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INTERGOVERNMENTAL FISCAL TRANSFER AND THE FATE OF SUB-NATIONAL GOVERNMENTS IN ETHIOPIA: THE CASE OF LOCAL GOVERNMENTS IN OROMIA REGION

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ABSTRACT

The study has scrutinized intergovernmental fiscal transfer under Ethiopia fiscal federal ism frameworks by mainly emphasizing on sub-national government using descriptive study. The study employed interview and document review in order to collect primary and secondary data respectively. The study aimed to identifythe trends, performance, and constraints of inter governmental fiscal transfer at sub-national governments in Ethiopia. The study found, revenue and expenditure decentralization to sub-nationalgovernment in Ethiopia has resulted in severe vertical and horizontal fiscal imbalance. An average vertical fiscal imbalance in the country is about 60% while variation among regions ranges from 25%-91%.An average vertical fiscal imbalance among local governments is about 75% whereas the variation among localities ranges from 17%-94.1%. Vertical and horizontal fiscal imbalance in Ethiopia is mainly caused by difference in revenue generation capacity; assignment of unproductive and none buoyant revenue sources to sub-national governments; mismatch between revenue and expenditure decentralization; difference in expenditure needs; difference in economic and business activities and difference in natural resource endowment among sub-national government in Ethiopia.Although these problems are widely prevailing, the nation does not instituted appropriate and adequate legal framework or system to close vertical and horizontal fiscal imbalance. These problems resulted in more fiscally dependent and none autonomouslocal governments which may lead to poor local service provision and low accountability. The limitations are basic and require hasty action on such areas as revision of revenue and expenditure decentralization; inter governmental fiscal transfers design and revision of legal framework for intergovernmental fiscal transfer.These recommended policy directions is believed to have the potential to separate Ethiopia sub-national governments from its diverse and inherent fiscal problems.

KEYWORDS: *Fiscal Transfer, Fiscal Decentralization, Sub-national Governments, Local Governments.*

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Introduction

Back Ground of the Study

Fiscal decentralization is the distribution of fiscal decision making powers among different levels of governments such as central, regional, and local. It consists of principles of fiscal relations between national and sub national governments. The main elements of fiscal decentralization are division of revenue sources and expenditure functions, designing appropriate level of transfer to reduce vertical and horizontal imbalance among different level of government and establish adequate legal and institutional framework to deal with the issues of fiscal federalism (Bahl, 2001and Birhanu, 2009).

Intergovernmental fiscal transfer which is often considered as the third fundamental elements in intergovernmental fiscal relation is the corner stone for lower level of governments in a federation. It is the financing instruments for state and local governments in the form of grants, subsidies, and tax sharing. It aimed to achieve vertical and horizontal balance, provide funds for basic expenditure priorities and it is also established for other administrative reasons (Bah l, 2000).

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Fiscal imbalance in Ethiopia is caused by the interaction of revenue and expenditure division and uneven distribution of tax base and economic resources across the country at both regional and local levels. Federal and regional constitution instituted the systems of fiscal transfer between federal and regional and regional and local government (woreda) level to subsidize the shortage of revenues. But, the design, allocation techniques and over all transfer administration at federal and regional levels is criticized for some constraints. The first critic is related with the determination of the aggregate amount of subsidy at federal and regional levels. Many observers questioned the transparency and certainty of grant pool determination (total amount of subsidy) at both levels. Even though the allocation of or distribution of grant pool from federal to regions and from regions to local is formula based and has achieved some level of transparency and certainty, some scholars questioned the comprehensiveness and fairness of elements included in the formula and the weight attached to them; the reliabilities and timeliness of data used and overall effectiveness of transfer program administration at federal and regional level (Bahl, 2000; Chekol and Getnet, 2010).

Federal and regional government constitutions lay the base for legal frame works for fiscal transfer in Ethiopia. However, many observers criticize the clarity, comprehensiveness, and adequacy of the legal frame works that govern fiscal transfer at regional and local levels (Dickovick and Tegegne, 2010).This paper tries to investigate the trends, performance and constraints of intergovernmental fiscal transfers at sub-national governments in Ethiopia in general and in local governments in Oromia region in particular.

Objectives of the Study

- **General Objective**

The overall objective of the study is to investigate the trends, performance, compositions, constraints, and success of revenue and expenditure assignments and fiscal transfer at Ethiopia local governments.

- **Specific Objectives**
  - To investigate the structure, distribution techniques, and constraints of fiscal transfer to regions and local governments over the past eight years.
  - To review the existing legal framework on fiscal transfer at federal and regional level to identify none clarity, none adequacy, inconsistencies and ambiguity in the current constitution, laws, regulations, directives, and procedures.
  - To examine the level of consistencies and deviations of fiscal transfer at sub national level in Ethiopia with theoretical frame work and international practice.

Significance of the Study

The study is hoped to create better understanding about the current situation in transfer program in Ethiopia local governments. The study is believed to create deep understanding about the trends, performance and constraints in existing intergovernmental fiscal transfer at sub national levels. As a result, the findings of the study may help policy makers to differentiate the basic problems and constraint of fiscal transfer programs and reconsider the issues to reduce or eliminate those constraints. The research may provide some clues for researchers and scholars about the topic under consideration.

Scope and Limitation of the Study

The study is conducted on intergovernmental fiscal transfer at sub-national in Ethiopia including three hundred and four (304) local governments/both urban and rural locality/ in oromia region. The study covers three major areas. Primarily, the study analyzes the structure, distribution techniques and constraints of fiscal transfer from federal to regions and from regions to local/woredas over the past eight years. Secondly, the study reviews the existing legal frame works on fiscal transfer and scrutinizes prevalence of contradiction, inconsistencies, inadequacy, and none clarity in existing laws, regulations, and working procedures. Lastly, the study compares and contrasts fiscal transfer in Ethiopia at sub national levels with international practice of Nigeria, Brazil, Canada, and Germany to draw valuable lessons on fiscal transfer at Ethiopia sub national level against existing theoretical frame work.

Organization of the Paper

The entire paper is organized in five chapters. The first chapter is introduction. Review of related literature, experience of selected countries in intergovernmental fiscal relation and an overview of fiscal federalism in Ethiopia are undertaken in chapter two. This is followed by research methodology in chapter three and chapter four presents intergovernmental fiscal transfer atsub-national governments in Ethiopia while chapter five concludes the paper and forward policy recommendation.

