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ASSESSMENT OF THE PRACTICES OF FISCAL FEDERALISM IN ETHIOPIA

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Abstract

The main objective of this study is to assess the practices of fiscal federalism in Ethiopia since 1995 by focusing on parameters like power and public functions devolution, financial capacity, and fiscal autonomy. The study used both primary and secondary data to achieve the objective of the study. The findings of the study indicates that there is lack of clarity on the assignment of expenditure and taxing responsibilities between the federal government and Regional States, which creates duplication of responsibility and conflict between both levels government. the study also find that the devolution of expenditure responsibility to regional states is not accompanied by adequate financial resources, which in turn creates high vertical fiscal imbalances and limits the regions' fiscal autonomy. The study recommends that the federal government need to enhance the revenue raising capacity of regional states, so as to reap the benefits of an effective fiscal federalism in Ethiopia.

Keywords: Fiscal Federalism, Revenue assignment, Expenditure assignment, vertical fiscal imbalance, fiscal autonomy

1. INTRODUCTION

Fiscal federalism, one dimension of a decentralized system in a multi-tiers government, has become an important topic among policy decision makers, researchers and academicians in many countries with varying levels of socio-economic development and political system of governance in the last five decades (Thiessen, 2003). The main reasons for the increase trend towards fiscal federalism in recent periods is that the 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, 2002). Additionally, the development in European Union (EU) has also contributes towards the growing interest in fiscal federalism.

Fiscal federalism basically deals with allocation of expenditure responsibility and taxation power among different levels of government, and intergovernmental transfer mechanisms for adjusting horizontal and vertical imbalances as well as sub-national borrowing (Oates, 1999).The basic economic rationale behind a decentralized fiscal system is improve the efficiency of resources allocation (leads to a maximum society well-fare) by matching the provision of public services with the needs, preferences, and circumstances of citizens as compared to the centralized system, which provides a uniform public services across all jurisdictions (Musgrave, 1959; Oates, 1972). Moreover, it could improve the efficiency of public service delivery at sub-national levels through competition (both vertical and horizontal) among different levels of government units (Brennan and Buchanan, 1980). Additionally, it also enhance the responsiveness and accountability of sub-national authorities to the citizens by improving the political participation of citizens, which in turn improves the governance quality at sub-national levels (Lockwood, 2005).

However, if fiscal decentralization measures are taken before establishment of an 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 and corruption (Tanzi, 1996:26; Prud'homme, 1995:17). The theory of fiscal federalism argue that certain preconditions and circumstances requires to realize the potential benefits of fiscal decentralization, which includes: enabling environment; assignment of appropriate expenditure and taxing responsibilities to sub-national governments; adequate financial autonomy; effective administrative and political institutions at sub-national levels; sufficient flow of information; and effective participation and consultative mechanisms (Smoke, 2001). Thus, the effectiveness of fiscal decentralization reforms depends both on the context where it is implemented and, on the way, it is designed.

After practiced a highly centralized and unitary political and administrative systems for a century, Ethiopia has introduced a decentralized system and federal form of governance de-facto in 1991 and de-jure in 1995. The country has been taken several decentralization measures in two phases, with the aim of attempting to ensure a self-administration at sub-national levels. The first phase was implemented in 1991 by devolving power and fiscal responsibilities 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 and devolves legislative, administrative and fiscal powers to the Woreda level (district) of government (Meheret, 2007).

Despite the fact that Ethiopia has been practiced fiscal decentralization at sub-national levels of government for the last three decades, a little research studies has been done on the subject matter. Abdu (2005); Assefa, (2007); and Gebrehiwot, (2015), has indicates the fiscal decentralization in Ethiopia is infant stage which characterized by high vertical fiscal imbalance and limited fiscal autonomy of authorities at sub-national level. Therefore, this paper attempts to assess the implementation and progress of fiscal federalism in Ethiopia since 1995 with particular reference to the federal-regional states by emphasizing on parameters like power and fiscal responsibility devolution, financial and Administrative capacities, and fiscal autonomy.

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Given the above problem, this paper attempts to address the following basic research questions related to fiscal federalism in Ethiopia.

i. To what extent are the power and fiscal responsibilities decentralized in Ethiopia?
ii. What are the principles of fiscal federalism which used in the assignment of expenditure responsibility and taxation power between the Federal government and Regional States in Ethiopia?
iii. To what extent do the regional states governments in Ethiopia enjoy spending and tax autonomy?
iv. What are the major challenges of fiscal decentralization in Ethiopia?

This paper is organized as follows: Introduction; section-two focus on conceptual framework of the study; section-three focus on research design and methodology of the study; section-four and five presents the results and discussion of the study; finally section-six presents the conclusion and recommendations of the study.

2. THEORETICAL FRAME-WORK OF THE STUDY

2.1 Concept and Rationales of Fiscal Federalism

Fiscal federalism basically deals with the allocation of expenditure responsibility and taxation power among various levels of government, as well as the mechanisms for adjusting horizontal and vertical imbalances and the right of sub-national governments to borrow from financial institutions (Yusoff et al, 2016). Thus, fiscal federalism deals not only with the division of policy responsibilities among different levels of 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, but it can also applicable in unitary countries, which have government units at different levels with *de facto* decision-making authority (Adamolekun, 2006). But, this does not mean that all forms of governments are 'fiscally' federal; it only means that 'fiscal federalism' is a set of principles that can be applied to all countries which implementing 'fiscal decentralization' in their public sectors. While, fiscal decentralization is the actual practice of the principles of fiscal federalism (Sharma, 2009:7).

The basic economic rationale for a decentralized fiscal system is that it improve the efficiency of resources allocation (as the result maximum social welfare) by supplying public services as per the needs and preferences of local residents. The logic 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 that of a remote the central government. Moreover, it also improve the responsiveness and accountability of local officials by bringing the voice of local communities into the center of policy-making processes. 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 might bring several unintended outcomes includes:

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reducing the efficient of resource allocation; increasing society inequity and unbalance development among regions; and bad local governance, due to capturing local institutions by elites (World Bank, 2007). 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. Nevertheless, there is also a general principle which states finance should follow the public function.

