementation of Woreda decentralization policy since 2002. However, there is a lack of clarity and formality with regard to the assignment of power and fiscal responsibilities between regional and local governments particularly on shared responsibilities. The reason is that the process of assigning expenditure responsibilities to Woredas is done solely by regional governments without involving local authorities and communities. Moreover, the revised regional constitutions do not also provide guidance for resolving potential conflicts that could

occur between regional and local governments with regard to the shared responsibilities. As a result, it creates an overlapping responsibility problem and may lead to several conflicts between regional and local governments. Thereby, it further reduces the efficiency of local public service delivery and accountability at local levels.

When we consider the trend of expenditure assignment at the Woreda (district) level in Oromia and Afar Regions, the result shows high centralization of expenditure decisions, particularly capital expenditure. For instance, the share of Woredas' expenditure to the total regional expenditure was on average about 33% and 45% in the Afar Region and Oromia Region, respectively during the 2007–2008, 2015–2016, and 2017–2018 fiscal years. However, the expenditure share of Woredas has shown an increment trend over time in both regions, which indicates an improvement in the role and performance of the Woredas in the provision of public service delivery. In reality, the role and performances of Woredas in public service provision is still minimum, since most of the infrastructural facilities in the Woredas are built through regional sector bureaus and foreign donors financed by World Bank and IMF.

With regard to the revenue assignment, regional governments are delegated the responsibility to collect revenue from certain revenue sources for their respective local governments. The practice, however, shows that each Woreda governments are expected to collect a targeted revenue which is set solely by regional BoFED and deducted from their share of Woredas block grant. If the Woredas have collected more than the targeted revenue amount, the excess would be deducted from their shares of block grant entitlements. Thus, such a tax system discourages the local authorities from generating more revenue from their own jurisdictions and rationalizing expenditures at the local level. As the result, revenue collection is highly dominated by regional governments, accounting for 89% and 93% of the total regional revenue in Oromia and Afar regions respectively.

Therefore, the findings of the study show that the devolution of power and functional responsibilities to local governments by regional governments is not accompanied by the devolution of sufficient financial resources in either region. For instance, Woredas in the regions under study have the capacity to generate their own revenue, which can only finance on average about 10.6% and 20.4% of their total expenditure in Oromia and Afar Regions, respectively,

during the study periods. This, in turn, creates a high vertical fiscal imbalance and an indication of the heavy dependency of Woredas on regional transfers to carry out the functions they are responsible for. Hence, it further limited Woredas' fiscal autonomy and led to less efficiency in the delivery of public services and less accountability at the local level. There is also a high horizontal fiscal capacity gap between local governments within the region under study, mainly due to significant differences in revenue-raising potential and expenditure needs.

In addition to their own revenue, local governments are receiving funds in the form of block grants from regional governments, which are allocating among Woredas on the basis of a grant formula that considered only Woredas' expenditure needs. Findings of the study show that the grant formulas of both regions are disincentive Woredas to more own revenue and less effective in addressing the fiscal capacity gaps between districts within the regions. Finally, although Woreda governments located in urban areas are endowed with the right to borrow funds from domestic financial institutions, in practice they have not exercised their borrowing rights until now mainly due to the high direct control of regional executive councils. As the result, authorities at urban centers are forced to finance capital projects out of own revenue and regional transfers and thereby make them difficult to ensure intergenerational equity using debt finance.

Overall, the study found that the implementation of fiscal decentralization at district level in Oromia and Afar regional states are facing several problems and challenges. Some of these include Inadequate devaluation of decision-making power for local governments; weak administrative and technical capacity at the local level which is due to a lack of trained and experienced human power and necessary material resource; poor political willingness and commitment of authorities at the regional level to decentralize fiscal power in a real sense; and a lack of sufficient financial resources; and weak coordination with various decentralization stakeholders; and lack of local governments' access to domestic financial markets; as well as lack of an effective regional-local transfer systems.

6.0. CHAPTER SIX: MAJOR FINDINGS, CONCLUSION AND RECOMMENDATIONS

6.1. Summary of Major Findings

Fiscal federalism has been receiving a great attention among policy makers, researchers and academicians in many countries with vary levels of development and political systems since 1990s. The rationales for a decentralized fiscal system includes improve the efficiency of resource allocation; promote economic growth and quality of local governance. Although specific reasons for increase interest towards fiscal federalism vary from one country to the other, many countries have introduced a decentralized fiscal system in their public sectors for economic and political reasons. The practices, however, shows that the assignment of expenditure and taxing responsibilities among various levels of government are varies from countries to countries. In many countries, for example, central government collects a line share of the total national revenue and transfer funds to SNGs in form of unconditional and conditional grants. In many developing countries, like Nigeria, and India, local governments are collects very few revenues with low yield rates but makes expenditures by far greater than the revenues. This, in turn, limits local fiscal autonomy, which could undermine the realization of benefits of fiscal decentralization.

Ethiopia has introduced a federal form of government and decentralized system de-jure in 1995, with aim of ensuring a self-administration at sub-national levels. So far, two phases of decentralization has been implemented by government. The first phase of decentralization (1991-2001) was aimed at creating and empowering regional national governments, while the second phase which implemented since 2002, was concerned with devolution of more power and functional responsibility to Woredas (districts). Thus, this study is designed to assess the practices of fiscal federalism in Ethiopia with particular reference to federal-States and regional-local governments since 1995 by selecting two regional states, namely Oromia and Afar regional states. With this perspective, the major findings are summarized based on the major pillars of fiscal decentralization, which includes the extent of enabling environment, assignment of expenditure responsibility and revenue sources with reference federal-States and regional-local

levels of government, vertical and horizontal fiscal imbalances, design of intergovernmental transfer, and adequate local access to financial institutions.