Literatures Review

- **Theoretical background of Intergovernmental Fiscal Transfers**

It is commonly argued that in most countries without exception, expenditure division is highly decentralized while its revenue counterpart is highly centralized based on the traditional Musgrave principles of financial resources sharing which result in mismatch between revenue resources and functions at lower level government which leads to vertical fiscal imbalance on sub national government. And again due to difference in distribution of economic resources or due to particular tax assignment like assigning geographically concentrated natural resource taxes to local government, there would be horizontal fiscal imbalance or fiscal disparities among the same level of government (Fjeldstad, 2000 and Bah l, 2001). Existence of fiscal imbalance (vertical and horizontal) raises the issue of designing fiscal transfer among different levels of government to counteract it. Authors like Bah l(2001) argued that intergovernmental fiscal transfer design raises the question of how to design the grant pool or the total amount of transfer which aimed to reduce vertical fiscal imbalance and how to distribute the aggregate or total grant to lower level of government which aimed to offset the horizontal fiscal imbalance among different level of government. The subsequent section would briefly present how to design intergovernmental fiscal transfers or how to design the aggregate pool and techniques employed to distribute it to lower level of government.

As mentioned above, a transfer system is designed based on vertical and horizontal dimensions of imbalance. A vertical dimension of transfer aimed at designing the total amount or the aggregate amount to be distributed where as the horizontal dimension of transfer seek techniques to be employed to allocate the aggregate or total amount to the respective recipient government unit and this section would illustrate both transfer design one by one as follow.

- **Designing the Grant Pool/the Total Amount to Be Transferred/Subsidy**

According to Bahl (2001) the aggregate amount or the total grant which aimed to counteract the problem of vertical imbalance can be designed on systems such as tax sharing, ad hoc approach and cost reimbursement approach.

- **Tax Sharing**: As one approach in designing the aggregate pool, the federal government allocate some fixed percentage of specified tax to lower level of government to be shared and this mechanisms is widely practiced in developing and transition countries like Russia, China, India, Colombia, Mexico and Brazil. As to the type of tax to be shared and the percentage of sharing, there is no agreed conventional pattern to be prescribed for all countries and different countries share different type of tax on ad hoc basis. For example, China and Russia share VAT using different percentage while India share excise tax, and Nigeria share natural resource tax on different percent (Fjeldstad, 2000).
- **Ad hoc Based Design**: This is the second approach of designing the aggregate amount to be transferred and it is made based on the discretionary power of central government on annual bases. Each year the legislative or the president decides the total amount to be transferred. The approach has been criticized for none transparency, uncertainty it impose on sub national government on planning, and has discouraging effect from sub national government perspective. Despite of its draw backs, it is widely used in developing countries (Bah l, 2001).
- **Cost Reimbursement Approach**: It is the third method employed to design the grant pool and in this case, the federal government specifically identify the services for which it cover the cost incurred by sub national government. In many instances the cost to be covered by central government is conditional and only up to some maximum amount beyond which the local government is responsible to cover. Cost reimbursement is argued to be essential in that it direct local government spending to priority area of central government and it also ensure uniformity of the services standards across the country but it is criticized for negatively affecting local choice, innovation, and imposing administrative and compliance cost on lower level government which perform huge reporting activities and it is widely used in many countries (Fjeldstad, 2000 and Bah l, 2001). To sum up, from different types of designing the grant pool, most of the time it is contended that, tax sharing provide transparency, certainty and less subject to political manipulation.

- **Design How to Distribute the Revenue/ Grant Pool to Sub National Government**

Bah l(2001) argued that the second dimension of intergovernmental transfer design is identifying the techniques employed to distribute/allocate the total revenue pool to respective recipient sub national government which aimed to offset the problem of horizontal fiscal imbalance. The author further explained that different approaches such as derivation, grant formula, ad hoc and cost reimbursement methods are employed to distribute the revenue pool to the recipient government units which have its own advantage and draw backs.

- **Derivation Method**: Fjeldstad (2000) suggest that derivation is based on the percentage of shared tax in determining the grant pool and every lower level government unit entitled to receive a specific percentage of shared tax as collected in their jurisdiction. For instance 25 percent of national collection of VAT in Russia is allocated to lower level government and this allocation is made based on the amount collected in the jurisdiction of sub national government. The author further argued that sub national government has no any power and authority to control it and it is the most common way of sharing revenue and it is widely used in developing and transition countries. The method is criticized for not equalizing, not stimulating adequate tax effort, and limiting local autonomy of local government.
- **Formula Method**: According to Bahl(2001) formula based transfer uses some quantitative criteria to distribute the revenue pool to sub national government and it intended to achieve transparency and certainty of the revenue to be distributed. The author further argued that there are three critical issues to be considered in employing formula grant such as the elements to be included in the formula; data used to implement the grant formula; and administrative consideration of the grant formula.

The basic and fundamental issue in the utilization of formula to distribute the transfer to sub national government is the element to be included in the formula. Grant formula is contended to reflect four important elements that includes regional difference in expenditure needs; improve fiscal capacity equalization; enhance tax effort; and help to balance the mismatch between revenue raising capacity and expenditure needs.

Consideration of regional difference in expenditure needs is one of the basic elements to be included in the grant formula. Different countries use indicators like population, physical factors such as land area and population density, percentage of school aged children, infrastructural coverage and percentage of safe drinking water coverage identify the local difference in expenditure needs and those lower level government which have more expenditure needs can get more revenue from central government(Bahl, 2001). The elements to be included in the formula should also reflect fiscal capacity equalization issues to be fair and transparent. It is argued that during grant formula design, the designers should consider the revenue raising capacity of sub national government and provide more transfer to those local governments which are low revenue generating capacity or weak revenue potential to reduce horizontal disparity due to uneven distribution of economic resources. The element of the formula is also required to consider the tax effort of local government. This element is required to enhance the revenue mobilization effort of sub national government. It is widely assumed that inclusion of revenue raising effort in the formula gives some incentives to sub national government to increase their revenue generation. Lastly, formula grant should consider or reflect the mismatch between revenue raising capacity and expenditure needs of lower level government and try to balance the existing mismatch accordingly. "Some countries like Korea define a standard level of expenditures according to a formula based on physical indicators of desired levels of service. This is related to a "normal level'' of revenue mobilization based on the size of the tax base'' and provides the difference as grant to sub national government. Bah l(2001) argued that utilization of formula grant to distribute the transfer can ensure transparency and certainty but it is criticized for the type and quality of data it used in implementing the system and for administrative difficulty it bear for developing and transition countries. The critics on the data includes none availability of data, none timeliness of available data, geographical limitation of some data and none reliability of available data which may impact the fairness and certainty of the transfer system. Formula grant is also criticized for its administrative difficulty such as costly maintenance of required data, updating it annually, manipulation in its utilization, monitoring periodically and the problems of litigation.