2.2 Elements of An Effective Fiscal Decentralization

Fiscal decentralization, one aspect of a decentralized of government, is refers to the transferring of power and fiscal responsibilities from the control of central authorities to the sub-national governments. Smoke (2001); identifies the basic preconditions that leads to an effective fiscal decentralization system. Those includes: an adequate enabling environment; assignment of expenditure responsibility; assignment of taxation power; design and implement of intergovernmental fiscal transfer system and sub-national borrowing. Here, it important to note that all those elements must be operated together in order to realize the potential benefits of an effective fiscal decentralization.

I. Adequate Enabling Environment

This 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.

II. Assignment of Expenditure Responsibility

The traditional theory of fiscal federalism (FGT) argues that the macro-economic stabilization and redistributive functions should be the responsibility of central government. The rationale is that if decentralized governments undertakes these functions solely, it may leads to ineffective outcomes, due to spillover effects and mobility of production factors (Oates. 1972:5; and Musgrave, 1999). The SGT, however, argues that macroeconomic stabilization and redistributive functions should not be carried by center only, but also by government units at all levels. The logic behind such argument is that if decentralized governments have high fiscal capacity they may design and implement fiscal and redistributive policies effectively by coordinating their policies (Dafflon, 2006:279; Boadwary, 2009:73). In practice, however, it is too difficult task to coordinate the policies of all government units at sub-national levels for one goal, because they may not have the same interest in the outcome of the policy coordination.

On the other hand, FGT argues that decentralized governments should have a predominate role in resource allocation such as provision of efficient regional and local public goods and services for citizens. The rationale is that a decentralized units of government have better knowledge about the preferences and conditions of local people than of the central government, as the result they can provide efficient public services by matching the supply of public services with the preferences of local residents (Oates, 2005). Likewise, the SGT also argues that decentralized governments could improve the efficiency of public services delivery and

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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). But, central government should has also responsibility in provision of public services that have national benefit effects (like Defense). Because, the provision such public services by the center would improve the efficiency of resource allocation and society well-fare, due to economic of scale and spill-over factors. Thus, the resource allocation function should be carried out by all levels of government.

III. Assignment of Revenue Sources

Once expenditure assignment has been determined, the next key questions is which revenue sources assigned for which levels of government in order to finance the costs of functions they are responsible for. The traditional approach (FGT) argues that an optimal tax assignment is directly related with the normative optimal assignment of public sector functions. Accordingly, it suggests that central government should has power to 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, 19972:137 and Musgrave, 1983).

Moreover, FGT also suggest that decentralized governments should impose *benefit taxes* such as service charges or fees on residents as payment for public services which they provided. 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, 1999:14). In practice, however, the traditional approach for assignment of tax sources is rarely fully respects in the real world (Tazi, 2001). Accordingly, while the general tax principles are useful, assignment of revenue sources to various levels of government in real world highly influences by specific circumstances of each countries. Thus, SGT argues that tax assignment in practice should be done by taking both economic factors (efficiency, national equity, and benefit received principle), and non-economic factors (accountability, tax autonomy, and tax flexibility etc). Moreover, the 'preferred tax assignment' should be changed over time with changes in the economy

IV. Intergovernmental fiscal transfer System

When the assignment of expenditure and taxing responsibility is done in accordance of the principles of traditional fiscal federalism theory (FGT), it often create fiscal problems (both vertical and horizontal fiscal imbalances). Vertical fiscal imbalance refers to the mismatch between the cost of functions and the available financial resources of government units at different levels. This occur when sub-national governments have responsibility for provision of several public service while central government empowered to levy and collect major tax bases. This, in turn, limits the ability of SNGs to cover the costs of services they are responsible for by their own revenues (Daflon, 2006:281; Shah, 2006:29). Horizontal fiscal imbalance, on the other hand, occurs when fiscal capacity of SNGs vary substantially, due to difference in

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revenue raising potential and expenditure needs between them. Thus, if expenditure and taxing responsibilities are highly decentralized, some regional/local governments would have higher fiscal capacity and able to provide similar quantity and quality of public services at lower tax efforts as compares to other regions. Such situation has both efficiency and equity implications, due to mobilization of factors of production.

Many countries around the globe have been designed various intergovernmental fiscal transfer systems to address fiscal problems (both vertical and horizontal fiscal imbalances), to achieve the provision of minimum standards public services and to internalize interregional externalities/spill-overs (UNDP, 2005). However, the process, extent, the nature of transfers to address the fiscal imbalances vary from one country to another, since countries vary in terms of specific conditions. Some countries are designed the transfer systems to be very decentralizing in nature while others are centralized. Intergovernmental transfer tools generally can be grouped into two major categories, namely, unconditional (general purpose) and conditional (specific purpose) grants.

Unconditional grants refer to transfers of funds from central government to lower levels of governments without any preconditions attached to the transfers. Such type of grants are often uses to increase the financial capacity and fiscal autonomy of sub-national government, (Shah 2007:25). The federal government can be allocated unconditional grants for SNGs on various ways: based on political negotiation or Ad-Hock, or a formula-based equalization system. Each approach has its own merits and de-merits in terms of data requirements and fulfilling the basic transfer principles and constitutional provisions. Many academicians agrees that a formula-based equalization system is preferred over the other approaches, if properly designed and implemented. There is a great consunse of several approaches of formula-based equalization system, the Revenue Raising Capacity and Expenditure Needs Equalization (RRCENE) Formula is more appropriate way for allocating federal grant, because it offer the potential for full equalization and measure the horizontal fiscal gaps in more accurate manner (Vaillancourt and Bird, 2005). However, it requires extensive data to estimate the revenue raising capacities and expenditure needs of sub-nationals.