With regards to expenditure assignment, the current Constitutional assignment of power and functions between federal government and States do not violent the general principles of expenditure assignment. However, there is an overlapping and duplication responsibilities, particularly on shared functions, which create unclear assignment and inefficiency public service delivery. Moreover, there is lack of clarity with regarding the assignment of power and functional responsibilities between regional and local government in Oromia and Afar regions. As the result, it create overlapping responsibilities and may breeds conflicts between government units at different levels. Moreover, there is not any explicitly stated guidance for resolving potential conflicts that could occur between different levels of government.

The study also found that the expenditure ratio of all States and Woredas in Oromia and Afar regions to total national expenditure is low, which indicates an existence of a high centralization of expenditure decisions, particularly capital expenditure, in Ethiopia. As the result, the SNGs play a limited role while the federal level sector bureaus play a significant role in fiscal matters. Factors contributed are; poor political commitment at higher level, weak technical and managerial capacity, and poor own revenue raising capacity. However, the expenditure ratio of States and Woredas has shown an increment trend over time in Ethiopia, which indicates an improvement of the role and performances of the lower levels of government in the provision of public service delivery.

With regarding to the revenue ratio, the share of States revenue to total national revenue is very low (accounted 22% only), which indicates existence of a high centralized revenue collection in Ethiopia. Factor contributed are: productive revenue sources are allocated to center; poor tax administration at sub-national levels, unwillingness of taxpayers to pay tax and corruption. In the case study, despite Woredas are delegated revenue collection responsibility by regional governments on certain revenue sources, they are expected to collect a targeted revenue amount which set by regional BoFED. If they collected more than the targeted revenue amount, an equal amount of money will be deducted from their shares of Woreda block grant entitlements. Thus,

such tax system may discourages the local authorities to generate more own revenue from their jurisdictions and rationalize the expenditures at grass-root levels.

The study also found that devolution of power and functions to lower levels of government is not accompanied by sufficient financial resources and taxation power, which create a high vertical fiscal imbalance at regional and local levels. The share of own revenue of States to total own budget revenues is very small. During the study periods, the States have covered not more than 30% of their expenditure from own revenue collection. As the result, they heavy depends up on the federal transfers to cover more than 80% of their total budgets. Similarly, the share Woredas' own revenues to their total budgets are on average about 20.4% in Oromia and 10.6% in Afar; while the share of regional transfers to total Woreda budgets are on average 80% and 90% in Oromia and Afar regions respectively during the study periods. This, in turn, limits their fiscal autonomy and make vulnerable to the influences and manipulation of regional governments. Besides, there is a wide fiscal capacity disparities across States and Woredas within the States, due to the existence of a significant variation in terms of per-capital revenue raising capacity and per-capital expenditure needs. The factors contributed are variation in economic activities and the cost of public services delivery, due to differences in geographical and demographical conditions, economics and cost of material inputs.

In addition to own revenue, regional states are receiving transfer funds from the Federal Government in form general purpose grants (revenue sharing and federal subsidy) and specific purpose grants. The transfer system is dominated by federal subsidy, accounted one-third federal budget and 80% regional budgets. The general purpose grant is allocated among regional states on the basis of a grant formula that considers both the revenue raising capacity and expenditure needs of each States. As a result, it has attempted to equalize about 90% of revenue raising capacity and 95% of expenditure needs of regional States. In the case study, the Woreda governments are also received fund from regional governments in form of regional blocked grant. At present, the total size of woreda block grant is distributed among Woredas by Expenditure need grant formula. Such grant formula is disincentive local authorities to generate more own revenue and wedding the fiscal capacity disparities of Woredas within the regions. The practices also shows that larger portion of WBG is allocated to finance the Woredas' recurrent budget needs. The regions are employed the specific purpose grant to finance larger

part of the Woredas' capital budget needs, so as to ensure the provision of minimum public services to all citizens in the regions in fair and equitable manner.

In addition to federal subsidy, conditional grants are also allocated for regional and local governments through the federal line of ministries to achieve MDGs. The conditional grants are allocated in the form of closed-end matching grants since it requires the beneficiary regional and local governments to contribute less than 20% of total costs of the projects (often made in the form of kinds like labor and material). Hence, such a transfer mechanism is unique in nature and effective in addressing horizontal fiscal disparities and achieving national goals like MDGs since it does not require SNGs to sacrifice their scarce resources to meet the national goals. Finally, although sub-national governments in Ethiopia endowed the right to borrow funds from domestic financial institutions owned by federal government, in practice they are not yet exercised their borrowing rights until now, particularly on long-term loans, due to high direct control of federal and regional executive councils.

Overall, the finding of the study shown that there are achievements and challenges related to the implementation of fiscal decentralization in Ethiopia. With regarding achievement, there is a slightly improvement in the role and performances of lower levels of government in public service delivery. In the contrast, there are several problems and challenges, which includes: Inadequate devaluation of decision-making power and autonomy; lack of clarity in assignment of fiscal responsibilities; Weak administrative and institutional capacity; Poor political willingness and commitment of authorities; lack of sufficient own revenues; lack of IGRs & weak coordination; access to domestic financial markets, and poor design of regional-local transfer system.