Another mechanism to distribute the revenue pool is cost reimbursement and ad hoc method. In case of cost reimbursement, the federal government agrees with lower level government to reimburse all or some portion of cost incurred by sub national government on specified services. As it is happened

most of the time, some condition is tied with cost reimbursement method and it is essential in directing the service provision to national priority areas and enable national government to standardize the priority services across the country. Ad hoc method of revenue pool distribution is based on the discretionary power of the federal government where the legislative or the president decides on how the total amount of transfer is to be allocated to each sub national government.

Review of International Experience on Fiscal Transfer Design

This section examines the international experience of some selected countries such as federal republic of Germany, Canadian federation, federative republic of Brazil and federal republic of Nigeria on fiscal transfer design among central, regional and local government levels to draw some valuable lesson which can improve fiscal federalism in Ethiopia.

- **Intergovernmental Fiscal Transfer in Federative Republic of Brazil**

As per article 18 of the 1988 constitution of the federative republic of Brazil, the political and administrative organization of the country is divided in to the union/central, the states and local government/municipalities. Thus, Brazil is divided in to the central government, twenty seven states (including federal district), and five thousand and five hundred fifty nine (5559) municipal or local governments. The constitution provides system of fiscal transfer to close vertical and horizontal fiscal imbalance which would be briefly presented in the following paragraphs.

As is true for other countries federations, revenue and expenditure decentralization in Brazil federative is also result in vertical and horizontal fiscal imbalance. To counteract with this imbalance, the government institute intergovernmental fiscal transfer among federal, states, and local government. There are two types of intergovernmental fiscal transfer in Brazil. These are revenue sharing and specific purpose transfer among federal, states, and municipal government which aimed to offset vertical and horizontal fiscal imbalance.

- **Revenue Sharing in Brazilian Federative**

Revenue sharing which is focused to counteract the vertical fiscal imbalance in the country, allocate funds to grant/subsidy pool at federal and regional level which is to be distributed among sub national government based on some formula.

The constitution of the country established states participation fund in which the federal government allocate the grant pool which later on would be distributed among the states. Accordingly, 21.5% of federal income tax and 21.5% of federal industrial product tax is allocated to states participation fund. These two revenue sources are shared between federal and states. As to the distribution of allocated revenue pool among the state, there are constitutional guidelines which prescribe some critical rules. Accordingly, by considering interstates disparities, the guidelines first set aside 85% of the shared revenues to the poorest states while the rest set aside for the rich states. Following this allocation, the distribution of the fund among the states is based on such formula indicators as population, per capital income, revenue effort and land areas and this aimed to offset horizontal fiscal imbalance.

Similarly, the constitution established municipal participation funds in which the federal government shares federally collected taxes with municipal government to close vertical fiscal imbalance at local levels. Thus, 22.5% of federally owned income tax and 22.5% of federally owned industrial product tax are allocated to this fund for latter distribution among local/municipal government. From municipal participation fund, 12% is allocated to states capital and municipalities that have population number greater than 400000 where as 6% of the fund allocated for large municipalities and the rest (82%) distributed among the municipal government based on such indicators as population and per capital income. Municipal government also constitutionally entitled to receive some revenue which are owned and collected by federal government from each municipal jurisdiction in addition to municipal participation fund. Accordingly, 50% of rural property tax in proportion to real states property value located in their jurisdiction, 100% of payroll tax of municipal employees, 70% of gold tax originated in each jurisdiction, 50%of hydroelectricity and mineral tax by sales values of the mineral originated in each jurisdiction, and 2.3% of revenue from cured oil on the basis of their production value are constitutionally allocated to municipal government.

Brazilian constitution also mandates states-municipal revenue sharing which constitutes revenue sharing at sub national government between the states and local governments. Thus,

25% of value added tax of states collection, 50% of motor vehicle registration tax of states competence, and 25% of industrial product tax of federal transfer to states (pass through revenue) are allocated to municipal government. The distribution of these revenues among local revenue is based on their origination in each municipal jurisdiction.

- **Specific Purpose Transfer in Brazilian Federative**

There are various types of none constitutional specific purpose transfer in Brazil which are pumped from federal government to states and local government and also from states to local governments for capital projects, regional development, health, education, agriculture, and housing.

- **Intergovernmental Fiscal Transfer in Canadian Federation**

Canadian federation is composed of three territories and ten provinces and is governed by three orders of governments namely the federal, the provinces and local governments. The divisions of power between federal and provincial governments are constitutional where as the power of local governments are not but it is delegated by exclusive discretion of the provincial governments. Canadian constitutional act of 1982 provides different functions and revenue raising power to the federal and provincial government. There is also instituted fiscal transfer system which would be briefly presented as follows.

As it is true for all other federation, in Canada also there is vertical and horizontal fiscal imbalance despite difference in the degree of those imbalance. Some authors like Boadway and Watts(2004) argued that due to high revenue decentralization in Canadian federation, the issues of vertical fiscal imbalance is not serious problem in the country. They further argued that the main problem of Canadian federation is the prevalence of widened horizontal fiscal imbalance.

Intergovernmental fiscal transfer in Canada is constitutional in nature as article 36(2) provide and it says the federal government make "equalization payment to ensure that provincial government have sufficient revenue to provide reasonably comparable levels of public services at reasonably comparable levels of taxation" and the country make two main type of fiscal transfer to provincial government such as equalization transfer and Canadian health and social transfer.

- **Canadian Health and Social Transfers (CHST):** Canadian health and social transfer is focused mainly to close vertical fiscal imbalance in the area of health, education, and social insurance. It composed of tax transfer and cash transfer parts. Tax transfer component is where federal government required to allocate annually 13.5% of federally owned and collected personal income tax and 1% of corporate income tax to CHST program to be distributed to provincial governments but in case of cash transfer component, the federal government decided based on its own discretion the amount of cash to be allocated as part of CHST each year and currently the federal government annually allocate $21 billion dollar in cash to be included as CHST component. Revenue pool allocated to CHST fund concern with closing the vertical balance and the second stages which aimed to horizontal balance is distribution of the CHST to each provincial government. Canadian health and social transfer, which is a conditional transfer, in principle distributed to all provinces based on a formula of an equal per capital value available to all provinces. It has no elaborate equalization formula based on different indicators.
- **Equalization Transfer:** Equalization transfer is the second type of intergovernmental transfer in Canada. It specifically aimed to close horizontal fiscal imbalance among different provinces and it is established to compensate poor provinces that have revenue generating capacities less than minimal national standards. This clearly indicates that equalization grant is not available for all but only to those provinces that have tax capacities below a national standard. Boadway(2003) describes the procedure to be followed to determine the amount of equalization transfer as follow.