Conditional (specific purpose) grants, on the other hand, refer to grants attached with some kind of preconditions the grantor wants to achieve 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. Hence, these types of grants limits the fiscal autonomy of SNGs and thereby partly against the arguments for decentralization. Central governments often uses such grants to influences SNGs to allocate their budgets in line with national objectives/goal such as provision of a minimum standards of basic public services (Ahmad and Craig, 1997:87). Conditional grants may also be further classified into matching or non-matching grants. In the first case, the recipient government requires to make some contribution either in cash or kind to cover some part of the total cost of a specific project/ program while in the latter case the recipient government does not require to make contribution own resources as long as it used the grant funds for a specific purpose. Matching grants can also be either ***open ended*** or ***closed ended.*** In the first case, the grantor

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contributes the same level of resources to be spent by the recipient governments in specific area and often used it to incentive the sub-national authorities to design their expenditure programs by considering any positive spillover effects to residents of other jurisdictions (Boadway, 2007:62). While in the latter case, the grantor specifies the maximum amount of funds that it will contribute in order to put a ceiling cost borne by it.

3. METHODOLOGY OF THE STUDY

There are several types of research methods in social science to choose from. For the purpose of this study, qualitative research approach is employed. The reason for employing such research approach in this study is gives an opportunity to gather sufficient information and obtain a deeper understanding with regards the implementation of fiscal decentralization at regional level in Ethiopia. And the study designed by gathering primary data from key-informants through conducting depth interview and discussions with the intention of other secondary data complement it. The study has taken Federal government and all regional states including the two city administrations (Addiss Ababa and Dire-Dawa) as units of analysis to achieve the research objectives.

3.1 Conceptual Framework of the Study

In fiscal federalism literatures, there are two alternative theories of fiscal federalism with different views related to the determination of an optimal fiscal decentralization structure; namely: traditional approach, commonly known as "First Generation Theories" and the Political Economic approach, commonly known as "Second Generation Theories". The basic assumption of FGT is that governments at all levels are benevolent social planner and seek to maximize the welfare of entire society as whole. The theory consider only economic criteria (like efficiency and equity) as a basis for assignment of expenditure and taxing responsibilities among different levels of government. In contrast, the SGT consider 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, theory argues that the effectiveness of fiscal decentralization depends to a large extent on the establishment of an effective fiscal and political institutions at sub-national levels as well as introduce of hard budget constraints (Oates, 2005). The SGF is more pragmatic, less bound to convention, and positive in approach when compared with FGT. This branch of literature on fiscal federalism is drawn and developed models by incorporating of theories in new disciplines such as public choice theory, Principal-Agent problem, and the economics of information and organization theory. The SGT, generally argue that the allocation of expenditure and revenue responsibilities among various levels of government should be done by considering both economic and non-economic variables.

Many scholars in public finance commonly applied two standard measurements to assess the degree of fiscal decentralization; namely: Expenditure ratio (ER) and Revenue Ratio (RR). Expenditure Ratio is computed by dividing the total sub-national expenditure (the sum of regional and local governments' expenditures) to the total national expenditure (the sum of sub-national and central government' expenditure). This ratio provide insights into the role of lower

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levels of government in delivering of public goods and services to citizens. Before computing expenditure ratio, thus, it is important to consolidate the expenditure data of each levels of government so as 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. Revenue Ratio (RR), on the other hand, is computed by dividing the total sub-national revenue to total national revenue. In both cases, when the value is closer to one, it indicates high degree of fiscal decentralization. For the purpose of the study, therefore, both Expenditure Ratio (ER) and Revenue Ratio (RR) are used so as to measure the degree of fiscal decentralization in Ethiopia.

3.2 Data sources and data collection techniques

The study collected and analyzed both primary and secondary data. The primary data were collected from key informants (politicians, budget experts, public officials and staffs, and sector office heads) through conducting an in-depth interviews by designing semi-structural interview. The key informants were selected purposively from institutions at federal and regional levels on the basis of their levels of knowledge on the research topic. The data from the in-depth interviews were used to identify the factors that promote or challenge facing the implementation of fiscal decentralization in Ethiopia, as well as to substantiate data gathered from secondary sources. The study also used checklist-guided field (office) observations as a technique to collect primary data. The secondary data were gathered from published and unpublished materials, which available in form of books and journal articles, and actual annual reports of the institutions at federal and regional levels; Federal and regional' constitutions, proclamations, census reports, statistical bulletins, as well as research studies which conducted and presented for policy discussion and conferences etc.. Accordingly, 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 the federal and regional institutions annual reports and thoroughly analyzed and interpreted in the study.

3.3 Method of data analysis

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 and discussion, and field observations were analyzed using qualitative data analysis method 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 then 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.

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3.4 Ethical Issue

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

4. RESULTS OF THE STUDY

In this section of the study, the paper presents the major finding in line with objective of the study.

4.1. The Constitutional Expenditure Assignment in Ethiopia

The FDRE Constitution allocates the public power and functions either exclusively to the Federal governments (Article 51) or to the Regional States (Article 52) or shared between both levels of government. Accordingly, 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 administrating major development infrastructures (like air, rail, sea transportation, interregional roads, postal and telecommunication services) exclusively for federal government (Art. 51). Article 52 of the FDRE Constitution also specify certain power and responsibility of Regional governments, which includes: formulate and implement language, culture and education policies; enact their own constitutions; formulation and execution of economic, social and development policies, strategies and plans; administration of land and other natural resources in the territory; levying and collecting of taxes; design standards for State level civil services and payment; and establishing and administering a regional police force and maintaining public order(Art. 52). They are also empowered to provide several public services that have local and regional benefit impacts such as referral and zonal hospital, primary, secondary and post-secondary education (like TVET); construction rural roads; water supply and sanitation, parks and sport frequenting sites and other municipal services. In addition to these powers, all residual powers are reserved for the regional states, with the aim of avoiding any potential interference or pressure that could be done by the Federal Government on significant matters that can affect the internal affairs of the Regional States.