6.2. Conclusion

Fiscal federalism has been receiving a great attention among policy-makers and scholars across countries globally with vary development levels and political systems since 1990s. The practices show that expenditure decentralization is given more priority rather than revenue decentralization in many countries across the world. The fiscal federalism theories, however, suggests that if a local government is assigned a significant expenditure responsibilities, it should be devolved adequate taxation power that can enables it to finance its functions as much as

possible, so as to realize the potential benefits of fiscal decentralization. In many countries, lower government levels are heavily depends on central transfers to carry out their tasks and thereby limits their fiscal autonomy. The practice also shows that central governments should have taxation power on broad-based elastic tax bases (PIT, CIP or VAT) to achieve the stabilization and income redistributive objectives effectively. This indicates, therefore, each country should be developed its own optimum fiscal structure through taking into account its specific circumstances so as to realize the potential benefits of an effective decentralized fiscal system.

In principle, the existing expenditure and taxing responsibility assignment of Ethiopia between the federal government and states is among the most decentralized systems in developing countries including Africa. The practices, however, show there is lack of clarity in the assignment of power and fiscal responsibilities between federal-states and regional-local governments. This, in turn, creates overlapping responsibility, particularly on shared functions, and would breeds conflicts between federal- states and regional-woreda government. This leads to less efficiency of public services delivery and accountability at sub-national levels in Ethiopia.

The practice, however, show that there is a gradual improvement in the expenditure ratio at regional and Woreda levels, which indicates an improvement of the role and performances of the SNGs in the provision of public service delivery in Ethiopia. Particularly, following the implementation of DLDP in Ethiopia since 2002, the expenditure share of Woredas in Oromia region has shown a significant improvement over time as compare to Afar region. However, it is difficult to conclude that fiscal decentralization has potential to improve significantly the efficiency of public services delivery at local level by matching the supply of public services as per the preferences of local residents. Since, most of public service facilities which constructed in Woredas of the Oromia region are built by other actors like zonal, regional, domestic and foreign donors. Thus, in real terms the role and performances of local governments in delivering of basic public services is still limited. The reason is the regional governments are interfered in the local expenditure competencies and thereby limits the fiscal autonomy of local governments.

When we concern with the revenue collection responsibility, the fiscal system of Ethiopia in general and the selected regions in particular is characterized by high revenue collection centralization, which create a high vertical fiscal imbalance at regional and local levels. As the

result, sub-national governments in Ethiopia are highly depends on the federal transfers to finance more than 80% of their annual budgets. This, in turn, limits the decision-making autonomy of SNGs in political, administrative and fiscal matters that affect their internal affairs directly, which could undermine the efficiency of service delivery and accountability at sub-national levels. Besides, there is a wide fiscal capacity disparities across States and Woredas within the States due to significant variation in terms of per-capital revenue raising capacity and per-capital expenditure needs across regions. The factors contributed are: variation in levels of economic activity and infrastructural development, as well as differences in cost of public services delivery due to differences in geographical and demographical conditions, economics and cost of material inputs.

Thus, the Federal Government has been employed various fiscal transfer mechanisms to achieve various national objectives such as address fiscal problems (both vertical and horizontal imbalances) and ensuring provisions of basic public services to all citizen in equitable and fair manner. The transfer system in Ethiopia is dominated by federal subsidy and allocated among regional states on the basis of a grant formula, which adopted by HoF.

At present, the general purpose grant is distributed across regions by a grant formula that considers both the revenue raising capacity and expenditure needs of each States. hence, the existing grant formula is fulfill the criteria of fiscal autonomy, predictability, tax effort incentive, efficiency, fiscal capacity equity, accountability and fiscal discipline at regional level. In addition to unconditional grants, federal line ministries are also transferred funds to regional and local governments in from of conditional grants to achieve MDGs. The conditional grants are distributed among lower government levels on the basis of political factors in Ethiopia. As the result, it is effective in addressing fiscal capacity disparities across regions and achieving national goals like MDGs. But, such grant type is less stable, predictable, and transparent, and thereby limited the capability of sub-national governments in preparing own budgets efficiently, and planning long-term objectives to provide adequate services for local residents.

In the case study, the regional governments are also transferred fund, which received from federal government, in form of unconditional grant for their respective Woreda Administrations. The total size of Woreda Blocked Grant is determined solely by regional BoFED, and distributed among Woredas on the basis of a grant formula, which taken into account expenditure need

indicators only. the existing grant formulas of both regions, however, are not only discourages the local officials to collect more own revenues, but also widening further the fiscal capacity gaps between Woredas within the regions. As a larger share of WBG is allocated to cover the Woredas' recurrent expenditure needs, they can be not involved in the allocation and implementation of major capital expenditure activities. As the result, it could undermine the efficiency public services and ensure accountability at local levels.

Finally, sub-national governments in Ethiopia have no autonomy in borrowing funds from domestic credit sources until now, particularly on long-term loans. The reason is that sub-national borrowing power is subjected to high direct control by the executive councils at federal and regional levels. The limited access of regional and local governments to financial markets could constraints the capability of sub-national authorities to provide adequate public services as per the needs of local residents and ensure intergenerational equity through borrowing.

Overall, the study found that there is a significant gaps between the constitutional provisions and the practices on the ground related to fiscal decentralization in Ethiopia. The implication is that the implementation of fiscal decentralization in Ethiopia in general and in Oromia and Afar regions in particular faces several problems and challenges. Some of the major challenges includes: lack of clarity in expenditure and revenue assignment between government units at different levels; limited sub-nationals spending autonomy due to lack of revenue autonomy; Weak managerial and technical capacity due to unavailability of trained and competent human resources as well as necessary material resources and infrastructural facilities at grass-root levels; Poor political commitment and leadership of authorities at upper levels; weak coordination and cooperation between government units at different levels and presented at the same levels ; limited access to domestic credit sources, and poor design of regional-local transfer system.