To arrive at the amount of equalization grant, a common national tax base which is the representative of actual tax base at provincial levels is defined and a national average tax rates on each base is calculated as the ratio of total provincial revenues to aggregate of the base over all ten provinces. A province's per capital equalization entitlements for a given revenue sources is then calculated by multiplying the national average tax rate by differences between the per capital average tax base across five standard provinces and the province's own per capital tax base. These entitlements are then summed over 33 revenue sources to give the province's total per capital equalization entitlements. For those province's eligible for transfer, the transfer is made from the federal government's general revenues in an amount equal to the total per capital entitlement times province's total population.

- **Intergovernmental Fiscal Transfer in Federal Republic of Germany**

The administrative structure of the federal republic of Germany is composed of the federal, sixteen (16) Lander (state), and 11500 local governments. As per version 2010 of the basic law of federal republic of Germany, the division of legislative power includes exclusive federal, joint power of federal and the Lander (state), and the residual power of the Lander or the states. In terms of division of power related with fiscal federalism, the Germany case is unique in that all legislative power of defining tax base and setting the rate is exclusively belongs to the federal government while the administration of both federal and the Lander law is belongs to the Lander government but the revenue raising and expenditure power are concurrent power of the federal and the Lander government. In general, the basic law of Germany prescribes the assignment of expenditure and revenue to all the three administrative structure of the government and instituted the system of intergovernmental fiscal transfer among the federation as it would be briefly presented as follows.

As it is true for virtually all other federation, there is also vertical and horizontal fiscal imbalance in Germany. As it is mentioned earlier, the Lander or state government have residual constitutional responsibilities and responsible for administration of both federal and the Lander laws in addition to its own exclusive and joint responsibilities while the revenue side is highly centralized as mentioned above which leads to vertical fiscal imbalance. Due to difference in economic resources and difference in revenue raising capacities among the Landers and local government, there is also horizontal fiscal imbalance in the country. To counteract wider vertical and horizontal fiscal imbalance, the basic law of federal republic of Germany instituted comprehensive system of intergovernmental fiscal transfer. Fiscal transfer in Germany federation targeted to close both vertical and horizontal imbalance. Basically, fiscal transfer in Germany is divided in to conditional and none conditional fiscal transfer both of which are constitutional in nature. Conditional fiscal transfer is basically targeted to close vertical fiscal imbalance and it is aimed to finance projects related with joint expenditure responsibilities of the federal and the Lander government and the federal government is responsible to finance 50 percent in some projects and at least fifty percent in some others to achieve uniformity in all the Lander government.

Most of none conditional fiscal transfer is aimed to close horizontal fiscal imbalance in the nation and it is made under consecutive four stages which would be presented as follows.

- **Stage 1: Revenue Sharing**: At this stage, joint revenue sources such as personal income tax, corporate income tax and value added taxes are share among the federal, the Lander and the local government based on some division rules. Accordingly, from personal income tax, 42.5 percent to federal , 42.5 percent to the Landers and 15 percent is the share of local government where as the corporate income tax is divided between federal and the Lander 50 percent each.
- **Stage 2: VAT Distribution to the Landers**: At the second stages, 75% of the state's share of value added tax revenue is distributed on an equal per capital basis across the state or the Lander government. The second stage ensures, all Landers or states receive at least 92 percent of average per capital revenue.
- **Stage 3: Horizontal or Interstates Equalization Transfer:** At third stages, there is a system of financial transfer from financially strong Lander/states to financially weak states. Financially strong Landers are those which have per capital revenue above average standards of all state while financially weak states are those which have per capital revenue below average. Thus, those which have financial capacity above average are constitutionally forced to transfer to financially weak states from all of their revenue sources (own revenue, shared revenue and VAT receipt). This stage ensures that all Lander government including its local government receives at least 95% of average per capital revenues.
- **Stage 4: Supplementary Transfer from Federal Government**: At this stage, federal government is constitutionally required to transfer 25 percent of the remaining VAT revenue to those Landers/states whose revenue after stage 1-3 are still fall below the interstate/inter Lander average. This transfer ensures all Lander government receives at least 99.5 percent of average per capital revenue.
- **Intergovernmental Fiscal Transfer in Federal Republic of Nigeria**

Nigeria follows the federal government structure. The Nigerian constitution of 1999 allows the existence of the federating units and recognizes three levels of government namely federal, the states, and local. Currently, there are one federal government territory, thirty six states, and seven hundred and seventy four local governments in Nigeria. The constitution details the division of expenditure functions and areas of fiscal autonomy for each levels of government and again the constitution established the

system of intergovernmental fiscal transfer to close vertical and horizontal fiscal imbalance which would be briefly described as follows.

As it is mentioned under revenue assignment in Nigeria, the amount of revenue collected by states and local government together is only less than 7%. As opposite to this, most of the expenditure responsibilities are pushed to the states and local government. The idea of Ekpo (2010) support this argument. The author argued that fiscal federalism in Nigeria is featured by high concentration of revenue power at the hand of federal government and there is imbalance between assigned responsibilities and sources of finance at sub national level and the author further argued that "the federal government is the surplus unit while the states and local government is the deficit units." The argument clearly showed there is severe vertical fiscal imbalance in Nigeria. Due to availability of uneven distribution in economic resources like petroleum and difference in expenditure needs among states and local government, there is high horizontal fiscal imbalance. To close or minimize the existing fiscal imbalance, the constitution of federal republic of Nigeria instituted the systems of fiscal transfer from the federal government to states and local governments. Intergovernmental fiscal transfer in Nigeria targeted on both vertical and horizontal imbalance.