Generally, the FDRE constitution has 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) in allocating power and fiscal responsibilities between federal government and regional states. This indicates, therefore, expenditure assignment system in Ethiopia is complies with the theory of fiscal federalism. However, there is lack of

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clarity in the assignment of power and functions, particularly on shared responsibilities and as a result it creates overlapping and duplications of responsibility problems and leads to various conflict between the two levels of government. Therefore, it require more clarity on the assignment of power and functions, so as to avoid conflicts and ensure accountability at both government levels.

4.1.1. Degree of Expenditure Decentralization in Ethiopia

The study used the share of regional states' expenditures to the total national expenditures to measure the degree of expenditure decentralization in Ethiopia. The expenditure share of Regional States including the two city administrations, to total national expenditure is 36.82% on average during 1995/96 – 2013/14 FYs (refer table 4.1 below). This indicates that expenditure decisions, particularly on capital expenditure is 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 4.1.: Federal Government and Regional States' Expenditures (in Millions) and Expenditure Ratio during 1993/4-2013/14 FYs

Fiscal year	Expenditure						Expenditure Ratio (%)
	Federal	subsidy	Total Exp. (A)	Regional (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)

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4.1.2 Spending Autonomy of Regional States

SNGs' spending autonomy can be defined as the extent to which the States/LGs decides independently the nature, quality and quantity of public services to be supply for local people (Dafflon and Madies, 2009). In other words, it refers to the capability of SNGs to develop own policies and freedom over allocates of own budget resources between recurrent and capital expenditures as well as across various sectors without the influence of central government (Shah, 2006). The regional states in Ethiopia were financed larger portion of their budget resources (about 90% on average) by own revenues and unconditional grant during 1998/99-2012/13 fiscal years (refer table 4.2). This indicates, they have full autonomy to allocate their own budgets over recurrent and capital expenditures as well as across various sectors during the study periods. The reason is that they empowered to allocates of the financial resources, which generated from both own revenue sources and unconditional grants, in any expenditure areas they give higher priorities.

Table 4.2.: Share of States' Total Revenues Excluding Specific Purpose Grants to Regional States' total expenditure (1988-2013 FYs)

Fiscal years	RSs' TOR A	FUG B	RSs' TR C = (A+B)	RSs' TE D	Spending autonomy E (C/D)	F(A/D)
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 can be evidenced from Fig 4.1. below, regional states in Ethiopia are vary in terms of allocation of their capital budgets across various sectors. For instance, Tigrai, and Oromia regions are exhibited to be more development orientation in allocating their budgets, since they allocated about 93% and 97% of total capital budgets respectively for economic and social development sectors during 2013. Adiss Abeba, Dire-Dawa, Amhara and Gambella, on the other hand, are allocated about 90% of their capital budgets on average for economic and social

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sectors. While, Afar, Benshangul-Gumuz, SNNP, and Somalia are less development oriented, since, they allocated relatively a larger portion of their total capital budgets (about 24% on average) into general government administration sector during the same period. This factors contributed for differences in spending decisions on capital budgets between regional states are: variation in terms of managerial and technical capacity, as well as level of infrastructure development. Generally, emerging regions have low spending autonomy, because still they suffering from capacity problems, which includes: financial, human and material resources; as well as administrative and technical capacity. Additionally, they have very low capacity to generate sufficient own revenues, mainly due to poor tax administrative capacity as well as unwillingness of taxpayers to pay taxes and corruption, As the result, they are highly vulnerable to the interference and manipulation of federal organs and authorities.

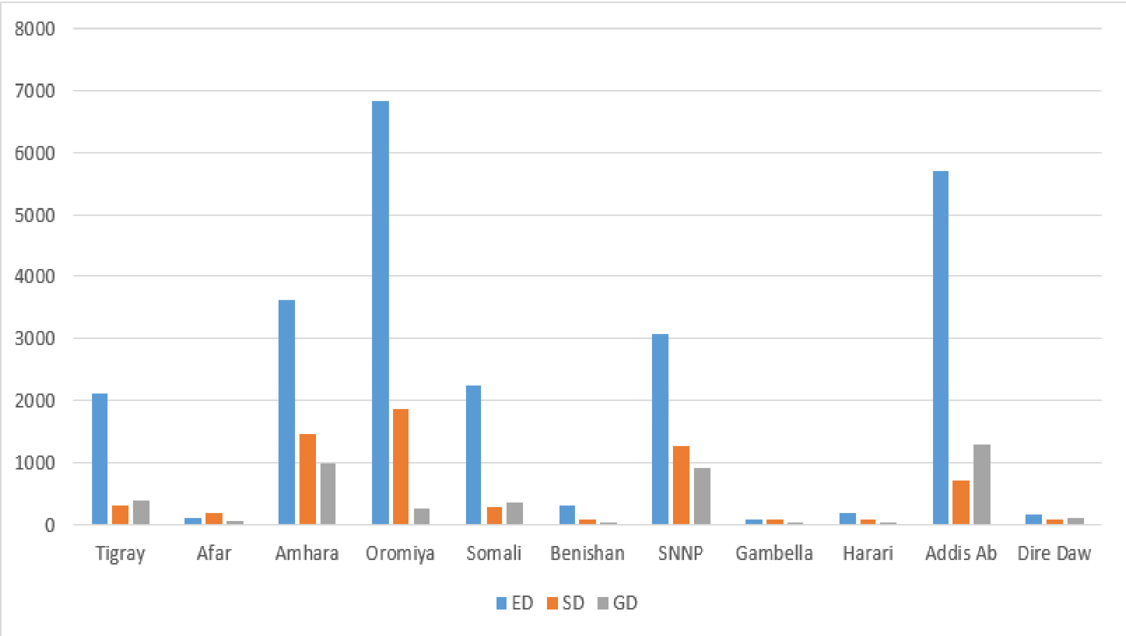

Figure 4.1: Allocation of Capital budgets by Regional States in Ethiopia, 2013

Source: MoFED annual report, 2014

4.2. Constitutional Assignment of Taxation Power

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. In Ethiopia, all revenue sources with the exception of custom duties and monopoly taxes are divided between the Federal Government and Regional States not on the basis tax base, but based on category taxpayers, transactions, things. Thus, a single tax base is split between the federal and regional states on the basis of various principles such as ownership principle, categories of taxpayers, origin principle, national concern and administrative efficiency (refer table 4.3 below). Such tax assignment practice not only enables the Regional States access to various tax bases including mobile natures like BPT, PIT, VAT

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and excise taxes, but it also makes the tax assignment system in Ethiopia more decentralized and detailed as compared to other developing countries around the globe including Africa countries.