6.3. Policy Recommendations

The study provides certain policy recommendations to bring solutions for the challenges mentioned in the previous section, so as to improve the efficiency, effectiveness and equity of the fiscal decentralization of Ethiopia. The following recommendations are general in nature and might require adjustments to comply with the contexts of regional and local levels of government.

- It is better to clearly define the power and the fiscal responsibilities between the federal government and regional states as well as regional and local governments, particularly on shared responsibility to avoid potential conflicts between the government units at different levels and further improve the efficiency of public services and ensure accountability at sub-national levels. Thus, the federal government needs to take a comprehensive survey regarding the competency of each levels of government on expenditure responsibilities by unbundling different aspects of certain public functions in terms of policy making, regulation, service delivery and financing. Moreover, the regional governments should let all stakeholders of decentralization to participate in the process of devolving the power and fiscal responsibility to respective local governments. Moreover, power and the fiscal responsibility of each level of government should be reviewed and revised regularly and timely as the fiscal responsibilities of each level of government might change through time due to the change in production and delivery costs and technology developments.
- It is wise to enhance the political commitment and leadership of authorities at federal and regional levels to improve the managerial and technical capacity of SNGs through providing capacity building programs in areas of hiring and retaining professional and competent human power. It also requires transferring necessary resources including human, financial and material resources as well as necessary infrastructures to sub-national governments to improve their capability in developing their policies; planning and allocating their budgets into capital and recurrent expenditures as well as across various sectors without the influence of higher levels of governments.
- Abolishing the zonal administration from the administrative structure of the regional states to avoid the potential interference of regional sector bureaus in internal affairs of local governments through the zonal administration. The existing functions of zonal administration could be replaced through introducing other mechanisms such as establishing a special district or Woreda governments association to coordinate their functions horizontally. This mechanism might enable the local governments to control their activities without interference of zonal administration. Furthermore, it requires establishing strong and effective internal and external control mechanisms at local levels

to enhance transparency and accountability of local authorities in mobilizing and utilizing their budget resources effectively.

- Revising the existing assignment of power and fiscal responsibilities between the regional and local governments by taking the specific conditions of each local governments into account such as population size and density, fiscal capacity as well as administrative and institutional capacity so as to realize the benefits of fiscal decentralization such as improving the efficiency of public service delivery and promoting economic growth at sub-national levels. The reason is that some local governments encountered several problems and challenges to carry out the power and fiscal responsibilities that are devolved by regional governments, due to weak administrative and institutional capacity. Thus, each regional governments has to devolve the excessive power and fiscal responsibility for the local governments that have larger population sizes and better administrative institutional capacity, so as to realize the benefits of an effective fiscal decentralization at sub-national levels in Ethiopia.
- Improving the own revenue-generating capacity of SNGs to reduce their dependency level on federal transfers and thereby further enhance their fiscal autonomy through undertaking several measures. Some of the measures are summarized as follows:
 - a) Improving tax administrative capacity of SNGs through building an effective and reliable information system at sub-national levels. In addition, the federal government needs to establish capacity building offices at sub-national levels in collaboration with MCB, which is responsible for improving the managerial and technical capacities of regional and local governments on areas of information technology, tax planning and forecasting, and monitoring and evaluation of tax collection. Besides, regional and local governments need to introduce appropriate tax enforcement mechanisms and create awareness of their tax-payers to fulfil their tax obligations honestly, so as to avoid tax evasion and corruption.
 - b) Endowing full freedom for the sub-nationals to introduce new tax bases in their jurisdictions and allowing them to exercise tax autonomy at least in setting tax rate on revenue sources under their domain because it enables them to generate more own revenue by altering the tax rate of their own revenue bases. Such a mechanism, however, might give incentive to the regional governments to engage

in unhealthy tax competition with each other to attract individuals and business to its jurisdictions. This may cause several problems such as race-to-bottom, high administration costs, and distorts allocation of production factors. To avoid such problems, therefore, the federal government's need to introduce some mechanisms such as setting a minimum floor of tax rate or harmonize the tax systems.

- c) Allowing the regional governments to levy and collect taxes on some tax bases under the domain of the federal government, for example, levy surcharge on incomes of federal employees and profits driven from public enterprises owned by the federal government (like Tele-communication, Sugar Corporation and Electric Utility). The reason is that the regional governments are providing basic public services (like health and education) not only for their civil servants but also for the individuals working in federal public enterprises located within their jurisdictions.
 - d) Privatizing some of the public profit-oriented enterprises owned currently by the federal governments (like Ethio-Telecom and Sugar Corporation). The reason is that if these enterprises are privatized, the power to levy and collect taxes on profit, production and sales of these enterprises, which previously under federal taxation power would fall under concurrent taxation. As a result, the share of regional states on proceeds generated from concurrent taxes would increase.
 - e) Revising the existing shared revenue ratio (70:30) which applies to divide the proceeds generated from indirect concurrent tax bases in favour of the regional states. Such a mechanism, however, may limit the role of the federal government in redistributive income and address the existing fiscal capacity disparities
 - f) Regional governments need to take into account the revenue collection efforts of Woreda governments while distributing the regional block grants horizontally among Woreda governments.
- Clearly define the sources of finance and the size of the grant divisible pool (both the federal subsidy and the Woreda block grant) on the Federal and Regional Revised Constitutions, so as to further improve the stability, predictability and transparency of the intergovernmental transfer system of Ethiopia. This, in turn, enhances further the capability of regional and local governments in estimating their revenues accurately and

preparing budgets effectively as well as planning long-term objectives to provide adequate public services to their residents. Moreover, it also limits the federal government not to intervene in the internal affairs of sub-national governments through using its fiscal power.