Transfers Targeted on Vertical Fiscal Imbalance

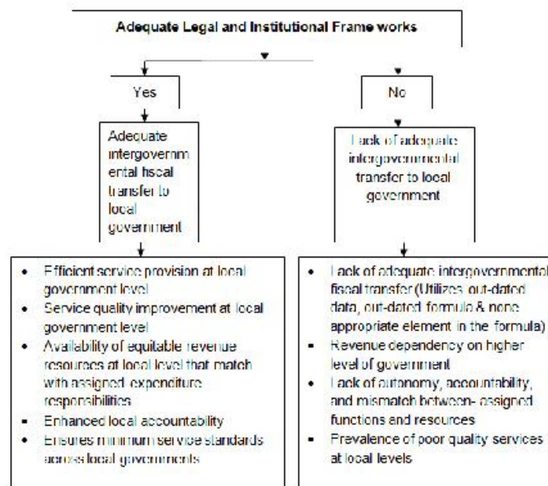
To close vertical fiscal imbalance in the country, there are two constitutionally mandated systems. The first of this system is constitutional establishment of the federation account by federal government. Federal government is constitutionally required to establish the federation account and paid some federally collected taxes such as custom duties, excise duties, mining and royalty, petroleum profit tax, and company taxes in to this account which later on distributed among the federal, states and local government. All proceeds from these taxes are allocated to federation account and the total revenue of the account is divided among federal, states and local governments based on some proportion. Currently, the federation account is divided as 52.68%, 26.72%, and 20.60% for federal, states, and local government respectively. The second system instituted to close the vertical imbalance is allocation of VAT proceeds among the three levels of government. VAT revenue is shared tax and the total revenue collected from this source is divided as 40%, 35%, and 25% for federal, states and local governments respectively. After vertical fiscal balance is achieved by these systems, the issue of horizontal balance arise which intended to distribute vertically allocated revenue among states and local governments.

Transfers Targeted on Horizontal Fiscal Imbalance

Horizontal distribution of vertically allocated revenue is based on some indicators with different weights attached to it. Currently, the existing indicators are minimum expenditure responsibilities or equality, population, social development indicators (like primary school enrolment, health, education, and water), development factors, land mass and internal revenue generation effort. Accordingly, the weight attached is equality or minimum expenditure responsibility 40%, population 30%, development factor 10%, land mass 10%, and internal revenue effort is 10%.

Conceptual Frame Works ofthe Study

Fig. 1



The study argued that the state of intergovernmental fiscal transfer at sub-national level in Ethiopia is depends on status of existing legal frame works (independent variable) which govern intergovernmental fiscal transfer (dependent variable which depends on legal frame works). The legal frame works are constitution, laws, regulations, directives and procedures which are placed to design intergovernmental fiscal transfer to sub-national level.

Existence of adequate legal and institutional frame works in Ethiopia would result in availability of appropriate intergovernmental transfer to sub-national level to bridge mismatch between assigned revenue and expenditure at local level. The commutative and overall effect of appropriate intergovernmental fiscal transfer would be: efficiency in local service provision in accordance to local needs and preferences of local communities; autonomous local government which freely plan and operationalize local services in accordance with local priority; ensure availability of equitable local financial resources which match with expenditure responsibility of local government; and ensures local accountability to local communities through local election and periodic performance monitoring and evaluation by locally elected councils as well as direct participation of local residents which ensures provision of quality services by local authority.

Absence of adequate legal and institutional frame works result in the reverse which means prevalence of inefficiencies, lack of autonomy at local government levels; severe vertical and horizontal fiscal imbalance; low level of accountability, and overall poor quality services at sub-national levels.

Research Methodology

This section deals with different procedures and techniques required to answer the major study questions. It consists of research design, population and sample design, data type and its sources, data collection techniques/instruments, and method of data analysis employed

- **Research Design**

In this paper, the study employed descriptive research design. The study adequately analyzes the design, trends, performance and constraints of fiscal transfer at federal and regional levels. It also examines the consistence and inconsistencies of fiscal transfer in Ethiopia against international practices and conceptual frame work.

- **Population and Sample Design**

The study focussed on fiscal transfer from federal to regions and two city administrations and from regions to local governments mainly by focussing on local governments in oromia regions. In Oromia regional state, there is three hundred four (304) local governments from which two hundred sixty five (265) are rural while thirty nine (39) are town administration. The defined population for the study is ministry of finance and economic development, Oromia bureau of finance and economic development and all urban and rural/district (304) local governments in the region. The data is collected from ministry of finance and economic development and regional bureau of finance and economic development.

- **Data Type and Its Sources**

The study employed secondary data. All secondary data on trends, performance and constraints of fiscal transfer is collected from MOFED, BOFED and some selected local governments. Different documents such as federal & regional constitution and related laws, regulations, directives; related with fiscal transfer from federal to regions and from region to local governments are used to collect secondary data. To supplement the study with international practices, experiences of selected countries on intergovernmental fiscal transfer are collected from secondary sources such as Internet.

- **Data Collection Instruments**

The study employed desk study as an instrument for data collection. Document review is employed to collect secondary data from federal, regions and local governments. Different documents such as national and regional constitution, laws, regulations, annual budget proclamation, directives, manuals and annual reports which are related withintergovernmental fiscal transfer is thoroughly reviewed and analyzed to clearly identify the design and practices of fiscal transfer at federal and regional level; and the trends, performance, and constraints of fiscal transfer. Desk study is also employed to examine international practices in fiscal transfer in federal republic of Nigeria, federal republic of Germany, Canadian federation, and federative republic of Brazil from Internet sources.

- **Method of Data Analysis**

The study adequately investigate the structure of total grant pool determination at federal and regional level, elements included in the formula to distribute transfer to regions and local governments and compare and contrast it with the experience of federal republic of Nigeria, federal republic of Germany, Canadian federation, and federative republic of Brazil to draw valuable lessons.The study also compares and contrasts intergovernmental fiscal transfer practice in Ethiopia with theoretical framework to evaluate alignment and deviation between the two. Analyze subsidy performance through calculating the proportion of expenditure financed by own source revenues and federal or regional subsidy and also examine and analyze subsidy structure or how to determine the total subsidy pool at federal and regional level and how this is distributed to recipient sub national governments.

Intergovernmental Fiscal Transfer in Ethiopia

- **Introduction**

In any country of the world, the mismatch between means of finance and expenditure needs is common even if its degree may vary across the nations of the world. Some degree of mismatch between revenue and expenditure assignment is acceptable from theoretical frame works and economic principles perspectives. For efficiency and effectiveness purpose, some types of tax require central administration and this by itself create certain level of vertical fiscal imbalance. Due to difference in economic resources among sub national governments, horizontal fiscal imbalance is also common in any federation. Due to these reasons, intergovernmental fiscal transfer is required to fill such kinds of fiscal imbalance at lower level of governments. This section deals with this issue in the context of Ethiopia on such topics as vertical and horizontal fiscal imbalance; legal frame works for intergovernmental fiscal transfer; and intergovernmental fiscal transfer in practice in Ethiopia and comparative evaluation of intergovernmental fiscal transfer in Ethiopia with theoretical frameworks and international experiences as follows.