The existing assignment of taxation power in Ethiopia, however, is unique in nature, since many federations around a globe allocates 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). Additionally, it is also not compliance with the general principles of tax assignment under traditional approach, which argue tax on mobile factors should be imposed only by central government. The reason is that if decentralized governments have power to levy and collect taxes on mobile tax bases, 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).

In addition to own tax sources, FDRE constitution assigned taxation power jointly for both federal government and regional states over tax bases listed under "Concurrent taxation power" (Article 98). However, there is lack of clarity with regards the constitutional provision, because it fails to explicitly underlying the procedure for determining tax bases and rate on concurrent taxes jointly by both government levels. The implication of the Constitution may be the authorities of the two levels of government conjointly are determined the tax bases and rates of tax revenue listed under "concurrent taxation power" through negotiation and discussion. The practice, however, shows the Federal Government is empowered to decide tax bases and rates on concurrent taxes as well tax administrative by both federal houses (HOF and HOPR) (FDRE Constitution, Art. 105(2)). Thus, unlike the practice in USA, concurrent taxes are levies and collects solely by federal government in Ethiopia, while the regional states empowered only to receive a share of the proceeds from these taxes in 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.

Finally, unlike other countries, taxation power on tax bases, which are not assigned exclusively either for federal or regional states or both levels of government jointly, are allocated between federal and regional states by the meeting of two-third of the two federal houses such as the HoF and HoPR in Ethiopia (The FDRE Constitution, Art.99). This, in turn, limits regional states to generate revenue by introducing a new taxes or sources on their jurisdictions. However, in practice some regional states such as Afar, Somalia and Oromia regions are introduced new tax base like livestock tax without waiting the decision of HoF and HoPRs (key-informants interview).

4.2.1. Degree of Revenue Decentralization in Ethiopia

As can be seen from table 4.3, 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 that the existence of high

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revenue centralization in Ethiopia and has shown a slightly improvement over time during the selected periods. Moreover, share of total regional revenue to GDP is very low, which accounted about 3% on average during the same period. This shows, they are lower efficiency in collecting revenue from their jurisdictions. Thus, although the regional States access to several tax bases including that have mobile nature like PIT, BPT, VAT and excise taxes, the practice shows that the revenue collection in Ethiopia is highly dominated by federal government (about 80% of total national revenue). This, in turn, makes regional states heavily depends on federal subsidy/grants for financing larger portion (about 78%) of the costs of functions they responsible for and leads to a low fiscal autonomy. as the result, it could undermine the potential benefit of fiscal decentralization such efficiency of public services delivery and promote economic growth.

Table 4.3.: Share of Revenue of the Federal Government and Regional States (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	120,818.50	0.7610	0.2390	0.1519	0.0363
2006/07	17,404	4,385	21,789	158,211.90	0.7988	0.2013	0.1377	0.0277
2007/08	15,836	5,478.4	21,314	229,132.50	0.7430	0.2570	0.0930	0.0239
2008/09	24,307	8,250	32,557	313,270.20	0.7466	0.2534	0.1039	0.0263
2009/10	31,923	9,835	41,758	351,144.60	0.7645	0.2355	0.1189	0.0280
2010/11	40,764	12751	53,515.1	469,434.10	0.7617	0.2383	0.1140	0.0272
2011/12	48,364	20132	68,496	685,586.80	0.7061	0.2939	0.10	0.0294
2012/13	59,095	28579	87,674	787,302.80	0.6740	0.3260	0.1114	0.0363
Average	21559.93	7285.36	28845.27	240281.91	0.7788	0.2212	0.1433	0.0302

Source: computed based on data from MoFED annual report, 2014

The main factor contribute for high centralization of revenue collection in Ethiopia is that tax bases which have higher yield rates such as all foreign indirect taxes (like tax on import and export trades) assigned only to the Federal Government. Besides, regional states in Ethiopia have poor tax administration capacity, mainly due to lack of professional and competent human power. In addition, there is lack of availability an appropriate mechanisms and procedures to assess and collect taxes; unwillingness of tax payers, due to lack of awareness. This indicates,

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therefore, require of intensive reforms to further improve the own revenue collection capacity of regional states and enhance their financial autonomy, so as to improve the efficiency of public service delivery and ensure accountability at sub-national levels in Ethiopia.

4.2.2. Tax Autonomy of Regional States

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). The study applied the OECD' model to classify regional states' own revenue based on the degree of tax autonomy they exercised over own revenue sources in practice in Ethiopia.

The FDRE Constitution (Art. 97) empowered both levels of government to decide independently tax base, set rate as well as administrative taxes on the same tax bases. Because, unlike other federations, in Ethiopia various tax bases are divided between federal government and regional states, not based on tax bases rather on category taxpayers, transactions, things. To avoid problems related to assignment of the same tax bases for more than two levels of government (such as unhealthy competition and high administration costs; Federal Government required the regional states to harmonize their tax bases with federal tax bases (Proclamation No 648/2009). As the result, regional states in the federation are have no autonomy to decide the tax bases on most of revenue sources under their domain (like BPT, PIT, and excise taxes). Thus, such own revenue sources of regional states are falls under (b) category in the OECD model.

On the contrast, regional states have full power to decide tax base, rate and tax administration on agricultural income tax and rural land use fees, as the result enables them to engage in tax competition for attracting domestic and foreign investors into their jurisdictions. Thus, these tax sources are falls under (b) category in the OECD model. However, the amount of revenue generated from these sources are insignificant, as the result full tax power over these sources have no significant effect on the regions' fiscal capacity and spending autonomy. Overall, regional states in Ethiopia have tax autonomy over a few own revenue 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.