- Providing adequate access for sub-national governments to domestic credit sources by establishing a regional development bank in order to enable them to expand the production and provision of public services that can improve the living standards of people living in their jurisdictions through investing in capital projects. It also enables the sub-nationals to ensure intergenerational equity through financing the costs of long-term infrastructure projects through debts. The federal government should establish a development bank at regional level that can function as an autonomous institution that will take direct and final responsibility for sub-national borrowing. Thus, the institution should be managed by individuals with sufficient educational background and professional experiences in the banking area. The major function of such a development bank will be raising finance from various credit sources such as issuing bonds in the domestic and foreign capital markets and providing short-term and long-term loans for sub-national governments.
- Introducing an effective debt control mechanism for avoiding excessive borrowing and ensuring fiscal discipline at sub-national levels. Currently, the cooperative approach is the most appropriate mechanism to control the borrowing activities of sub-national governments in Ethiopia due to weak development of capital markets. This requires establishment of an intergovernmental forum that comprises finance experts working at federal and regional institutions such as MoFED and Regional BoFEDs. The responsibility of the forum will set targets for key fiscal indicators such as the fiscal deficit and the debt limits of each regional state before announcement of the annual budgets of federal government and regional states. The forum could meet regularly to evaluate the sub-national borrowing activities against the targeted fiscal deficit and debt levels. They would have suggested corrective measures if the regional states are not operating according to the targets.

Such a debt control approach, however, should be accompanied by appropriate fiscal rules, so as to fully realize its desired outcomes. This is due to the fact that the spirit of

cooperation which is required for the success of the forum may not be achieved easily in Ethiopia at present because frequent conflicts of interests among regional states, especially between big and small regions, in the upper house have been occurring over the last decade. The conflict of interest would be more intensified if different political parties took power at the federal and regional levels and the possibility of opposition for the sake of opposition cannot be easily avoided in such a situation. The fiscal rules must be implemented through undertaking continuous research in fiscal areas based on domestic data.

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APPENDIXES

Appendix A

Points for Interview Questions and Discussions

The questions below are used as a checklist for the individual interview made with key-informants currently worked at all levels of government in Ethiopia. The interview process should not necessarily follow the sequence and be limited to the availed questions. The questions serve as guide in directing the individual interview process.

A. Interview Questions for Federal Key-Informants

1. To what extent was the political, administrative and fiscal decentralization practiced in Ethiopia since 1995?
2. What is your overall impression on how decentralization has thus far been implemented by the Ethiopian State and local governments?
3. What are the main benefits of fiscal decentralization to your governmental unit?
4. What are the principal problems that you have experienced during its implementation at regional level?
5. What Principles and criteria are applied to allocate both expenditure responsibilities and revenue sources (tax and non-tax revenues) between the Federal Government and Regional States in Ethiopia? Do you observe any problem in the current assignment system with regard to the theory of fiscal decentralization and experience of other federations?
6. Do you think that under the current assignment system, the expenditure and revenue responsibility is de/centralized against the theory of fiscal federalism? If your answer is “Yes”, what are the major indicators?
7. In your opinion, do Regional States have political, administrative and fiscal autonomy in designing, managing and implementing their expenditure programs? If your answer is

“Yes”, to what extent? If your answer is “No” what were the major factors that limited their autonomy?

8. In your opinion, do regional states have the capacity to generate sufficient own revenue that can enable them to cover the costs of functions they are responsible for? If your answer is “No” what were the factors that contributed for vertical fiscal imbalance?
9. In your opinion, do Regional States have administrative and fiscal autonomy in determining tax bases, setting tax rates and collecting revenue sources assigned to them? If your answer is “Yes”, in which sources of revenue?
10. What kind of roles should be played by Federal Government to improve the capacity of tax collection and administration at the regional and local (Woreda) levels?
11. What are the procedures used by the Federal Government to determine the size of federal subsidy? Do you think it is stable, predictable and transparent?
12. What are the roles of Regional States in determining the amount of grant divisible pool and designing the allocation of grant formula, which is provided to States by Federal Government?
13. How effective is the current intergovernmental transfer system of Ethiopia in improving the Regional States’ tax effort and spending autonomy in allocating their budgets in accordance to the needs and preferences of local people?
14. What measures have so far been taken by the Federal Government to narrow the horizontal fiscal disparity or to bring balanced economic development among the regions in the country, in the last two decades? Do you think they were effective?
15. How effective were the fiscal transfer instruments used by Federal Government in eliminating any inter-regional externalities or spillovers in the last two decades? Do you think they were effective?
16. What are the major problems or challenges of the current Federal Government transfer system of Ethiopia and what possible measures do you think should be taken to alleviate them?
17. What are the procedures which must be followed by the Regional States to borrow fund from domestic financial institution? Do you think it is simple and transparent?

18. Do you observe any problem with devolution of borrowing power to regional States in Ethiopia in the view of the theory of fiscal decentralization and experience of other federation?
19. To what extent did regional States exercised their constitutional borrowing right in practice since 1995? What were the major factors that limited them to exercise their borrowing right?
20. In your opinion, what problems or challenges are encountered in improving the under implementation fiscal decentralization process at the regional levels in Ethiopia?
21. What roles do you think the Federal and State governments should play to improve the effectiveness and efficiency of fiscal decentralization system of Ethiopia?