- **Vertical and Horizontal Fiscal Imbalance in Ethiopia**
  - **Vertical Fiscal Imbalance in Ethiopia**

As mentioned earlier, vertical fiscal imbalance is arises from none correspondence between assigned revenue and expenditure at state and local government levels. The mismatch between revenue means and expenditure needs mainly arise from such sources as limitation of legal frame works for revenue and expenditure assignment; weak revenue administration capacity of states and local governments; low tax collection effort and low level of tax compliance in Ethiopia. Expenditure and revenue decentralization in Ethiopia has resulted in wide gap between functional responsibilities and means of finance in Ethiopia. States and local governments'in Ethiopia together cover over 45% of national expenditure while this level of government together owned and collects only 18% of national or general government revenue during the same period. This is a crucial indicator of none correspondence between revenue and expenditure assignment in the nation. To create more understanding on this issue, it is important to examine the level of coefficient of vertical fiscal imbalance at states and local government in Ethiopia as follows.

Table 10: Coefficient of vertical fiscal imbalance of states and local governments in Ethiopia in '000,000' Br (1998-2002 E.C)

Particulars/years	1998	1999	2000	2001	2002	Average
Aggregate regions revenue(R)	3220.9	4384	5787.4	8250.70	8964	6121.40
Aggregate national revenue(R’)	18354	21314	30982	40646	53736	33006.40
R/R’	0.18	0.21	0.19	0.20	0.17	0.19
Aggregate regions expenditure(E)	12682	14639	21978	25111	27795	20441
Aggregate national expenditure(E’)	29656	34073	45138	50094	66857	45163.60
E/E’	0.43	0.43	0.49	0.50	0.42	0.42
(R/R’)/(E/E’)	0.41	0.48	0.38	0.40	0.40	0.42
1-(R/R’)/(E/E’)	0.59	0.52	0.62	0.60	0.60	0.58

Source: Researcher Computation from MOFED data

As it is evident from this table, the average aggregate coefficient of vertical fiscal imbalance for Ethiopia regions together is nearly 60% during this period. This is an aggregate figure but individual regional analysis tells different history of fiscal imbalance. Average vertical fiscal imbalance for Somale, Gambela, Afar, and BenishangulGumuz regions is ranges from 87.09-90.80% while for SNNPR, Amhara,

Oromia it ranges from 80.53-82.49% during 1998-2002 E.C. For Harari, Diredawa, and Tigray regions vertical fiscal imbalance ranges from 70.42-77.80% while for Addis Ababa city administration it is 24.66% during the same period. The average vertical fiscal imbalance for regions and city administration is 76.78%.

Vertical fiscal imbalance of Oromia region is about 75% where as the aggregate fiscal imbalance at local level within the region is about 70%. This means the mismatch between revenue and expenditure in Oromia region as a whole is around 75% and the state covers only 25% of its expenditure. The local governments within this region as a whole cover 30% of its expenditure from revenue collected within their jurisdiction while 70% of its expenditure is covered by the region. This is an aggregate vertical imbalance of local governments in the region but individual vertical fiscal imbalance among urban local governments ranges from 74% of revenue deficit Awaday town of east Hararghe Zone to 399% revenue surplus of Sabata town in special zone surrounding Addis Ababa. The average vertical fiscal imbalance among urban localities is only 7%. The situation among rural local government is the worst and the vertical fiscal imbalance ranges from 94.1% of revenue deficit kumbworeda in east Hararghe Zone to 17% revenue surplus of Adeaworeda in east Shoa Zone and the average vertical fiscal imbalance among rural locality is 82.24%. This discussion indicates vertical fiscal imbalance in Ethiopia is very severe and varied especially in Ethiopia local governments.

- **Horizontal Fiscal Imbalance in Ethiopia**

Horizontal fiscal imbalance arises either from revenue or expenditure side or both. Expenditure needs varies across different sub national governments as needs for health, education, infrastructure and others may not be the same. Similarly, the revenue raising capacity of sub national governments are different due to difference in economic and business activities and difference in natural resource endowment of different jurisdiction at the same level. Horizontal fiscal imbalance also exists in Ethiopia as the expenditure needs and revenue raising capacity of regions and local governments is varied and different. The variation in population among regions ranges from 183,415 people in Harari region with estimated area of 311.25 square kilometres to over 27 million of people with an estimated land area of 284, 538 square kilometres of Oromia region according to 2007 census. The variation in expenditure per capital ranges from 268 birr in Oromia region to 1,586 birr in Addis Ababa city administration in 2002 E.C. The variation in revenue per capital is also immense and it ranges from 43.5 birr in Somale region to 1,385 birr in Addis Abeba city administration in the same year. In terms of ability to cover its expenditure from own source revenue, the variation is very severe and it ranges from 9.39% in Afar region to 87.4% in Addis Ababa city administration in the same year.

The situation at Ethiopia local governments in Oromia region is more severe than variation among Ethiopia regions interims of area land mass, population, expenditure needs, and revenue generation capacity among different localities. The variation in urban and rural district population ranges from 8,224 people in Sululta town of Oromia special zone to 338,457 people in Dedo rural district of Jima zone in 2005 E.C according to Ethiopia central statistics agency projection. The variation among urban localities in public spending ranges from 13,482,682.70 birr in Sandafa town to 81,268,579.90 birr in Adama city administration in the same year. The variation in revenue generation capability among urban local governments ranges from 7,184,727.87 birr in Dadar town to 300,699,493.95 birr in Adama city administration and the ability to cover its expenditure by its own revenue sources ranges from 26% in Awaday town to 499% in Sabata town in 2005 E.C. The public spending variation among rural local governments ranges from 18,361,695.10 birr in Kumbi district to 56,957,418.40 birr in Arsinegelle district in the same period. In the same year, the revenue generation capacity of rural locality ranges from 1,083,321.82 birr in Kumbi district/woreda to 49,872,605.66 birr in Adeadistrict/woreda and the ability to cover its expenditure by revenue collected within its jurisdiction ranges from 5.9% in Kumbidistrict/woreda to 117% in Adeadistrict/woreda in the same year. The above discussions clearly showed, vertical and horizontal fiscal imbalance at state and local governments in Ethiopia is very severe and wide and to fill or reduce it, appropriate legal frame works is required and this is the point of discussion in the next section.

- **Legal Frame Works for Intergovernmental Fiscal Transfer in Ethiopia**

The legal base for intergovernmental fiscal transfer in Ethiopia is the FDRE constitution. Article 94 and sub article 2 of the constitution says "the federal government may grant emergency, rehabilitation and development assistance and loans to the states and have the power to audit and inspect the proportionate development of the states." The quoted sentence has two main implications. First,

intergovernmental fiscal transfer in Ethiopia is constitutional and it is given to finance emergency, rehabilitation and development purposes in each region. Second, the constitution gives the federal government to ensure equal development of states. Thus, intergovernmental fiscal transfer is required to ensure equal or proportionate development of the regions. This constitution kept silent about the financial assistance to be given to urban and rural local governments in Ethiopia. Financial assistance to be given to urban and rural local governments is not stipulated in regional constitution too but proclamation No 65/2003 E.C of urban local governments in Oromia region entitled urban cities within the region to have a defined portion of revenue collected within its jurisdiction.