4.3. Fiscal Imbalances in Ethiopia

4.3.1. Vertical fiscal imbalance

The study has used the share of regional states' expenditure needs are financed through their own revenue to measure the extent of vertical fiscal imbalance in Ethiopia. From table 4.4 below, regional States including the two City Administration have a combined expenditure share of 44.46% on average and revenue share of 22.08% on average during 1995-2913 FYs. This shows that, in practice, the expenditure responsibility is more decentralized as compares to the revenue sources in Ethiopia, which create a VFI with a coefficient of 0.53 on average (refer table 4.4). the coefficient of VFI in Ethiopia is by far higher as we compared to other

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federations around a globe such as Australia (0.33), Brazil (0.35), India (0.23) and Germany (0.45) during 2010 (World Bank, 2010). The implication is that regional states in Ethiopia are heavily depends on federal transfers and lower fiscal autonomy as compares with other federation mentioned previously. The reason is that federal government highly influenced spending decisions of regional states through its fiscal power. This, in turn, reduces the efficiency of public service delivery and accountability at sub-national levels, due to lack of a strong linkage between revenue raising and spending decisions.

The factors contributed for the existence of a high vertical fiscal imbalance in Ethiopia are: devolution of revenue sources that have very low yielding rates; weak tax administrative capacity; lack of appropriate enforcement mechanisms and unwillingness of taxpayers to pay taxes. In addition to that, the key informants at regional level also claimed that high expenditure requirements due to low-level infrastructure development (especially the emerging regions), and high corruption practices at sub-national levels also contributed to the high vertical fiscal imbalance in Ethiopia.

Table 4.4.: ***Vertical Fiscal Imbalances in Ethiopia [1995/96 – 2012/13] FYs***

Fiscal year	Revenue Share			Expenditure share			Vertical fiscal imbalance
	Regional States	National	States' share	Regional States	National	States' share	
	A	B	C(A/B)	D	E	F(D/F)	1-C/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

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4.3.2. Horizontal Fiscal Disparity

The study measured the HFI in Ethiopia by comparing the actual total own revenue with the total expenditure needs of each regional States in Ethiopia, due to lack of available data with regards the potential revenue raising capacity of each regional states. From the table 4.5., there is a wide variation with regarding to 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.

There are two major factors which attributed for existence of a high horizontal fiscal capacity gaps between regions in Ethiopia. First, a significantly variation in per-capital revenue raising capacity between regional states, due to differences in terms of level of economic activity and infrastructure developments. The economic activity and infrastructure developments are highly concentrated in few regions of Ethiopia such as Adiss Ababa, Oromia, Amhara and Tigrai. Second, a significant variation in per capital expenditure needs between regional states, due to difference in terms of socio-demographic characteristics (such as population dispersion, urbanization rate, and social composition and age structure), cost of materials and physical features.

Table 4.5: Ratio of Regional States' Own Revenues to Their Total Expenditures during 2012/13 FYs (in %)

Regional States	2012/13			
	Total own revenue	*Total expenditure*	*HFI*	*Rank*
Tigrai	2222.6	5991.1	0.37	2
Afar	215.3	1924.1	0.11	10
Amhara	3334.1	14423.1	0.23	6
Oromia	5455.1	21042.6	0.26	4
Somale	627.4	5165	0.12	9
Benishangul	268.1	1204.3	0.22	7
SNNP	3066.6	12535.4	0.25	5
Gambella	140.8	750.61	0.19	8
Harari	142.5	542.3	0.26	3
Dire Dawa	331.2	810.5	0.41	1
A.A	12781	12413	1.03	
Averages	28584.5	76802	0.22	

Data Source: MoFED annual rport, 2007 & 2014

4.4. Intergovernmental Fiscal Transfers in Ethiopia

The Federal Government has transferred financial resources to the regional States through employing various fiscal transfer instruments to meet various national objectives: 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).

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The unconditional grant consists of two forms of transfers such as revenue-sharing transfer and Federal Subsidy (fiscal equalization) transfer.

4.4.1. Unconditional (General Purpose) Grants

The federal government in Ethiopia has been transferring subsidy in form of unconditional grant for regional government to address vertical and horizontal fiscal imbalances. 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 regional States (Solomon, 2006). In Ethiopia, the FDRE Constitution fails to clearly specify the sources of finance and the guidelines for determining the total size of the federal subsidy to be distributed for regional states. The practice, however, shows that the federal government determine the total size of grant pool discretionarily as part of its annual budget and approved it by the parliament. As a result, it makes the federal subsidy less predictable and stable and thereby 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.

The federal government allocate the total grant pool for each regional states based on a formula which adopted by the HoF since 1994/95. The grant formula has been revised several times since that period, mainly due to frequently changing in the socio-economic conditions of regional states and lack of reliable data (Assefa, 2007). Pre-2007, HoF has been adopted grant formulas which were 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. Thus, the HoF has adopted a new grant formula in 2007, 2009 and 2012 based on the experience of fiscal-gap equalization grant system of Australia, so as to improve the fairness distribution of federal resources and incentive regional states to generate more revenue from their sources. The new grant formulas estimating the potential revenue raising capacity and expenditure needs of each regional states to compute fiscal gaps and attempting to fill the fiscal gaps through the federal grant. This enable regional states to provide similar public services at similar tax efforts to citizens living in their jurisdictions.

4.4.2. Assessment of the 2012 Grant Formula

The current grant formula is adopted by the HoF in 2012 and used for the last fiscal years (2011/12-2017/18) to allocate the federal grants for regional states. This grant formula is computed fiscal gaps by estimating the revenue raising capacity using repetitive tax system and expenditure needs using representative expenditure system. It attempts to fill the fiscal gaps through allocating federal subsidy. The main purposes of the 2012 grant formula are: 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) to estimate the potential revenue raising capacity of each regional states. Thus, it takes into account six major tax bases, which constituted about 90 percent of the regional states' total tax own-revenue sources, in the

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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%). Moreover, the new grant formula uses the revenue raising potential rather than their actual collected revenues to measure the revenue raising capacity of each regional states. As the result, it pursues the principle of effort neutral approach in more effective manner than the previous grant formulas. It is also appropriate for the included of TOT in the 2012 grant formula, because such tax base has shown a consistently growth over time and across regional states recently in the country.