B. Interview Questions to Regional Level Key-Informants

1. What expenditure responsibilities and taxation power are assigned to Oromia and Afar regional States? Do you think these regions have political, administrative and fiscal autonomy in managing and carrying out the expenditure responsibilities assigned to them?
2. What procedures are employed to devolve power and expenditure responsibilities for local governments? Do you think it is transparent?
3. In your opinion, did the regional governments made all decentralization stakeholders (like local council, executive and communities) participate in the process of the assignment of expenditure and revenue between the regional and local governments? If “Yes”, how; and if no why not?
4. Do you observe any problem with the allocation of expenditure responsibilities and revenue sources between the regional and *Woreda* governments in your region when viewed to the theory of fiscal decentralization and experience of other federation?
5. In your region, what are the power and expenditure responsibilities actually devolved to the *Woreda* governments as per the legal framework? Do you think that the devolved power and expenditure responsibilities are clearly defined and adequate enough to let them act as autonomous unit of government?

6. Do the *Woreda* governments have administrative and fiscal autonomy in managing and carrying out the expenditure responsibilities assigned to them in practice? If “yes” to what extent? If “No” what are the reasons?
7. What revenue sources are actually devolved to the *Woredas* in your region? Do you think that the tax assignment has clarity and the revenue sources are sufficient to enable them cover their expenditure responsibilities as much as possible?
8. In your opinion, do the *Woreda* governments have fiscal power or autonomy in deciding tax bases, and setting tax rates, as well as tax administration over the tax revenues devolved to them?
9. Following the implementation of DLDP in your region, did the regional government transfer a significant number of personnel from regional sector bureaus to the *Woreda* administrations? How have these transfers affected your *Woreda*’s administrative capability?
10. What leadership requirements should decentralization actors, particularly heads of regional sector bureaus, possess in order to influence efficient and effective service delivery under conditions of scarce resources?
11. What are the major problems/challenges that are currently faced by the *Woreda* government in collecting and administering the revenue sources assigned to them?
12. In your region, do the *Woreda* governments obtain financial and technical support from other institutions, like foreign and domestic donors and local communities? If “Yes” how did they use these funds to implement the devolved functions?
13. In your opinion, what are the major areas the regional authorities need to give prior focus to improve the tax collection and administration capacity of the *Woreda* governments?
14. What sort of coordination is needed between your *Woreda* and other *Woredas* in the region in order to carry out the fiscal decentralized functions effectively and efficiently?
15. What are the procedures employed by the regional governments to determine the *Woreda* block grant divisible pool? How is the grant divisible being distributed among *Woredas*? Do you think it is stable, predictable and transparent?

16. In your opinion, does the regional government involve all local stakeholders in determining the *Woreda* block grant pool and designing the grant formula? If “Yes”, how; and if no why not?
17. Do you think that high decency of *Woreda* governments on regional transfer to finance their expenditure responsibilities have effects on the fiscal autonomy and tax effort of *Woreda* officials in raising own revenue sources and providing public service according to the needs and preferences of the local people?
18. How effective is the current grant formula adopted by the Oromia/Afar region in addressing vertical and horizontal fiscal imbalances, providing minimum standard public services at local level? And do you think that the *Woreda* block grant is the only mechanism to achieve the desired level of vertical and horizontal fiscal imbalance in the region?
19. What are the major limitations of the current grant formula adopted by Oromia/Afar region to distribute regional grant among *Woreda* governments, in all matters and what measures do you think the regional governments should take to improve the limitation?
20. Do you think that *Woreda* governments have right to borrow funds from domestic and foreign sources to finance their short-term budget deficit and capital projects? If your answer is “Yes”, do you think they exercise their borrowing right in practice? If “No” what are the reasons?
21. In your opinion, what problems or challenges are encountered in improving the existing fiscal decentralization process at the local levels, particularly at *Woreda* level?
22. What do you think are the possible remedies to overcome the encountered fiscal problems or challenges?

Appendix B

Major Powers and Functions Assigned by FDRE Constitution

Regional States	Federal Government	Shared
<ul style="list-style-type: none"> ● Enactment of Region constitution and laws; ● To establish a Region administration that best advances self-government, a democratic order based on the rule of law; ● to protect and defend the Federal Constitution; ● Formulation and execution of economic, social and development policies, strategies and plans; ● Administration of land and other natural resources in accordance with federal laws; ● Formulate regional Region laws; ● Establish executive administrations ● Establish Region councils and operate Region courts ● Fire protection and Water supply ● Levy and collection of taxes assigned to the Regions; ● Designing standards for Region level civil services and payment; ● Establish and administer a regional police force and maintain public order, and ● Residual power, i.e. any functions that are not assigned to federal government exclusively and shared between the federal and Regions by the EFDR constitution 	<ul style="list-style-type: none"> ● Administer National Defense and security ● Immigration and Citizenship ● Formulate Foreign policy/international relationship ● Utilize water sources connecting two or more Regions and crossing national boundaries ● Regulates inter-Region and foreign commerce ● Civil aviation, postal and Tele-Communications ● Constriction of highway roads ● Issuing Currency and coins ● Formulate/execute National monetary policy, and Regulate foreign exchange ● Establish uniform standard of measurement ● Establish national standards 	<ul style="list-style-type: none"> ● Police and internal Security ● Health and Social welfares ● Education (Post-Secondary) ● Science and Technology ● Economic and Social Policies ● Land and Natural Resources ● Agricultural ● Roads ● Environmental protection ● House Development ● Recreation and culture ● Preservation of culture and historical legacies

Source: Article (51) and (52) of FDRE Constitution (1995)