In comparing with other nations constitution such as Nigerian, Brazil, and Germany, Ethiopia legal frame works for intergovernmental fiscal transfer have two limitations. One of these limitations is related with absence of provision in federal and regional constitution which entitles grant or subsidies to local governments in nation from federally collected revenue sources or a defined portion from state collection which is true in afore mentioned nations' constitution. The second limitation is absence of provision either in constitution or other laws which regulate systems to fill vertical and horizontal fiscal imbalance at sub national levels. For example, the Nigerian constitution established the federation account to counteract vertical fiscal imbalance where the federal government is obliged to allocate a specified portion of some taxes to determine the aggregate subsidies to be distributed among federal, regional and local governments. The Brazilian constitution has also established state participation fund and municipal participation fund to counteract vertical fiscal imbalance where the federal government is obliged to allocate defined portion of proceeds from some specified taxes to determine the aggregate subsidies to be distributed among states. The Canadian constitution has also established Canadian health and social transfer mechanisms to counteract the problem of vertical fiscal imbalance and this too is constitutional. These countries constitution has also clearly established the systems or techniques to distribute aggregate subsidies among states and local governments which aimed to counteract horizontal fiscal imbalance and this is also constitutional. This discussion precisely indicates, legal frame works for intergovernmental fiscal transfer in Ethiopia has basic and fundamental limitation which denies financial assistance to local governments in the nation.

- **Intergovernmental Fiscal Transfer inEthiopia in Practice**

This section deals with Ethiopia practice in intergovernmental fiscal transfer at federal and regional level.

Theoretical frame works indicate existence of vertical and horizontal fiscal imbalance in any nation and prescribes some techniques to fill or reduce both of them. For example, to fill or reduce vertical fiscal imbalance; tax sharing, ad hoc and cost reimbursement methods are the existing options and mostly tax sharing is used by different countries of the world. The methods employed to fill or reduce vertical fiscal imbalance enable to accumulate adequate funds in a pool for later distribution among each tiers of government. It aimed to determine what to be divided among different levels but not how to distribute a given amount of funds among different levels of governments. Establishment of some mechanisms to distribute the aggregate or total subsidies among similarly situated government levels which aimed to correct horizontal fiscal imbalance is the second and crucial point in intergovernmental fiscal transfer. Mostly, this is made based on two different mechanisms such as derivation approach and formulas method. The essential point to be considered is each mechanism to fill or reduce vertical and horizontal fiscal imbalance is separate and has its own unique aim. To establish a healthy and appropriate intergovernmental fiscal transfer, the instituted systems should aim to counteract both vertical and horizontal fiscal imbalance.

The federal government of Ethiopia uses ad hoc method to determine the aggregate subsidy at national level to counteract vertical fiscal imbalance. Each year, the ministry of finance and economic development of Ethiopia in collaboration with Prime Minister Office determine the total amount of subsidies to be given to regions based on two steps. First, the total amount of recurrent and capital expenditure for federal government and available financial resource is estimated from internal revenue, assistance and loan. Second, federal government recurrent and capital expenditure is deducted from total available financial resources and the remaining would be the subsidy share for regional governments. The grant is block and unconditional in nature.

In comparing with other method such as tax sharing, determination of aggregate subsidy based on ad hoc method has two main limitations. Primarily, the share of regional subsidy is determined based on the will of central government and it does not increase each year in proportionate level with revenue

growth of the nation which is true in tax sharing method. This in turn highly impacts nearly none existent sub national revenue autonomy since there is no state participation in determining the total subsidy. Secondly, the method is none transparent and subject to political manipulation; uncertain from sub national government point of view and undermines effective fiscal planning and budgeting and it also deny the linkage between expenditure responsibility and revenue requirement of sub national governments. As it mentioned above, there is severe and widened vertical fiscal imbalance in Ethiopia and the country does not instituted a suitable technique to reduce or eliminate it. So, vertical fiscal imbalance in Ethiopia seems the problematic issues in the future too.

The second dimension of intergovernmental fiscal transfer is placing suitable mechanism to correct horizontal fiscal imbalance among sub national governments which are situated at the same level. From existing options such as derivation approach, formula method, ad hoc and cost reimbursement method, currently Ethiopia is using the formula method to distribute the total subsidy among regional governments. To design appropriate and equitable formula, there are two most important considerations to be made which includes the elements of the formula and the types of grant. First, for the formula to be appropriate and fair, the elements to be included in the formula should reflect expenditure needs of the recipients. Expenditure needs indicators used by different countries includes total population; physical factors such as land areas and population density that can increase service provision cost; variables which shows concentration of high cost population such as percent of school age children and indicators of infrastructure needs such as proportion of people accessed adequate water supply and percent of paved roads. Second, the formula element shall reflect fiscal capacity equalization variable where fiscally weak sub national governments are given more money than other. Third, the formula element shall include tax effort indicators in which those jurisdiction which generate more revenue are given more money relative to others in compensation and lastly, the formula element should reflect the balance between revenue generation capacity and expenditure needs of the recipients where the difference between expenditure needs and revenue generation capacity would be the total subsidy given to recipient governments.

The second important issues are the types of grant to be given. Theoretical frame works and international practice dictate provision of both block- unconditional grand and specific grant to sub national government to provide necessary revenue autonomy and to ensure minimum national service provision standards among sub national governments respectively. Theoretical frame works and international experience dictate inclusion of these four elements in formula to correct existing horizontal fiscal imbalance and also provision of block and specific grants to sub national governments.

Currently, Ethiopia is using the fourth or last option which is endorsed by House of federation on May 15, 2009 G.C following certain steps. First, the revenue capacity of each region is determined using some selected representative taxes such as employment income tax, business profit tax, agricultural income tax, rural land use fees, VAT, turn over tax and medical supply and treatment fees which accounts for 85-90% of average regional revenue for past five years. The second step is determining expenditure needs of states using selected sectors such as general administrative costs, health, education, clean water supply, agriculture and natural resources, micro and small scale enterprise development, rural road construction and maintenance and urban development works which accounted for more than 90% of average regional expenditure. In third step, fiscal gap is determined for each state by subtracting revenue capacity of each region from their estimated expenditure needs. From calculated fiscal gap, only 50% of estimated expenditure needs are given to each state with some adjustment each year. Before applying this formula, 1% of the total subsidy is set aside for emerging regions such as BenishangulGumuz. Afar, Somale, and Gambela and the rest 99% is divided among the regions.