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 regional states' total public expenditures. The functional areas with the weigh attached in each functional areas are: general administration (organs of the state, justice and security, and general service, (29%); primary and secondary education and public health (26%); agriculture and rural development and natural resources (14%), drinking water development (5%), and 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 is 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.

The revenue raising capacity of each regional states has been assessed by comparing the region' situation with the national average. The result for each tax bases or expenditure items includes in the formula may has 'positive sign' or 'negative sign. Accordingly, the estimated revenue raising potential and expenditure needs of each regional state is computed by summing up the results of each regional state on all tax bases and all expenditure factors included in the grant formula respectively. Thus, the fiscal gap of each regional state is computed by subtracting the estimated total expenditure need of each regional state from its corresponding revenue raising capacity. The net result may has a positive sign for some regions or a negative sign for others. If a region has a positive sign, it has lower than average capacity to generate own revenues as compared to its expenditure needs and should be filled the gap through federal subsidy. While, if a region has a negative sign, it has considered higher fiscal capacity to finance its expenditure needs than the national average. So it should receive less than average grant for this account. Finally, the percentage share of each regional state on the total grant pool is determined by dividing its fiscal gap to its total population size. Accordingly, the percentage grant share and grant per-capital of each regional which approved by HoF in 2011/12 FYs is presented in Table 4.8 below.

From the table 4.8, 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 of 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 of 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

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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 as compares 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. Additionally, it is effective in pursue the principle of effort neutral as the result it would not be affects 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.

Table 4.6: Budget Grant Shares of Regional States in Ethiopia during 2011/12 FYs

Regional States	Budget subsidy ($x10^6$ Birr)	Share from total Grant (%)	Share of population to total population (%)	Share of B to C
	A	B	C	4 = B/C
Tigrai	2407	7.04	6.04	1.17
Afar	1102	3.34	1.96	1.71
Amhara	7978	23.33	26.56	0.88
Oromia	11125	32.53	36.72	0.89
Somali	2883	8.43	6.02	1.40
Benshangul-Gumuz	670	1.96	0.87	2.25
SNNPR	6806	19.90	20.60	0.97
Gembella	534	1.57	0.34	4.62
Harari	304	0.089	0.27	3.30
Dire-Dawa	345	1.01	0.54	1.87
Total	342	100	100	100

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

4.4.3. 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 line ministries are selected the beneficiary regional states on the basis of political factors and willingness of foreign donors. As the result, it reduce the predictability, and transparency of the transfer system. The MoFDE is empowered to approve and supervise the specific projects/programs which 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 minister of finance (MoFED) and the foreign grantors. The conditional grants has been financing from two sources: external loans and/or assistances (accounted about 80% of the total grant size) and contributions from federal government and beneficiary regional states (accounted 20% of total

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grant size). This indicates, conditional grants are highly depends up on external loans and/or assistances, as the result makes such grants less predictable and further limits the capability of regional states to prepare an effective own budgets and plan long-term objectives for provision public services. Once the grant pool is determined and then provided for the selected beneficiary regional States in from of ***closed-end matching grants***, since it expected beneficiary regional States 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 the regional state 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 conditional grants are allocated to finance the costs of capital projects/programs in emerging regions, so as to promote their administrative capacity and infrastructure developments. The federal line-ministries are 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, so as to promote the administrative capacity and achieve the provisions of basic services like education, and health-care (see, MoE annual report, 2014). Moreover, the federal government has been allocates specific purpose grants to finance the costs of a specific program in urban areas such as Urban Safety-net to meet MDGs.

4.5. Access to Financial Market of Regional States in Ethiopia

In Ethiopia, the FDRE Constitution (under Art. 72) grants the right for regional states to borrow funds from domestic institutions (like MoFED, NBE and CBE) to finance their short-term budget deficit and capital projects. The practice, however, shows that all regional states with exception of few are exercised their rights only for borrowing short-term loans from domestic credit sources in filling their current budget deficits (interview with key-informants). The respondents are responded that long-term loans is subjected to the direct control of the Central Government. This is due to the fact that public debts have direct effect on the monetary and fiscal policies. The key-informants at federal level claimed that if regional states are allowed to borrow funds from long term loans without restriction, it might cause macroeconomic instability in the nation as a whole. This indicates that, there is a gap between the constitutional provision and the actual practice on the ground with regarding regional states access to borrowing in Ethiopia. Furthermore, despite fiscal discipline such as bailout problem is the main concern of all federal governments in developing and developed federal countries around the world, it is not a serious problem currently in Ethiopia for two reasons. First, the federal initiative borrowing schemes are designed to avoid bailout problem in Ethiopia. Second, sub-national governments in the Ethiopia federation have limited capacity in effectively utilizing their budget resources including financial resources which transferred to them by federal government.

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5. DISCUSSION

The main findings of the study are summarized based on the major pillars of fiscal decentralization, which mentioned in the theoretical frame-work of the study (refer chapter-two in above).

With regards to enabling environment, FDRE constitution not only grants for regional states a wide ranges of expenditure responsibilities including residual power, but also empower to levies and collects taxes on several revenue sources including taxes that have mobile natures. However, there is lack of clarity with regarding the assignment of power and fiscal responsibilities between federal government and regional states, particularly on shared responsibilities. As the result, it creates duplication and overlapping responsibility problem and may leads to several conflicts between the two levels of government. This, in turn, could undermine to reap the potential benefits of fiscal decentralization such as efficient public services delivery and ensure accountability at all levels of government.