Appendix C

Functions Assigned for Woredas in Oromia and Afar Regional States

Major Function	Woreda Level
Agriculture and Rural Development	<ul style="list-style-type: none"> ● Formulate strategy for the timely supply of agricultural inputs (fertilizers, selected seeds and loans) ● Planning and implementation of district based agricultural and rural development/pastoral development ● Implementation of Extension packages, ● Planning ,implementation and supervise of small scale and indigenous irrigation, adaptive research ● Coordinate the management of natural resources ● Ensure food security and self -sufficiency at an individual of family level
Education	<ul style="list-style-type: none"> ● Promoting expansion of educational coverage ● 1st and 2nd cycles (grade 1 to 8) primary education; and 1st cycle secondary education (grade 9 to 10), adult education ● Deploying primary school teachers, paying salaries ● Printing and distributing primary school text book, and supplies other necessary facilities ● Administrating primary school boarding, and coordinating school management ●
Health	<ul style="list-style-type: none"> ● Organize, administer and controls health centers covering up to 25,000 population, health posts covering up to 5000 population ● Managing health extension packages and administrating clinics ● Control and preventive HIV/AIDS and Malaria, ● Provide medical and ambulance services ● Allocate the district fund
Water Supply and Sanitation	<ul style="list-style-type: none"> ● Deliver drinking water ,providing support to communities to administer water schemes, springs, hand -dug wells, minor maintenance ● Gather data about water resources ● Supervising water related construction works
Roads	<ul style="list-style-type: none"> ● Access road, lower-grade rural roads connecting the locality, ● Rural travel and transport integrated development (rural road, pavement, etc)
Natural Resource	<ul style="list-style-type: none"> ● Admonition protection and development of land use and other natural resource
Administration and Financial Control	<ul style="list-style-type: none"> ● Preparing annual woreda budget and short, medium and long term plans ● Managing woreda treasury ● Controls expenditures of sector offices
Revenue Administration	<ul style="list-style-type: none"> ● Utilize Woreda untied block grant and other specific grants ● Collect and utilize Woreda revenue sources for Woreda expenditures by off-setting the grant earmarked ● Formulating strategies to expand tax bases ● Coordinating tax collectors at the different kebeles of the woreda
Municipal services/Urban development	<ul style="list-style-type: none"> ● Implement regional state functions in municipalities under the Woreda administration
Justice and Security	<ul style="list-style-type: none"> ● Ensure the maintenance of peace and security of the Woreda
Human Resource Administration	<ul style="list-style-type: none"> ● Hiring of district office personnel up to diploma level and sometimes degree levels

Source: The 2001 and 2004 revised Constitutions of Oromia and Afar Regional State

Appendix D

Revenue Trend in Ethiopia (*in million birr*)

FY	Regional States					Federal Government				Total Revenue	National Revenue	Share of RS		Share of FG		
	Own revenue			Federal subsidy	Total Revenue	Tax revenue			Non-tax Rev.			A/C	C/G			
	Direct taxes	Domestic indirect tax	Non-Tax rev			Direct taxes	Domestic indirect tax	Foreign indirect tax								
A			B	C (A+B)	D			E	F(D+E)	G (C+F)						
1993/94	623.1	532.8	299.4	0.0	1455.3	1131.0	948.5	1814.0	1800.0	5693.5	7148.8	1.00	0.20	0.80	0.29	0.68
1994/95	739.5	206.9	387.8	2891.0	4225.2	1167.0	1059.0	2163.5	1788.4	6177.9	10403.1	0.32	0.13	0.59	0.27	0.71
1995/96	852.7	230.3	513.2	3102.0	4698.2	1012.0	951.5	2218.4	2318.6	6500.5	11198.7	0.34	0.14	0.58	0.24	0.64
1996/97	875.8	229.4	475.0	3122.0	4702.2	1133.0	1000.0	2378.5	2586.7	7098.2	11800.4	0.34	0.13	0.60	0.25	0.64
1997/98	989.0	204.3	478.0	2475.0	4146.3	1378.0	1165.6	2675.8	2538.1	7757.5	11903.8	0.40	0.14	0.65	0.26	0.67
1998/99	1144.7	273.8	442.0	3987.9	5848.4	1682.0	1135.6	3324.0	2302.7	8444.3	14292.7	0.32	0.13	0.59	0.27	0.73
1999/00	1202.0	249.3	511.0	4653.0	6615.3	1632.0	1248.0	3564.0	1972.0	8416.0	15031.3	0.30	0.13	0.56	0.25	0.77
2000/01	1329.0	236.0	540.0	6043.0	8148.0	1792.0	1432.0	5276.0	2366.0	10866.0	19014.0	0.26	0.11	0.57	0.21	0.78
2001/02	1798.0	366.0	924.0	5970.0	9058.0	2183.0	1834.0	5746.0	2087.0	11850.0	20908.0	0.34	0.15	0.57	0.22	0.82
2002/03	2138.0	548.0	885.0	6365.0	9936.0	2775.0	2173.0	6587.0	2299.0	13834.0	23770.0	0.36	0.15	0.58	0.24	0.83
2003/04	2278.0	577.0	1542.0	7833.0	12230.0	3789.0	2534.0	8189.0	3829.0	18341.0	30571.0	0.36	0.14	0.60	0.26	0.79
2004/05	2393.0	841.0	1151.0	9880.0	14265.0	5437.0	3156.0	11693.0	3293.0	23579.0	37844.0	0.31	0.12	0.62	0.27	0.86
2005/06	3226.0	866.0	1396.0	14261.0	19749.0	8801.0	4226.0	11814.0	4598.0	29439.0	49188.0	0.28	0.11	0.60	0.35	0.84
2007/08	4432.0	1361.0	2468.0	17439.0	25700.0	1682.0	5964.0	17685.0	8708.0	34039.0	59739.0	0.32	0.14	0.57	0.07	0.74
2008/09	6105.0	1903.0	1827.0	20934.0	30769.0	1632.0	8824.0	6447.0	8719.0	25622.0	56391.0	0.32	0.17	0.45	0.10	0.66
2009/10	28585.0	1903.0	956.0	64508.0	95952.0	1183.3	6397.8	4674.4	6321.7	18577.0	114530.0	0.33	0.27	0.16	0.10	0.66
2010/11	6105.0	4344.0	2300.0	77228.0	89977.0	1511.0	8169.7	5968.9	8072.4	23722.0	113699.0	0.14	0.11	0.21	0.10	0.66
2011/12	7509.0	2741.0	1483.0	11781.0	23514.0	1792.7	9692.8	7081.8	9577.5	28145.0	51659.0	0.50	0.23	0.54		0.66
2012/13	623.1	532.8	299.4	13,001	1455.3	1131.0	948.5	1814.0	1800.0	5693.5	7148.8	1.00	0.20	0.80	0.29	0.68
Average	4018.0	978.5	1032.1	14582	5279.2	2317.4	3439.5	6072.2	4176.5	16099	36616	0.36	0.81	0.55	0.21	0.73