When we concerns with the trend of expenditure ratio and revenue ratio in Ethiopia, the result shows the shares of the regional states to the total national expenditure and revenue were on average about 44% and 22% respectively during1995/96-2012/13 fiscal years. This shows that the collection of revenue is highly centralized as compare to the expenditures responsibility, since the federal government is spent about 56% and collected about 78% of the national total expenditure and revenue during the same periods. The implication is that the decentralization policy of Ethiopia is implemented without devolution of sufficient financial resources to regional states. This, in turn, creates a vertical fiscal imbalance with a coefficient of 0.53 on average in Ethiopia which if fairly high. The factor contributed for the existence of a high VFI in Ethiopia is that assigning of tax bases that have low yield rates for regional states, poor tax administrative capacity and high corruption practices at sub-national levels. Consequently, the regional states are heavily depends up on federal transfer to finance the larger portion of costs of functions that they are responsible for and limits the regions' fiscal autonomy. Consequently, it reduces 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. Additionally, there is a wide fiscal capacity gap among the regional states in Ethiopia, mainly due to existence of significant differences in revenue-raising potential and expenditure needs across regions.

The federal government has employs various transfer mechanisms to address the fiscal problems (both vertical and horizontal). The transfer system of Ethiopia, however, is dominated by general purpose grants, commonly referred as Federal Subsidy, which accounted about 80% of regions' budgets. Currently, the federal subsidy is distributed among regions on the basis of a grant formula that considers both the revenue raising capacity and expenditure needs of each regional states. As the result, it is effective in addressing fiscal capacity gaps by equalizing about 90% of revenue raising capacity and 95% of expenditure needs of the regional states. The major problems associated with the Ethiopian fiscal transfer are less stability, predictability and transparency.

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Overall, the study found that the implementation of fiscal decentralization faces several problems and challenges, which includes: lack of clarity of expenditure and taxing responsibilities assignments; weak technical and administrative capacity at sub-national level, due to lack of availability of trained and experienced human resources; Poor political willingness and commitment of authorities at federal level to decentralize fiscal power in real sense; limited fiscal autonomy due to lack of sufficient own financial resources; less stable, predicable and transparent federal transfer system; and inadequate regional governments access to domestic credit sources, particularly on long-term loans.

6. CONCLUSION AND POLICY RECOMMENDATIONS

6.1. Conclusion

Although the regional states in Ethiopia grants a significant power and fiscal responsibilities including residual power by federal constitution (under Art. 52 and Art. 97), there is lack of clarity with regarding to the assignment of expenditure and taxing responsibility, particularly on shared responsibilities. As a result, it would create overlapping responsibilities and may breed conflict between the federal and regional governments and leads to reduce the efficiency of public services delivery and accountability at sub-national levels.

The expenditure responsibilities in Ethiopia by far is highly decentralized as compare to taxing responsibility and creates a high vertical fiscal imbalance. As the result, the regional states are heavily depends up on federal transfer to finance larger portion of their annual budgets and limits the fiscal autonomy. The implication is that the implementation of decentralization policy in general and fiscal decentralization in particular without devolution of adequate taxation power to sub-national governments in Ethiopia. Additionally, there is a significant variation in revenue raising capacity, and expenditure needs among regional states and creates a wide fiscal capacity gap in Ethiopia. Thus, the federal government has designed various transfer mechanisms to address the fiscal problems (both vertical and horizontal) and achieve the provision of minimum public services for citizens. Currently, the federal government has designed a grant formula that considers both the revenue raising capacity and expenditure needs of the regional states for allocating the general purpose grants among the regions. As the result, it is effective in addressing fiscal capacity gaps by equalizing about 90% of revenue raising capacity and 95% of expenditure needs of regional states.

Overall, the finding of this study shows that the implementation of fiscal decentralization in Ethiopia faces several problems and challenges. Some of the major challenges includes lack of fiscal autonomy, due to lack of sufficient own financial resources; weak technical and administration capacity, due to unavailability of adequate trained and experienced human and material resources; Poor political willingness and commitment of authorities at national level to decentralize fiscal power in real sense; and poorly design and implement of federal transfers; as well as lack of access to domestic credit sources, particular on long-term loans.

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6.2. Recommendation

The study provided practical recommendations to promote the opportunities and avoid the challenges identified by the study, in order to further improve the efficiency, effectiveness and equity of decentralized fiscal system of Ethiopia.

- Clearly Specifying the expenditure and taxing responsibilities of the federal government and regional states, particularly on shared responsibility, so as to further improve the efficiency of public services and ensure accountability at all levels of government. This, in turn, requires to take a comprehensive survey with regards the actual power and fiscal responsibilities of the regional states by unbundling the various aspects of each public function in terms of policy making, regulation, service delivery and financing.
- Federal government need to make more political commitment and leadership to improve further the technical and administrative capacity of regional states through introducing capacity building programs in areas of hiring and retaining professional and competent human power as well as transferring necessary infrastructures and financial resources to sub-national governments.
- Federal government should improve the capacity of regional states to generate more of own revenue from their jurisdictions through undertaking some measures, which includes: gives full freedom for regional governments to introduce new tax bases independently in their jurisdictions and exercise tax autonomy at least in setting tax rate on tax bases which assigned to them by the federal Constitutions.
- Regional states should be taken certain measures to improve their tax administrative capacity by building a reliable information system and hiring and retaining competent human resource as well transferring necessary infrastructures to regional and local' revenue offices. They should also be introduced an appropriate tax enforcement mechanisms and create awareness of the tax-payers to pay taxes honestly, so as to improve their capacity to generate more of own revenues.
- Revising the existing shared revenue ratio (70:30) which apply to divide the proceeds generated from indirect concurrent tax bases in favor of the regional states. Such mechanism, however, may limit the role of federal government in redistributive income and macro-economy stabilization.
- The federal government need to take measures to improve the stability, predictable and transparency of the existing federal transfers, so as to enhance the regions capability in preparing their own budgets accurately and planning long-term objectives to provide adequate public services to their people.
- Accessing the regional governments to domestic credit sources, particularly on long-term loans, by establishing a regional development bank in order enables 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. Additionally, it enables the

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regional authorities to ensure intergenerational equity through financing some portion of the cost of long-term infrastructure projects by debts.

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