Source, MoFED annual reports www.MoFED.org.et

Appendix E

Budget Grant shares of Regional States in Ethiopia during 2007/08 FY

Regional States	Mean Population	Mean per Capita Transfer	Diff.in Per Capita Revenue Capacity	Diff. in Per Capita Expenditure Needs	E	F	% of grant budget Share
	A	B	C	D	E=B+C+D	F=A(B+C+D)	G
Tigray	4.10	88.95	-5.04	10.25	94.16	385.59	6.38
Afar	1.33	88.95	3.33	21.95	114.23	151.57	2.51
Amhara	18.06	88.95	4.26	-4.57	88.63	1600.84	26.49
Oromia	24.97	88.95	-3.92	-3.44	81.59	2037.62	33.72
Somalia	4.09	88.95	6.14	3.58	98.67	403.68	6.68
B,S Gumuz	0.59	88.95	-4.42	60.54	145.07	86.03	1.42
SNNPR	14.01	88.95	3.06	-2.67	89.34	1252.10	20.72
Gambela	0.23	88.95	-22.59	172.80	239.15	55.87	0.92
Hareri	0.18	88.95	-56.91	133.38	165.41	30.40	0.50
Dire Dawa	0.37	88.95	-34.02	52.43	107.36	39.64	0.66
Total	67.94	88.95	0.00	0.00	88.95	6043.34	100.00

Source: HoF (2007)

Appendix F

Expenditure Trend in Oromia and Afar Region (in Million Birr)

FY	Description																			
	Recurrent Expenditure				Capital Expenditure				Total Regional Rec Exp.		Total Regional Capital Exp.		Total Regional Exp.		Share of Recurrent Exp.		Share of Capital Exp.			
	Regional level		Woreda level		Regional level		Wor eda level		AR S	ORS	AR S	ORS	AR S	ORS	AR S	ORS	AR S	OR	AR	OR
	AR S	ORS	AR S	OR S	AR S	OR S	ARS	OR S	AR S	ORS	AR S	ORS	AR S	ORS	ARS	OR S	AR S	OR	AR	OR
2007/08	119.6	4575	191.1	310.7	70.8	120.2.8	10.0	171.8	310.6	6260.7	80.8	1374.6	391.4	763.5.3	0.79	0.82	0.06	0.18		
2008/09	165.4	5771.0	248.1	431.3	12.1.4	142.0.1	28.3	433.5	413.4	4886.1	149.7	1853.6	563.1	673.9.7	0.73	0.72	0.08	0.28		
2009/10	240.2	6048.7	327.7	436.6.3	18.1.4	189.0.1	43.2	591.5	567.9	1008.4	224.6	2481	792.5	125.65	0.72	0.80	0.09	0.20		
2010/11	244.4	8014.6	371.2	586.6.4	59.9.1	250.3.9	52.5	794.2	615.6	1041.5	107.0.7	3298.1	1686.3	137.13.1	0.37	0.76	0.32	0.24		
2011/12	302.2	9672.9	405.5	695.7	68.0.3	488.3.4	74.0	532.3	707.7	1388.1	732.8	5415.7	1440.5	192.96.7	0.49	0.72	0.14	0.28		
2012/13	384.5	1007.3	481.5	888.7.9	98.4.1	895.9.9	102.5	821.4	866.0	1663.0	105.8.1	9781.3	1924.1	264.11.3	0.45	0.63	0.11	0.37		
2013/14	444.2	1108.0.3	558.5	977.6.9	88.4.1	107.5.2	119.8	903.1	100.2.7	2085.7.1	987.3	11655.1	1990	325.12.2	0.50	0.64	0.08	0.36		
2014/15	660.2	1218.8.6	119.5.9	112.4.3	12.5.4	134.4.0	911.2.	103.8.5	185.6.	2343.2.1	137.3.3	14478.5	3229.3	379.10.6	0.57	0.62	0.09	0.38		
2015/16	716.6	1301.4	105.3	134.9.2	12.6.5	169.3.4	102.1	116.3	176.9	2650.7	136.7	18097	3136	446.0.4	0.56	0.59	0.08	0.41		
Average	364.1	8937.6	536.9	755.7	67.1.1	688.7.4	1018.9	716.5	901.0	1477.3	782.7	7603.9	1684	223.76	0.58	0.70	0.12	0.30		

Source: BoFED IBEX Data Base of Oromia and Afar Regional States