The current system to correct horizontal fiscal imbalance in Ethiopia seems very helpful for emerging regions and for those with least revenue potentials but carry some limitations. The first limitation is related with determining representative tax for each region and its ability to represent the revenue raising capacity of each region. The second limitation is finding appropriate data on actual revenue collection from these sources to determine its potentials in each region. Third, provision of only 50% of estimated expenditure gap by federal government to regions. The first and second limitation hinders determining revenue potential of each region and may overstate or understate revenue raising capacity of the regions. Even if actual expenditure needs for each region is accurately determined which is very difficult in practice, provision of only 50% of estimated expenditure gap by federal government hider the strive for narrowing or correcting horizontal fiscal imbalance in the country. The system is very

helpful for emerging and weak revenue potential regions but seems undermine revenue effort of relatively richer regions. In general, the instituted systems to correct horizontal fiscal imbalance have the nature and approach to correct the same but due to afore mentioned limitations, its practical ability to do so is questionable.

At regional level, specifically in Oromia region, the practice of determining the total or aggregate subsidy to be given for local governments in the region follows ad hoc method which is similar with the federal government. There is also no local government delegate participation here too. The difference is the proportion of budget given to local governments each year. Each year, executive body of the region set aside around 60% of regional revenue resources for local government subsidy. The average subsidy given to local governments in the region for past eight years is nearly 60% and this grant is block and unconditional in nature.

The allocation of this among local governments is made based on expenditure needs assessment called unit cost approach for recurrent expenditure. Unit cost is determined based on some expenditure needs indicators such as school age population, actual number of student enrolment, actual number of student to be served, actual number of teachers, and number of schools and class rooms in educational sector. In health sectors, expenditure needs indicators like number of health centres and health posts, health staff salary, and standard operational expenditure for health institution are applied to calculate recurrent expenditure. In water, micro and small scale enterprises, agricultural sectors as well as administrative and general services sectors, similar fashion is followed based on unit cost approach. The standardized cost for each expenditure variables is determined and total recurrent expenditure is calculated by multiplying the quantity with standardized cost. Determination for capital expenditure is made based on infrastructure deficit parameters of strategic sectors such as education, health, agriculture, water, micro and small scale enterprise and others and also estimation of the distance of each local government from the centre is taken in to consideration and allocates more capital expenditure for highly infrastructure deficit and distant local governments.

- **Intergovernmental Fiscal Transfer in Ethiopia, theoretical Frame Works and International Experiences: A Comparative Evaluation**

This sub section present the main economic rationale for intergovernmental fiscal transfers and the appropriate types of transfer for each economic rationale and provides over all evaluation on consistence or inconsistence of Ethiopia practice with these economic principles and existing international experience.

According to Boadway(1990), one of the basic economic reasons for intergovernmental fiscal transfer is existence of fiscal gap at sub national governments such as states and local governments due to mismatch between revenue and expenditure. Due to different reasons, expenditure responsibility of the states and local governments may be higher than their own revenue sources which create fiscal gap and enforce central government to institute the system of fiscal transfer to state and local governments in the nation. Boadway (1990) further argued, there are two main reasons for the occurrence of fiscal gap which includes none appropriate revenue and expenditure assignments and unproductive and limited tax base availability for sub national governments. These reasons create shortfall of revenue over expenditure, undermine revenue autonomy at sub national levels, and leads to fiscal dependency. One of the alternative and appropriate options to correct fiscal gap due to these reasons is unconditional block grant from federal to state and local government according to this author. Unconditional block grant improves available revenue sources for lower level of governments and gives them autonomy to allocate the funds based on local preference and priority which may help to improve quality of public services. But the appropriateness of the method employed to determine the aggregate subsidy and fairness of the method to distribute it among sub national government is still crucial.

The second justification for requirement of intergovernmental fiscal transfer is achievement of minimum services standards as a nation. The underlying assumption of this idea is that assignment of expenditure responsibility for some essential public services such as education and health to state and local government alone may result in under provision of these services in access and quality. So, to ensure common minimum national standards in access and quality for some services, federal government shall finance it through specific none matching grant/subsidy. Thus, theoretical frame works advocate the inclusion of both block and specific grant for the existence of appropriate and healthy intergovernmental fiscal transfer. Unconditional block grant improves sub national revenue autonomy while the specific none matching grant help to attain national minimum service standards.

Intergovernmental fiscal transfer in Ethiopia has some consistence and deviation from theoretical frame works. Its consistence and deviation is mainly judged based on the appropriateness of the methods the country employed to reduce or correct vertical and horizontal fiscal imbalance and the structure of its grant. The methods employed by the nation to reduce vertical fiscal imbalance is ad hoc which is none flexible, none transparent, uncertain and outdated in nature and employment of this method deviate from contemporary fiscal federalism literature prescription while the mechanism employed to correct horizontal fiscal imbalance is more or less consistent with prescription of theoretical frame works. Regarding the type and structure of the grant, provision of unconditional block grant by federal government or the states in which the states and local government can allocate based on its local needs, preference and priority without central government or state intervention is the basic consistence between the two while lack of sustained specific grants from federal to states and from states to local or from federal to local on some basic and essential public services is its basic deviation. The first deviation creates lack of proportionate subsidy growth with national revenue growth while the second deviation may create lack of common minimum national service provision standard on some basic services.

From international experience perspective, the experience of different countries like Nigeria, Germany, and Brazil seems consistent with theoretical argument. These countries and Ethiopia is aligned in the structure of federal grant or state grant except absence of specific grant in the later. These countries employed suitable method to reduce vertical fiscal imbalance such as tax sharing where federal government is obliged by the constitution to accumulate specific percentage of some specific taxes to some accounts and this is not true in Ethiopia. There is consistence between the methods employed by these countries and Ethiopia to correct horizontal fiscal imbalance with the exception of Germany where different stage is there to correct the same. Lack of legal base for local government subsidy in federal and regional constitution or regional related laws is the last inconsistence between Ethiopia and these countries. To conclude, intergovernmental fiscal transfer in Ethiopia has some consistence and deviation from theoretical frame works as well as international experience.

To sum up, there is severe and wide vertical and horizontal fiscal imbalance at states and local governments in Ethiopia due to such reasons as lack of adequate legal frame works for revenue and expenditure assignments; weak revenue administration capacity at local governments; low revenue collection effort at local level and low levels of tax compliance and the country does not instituted adequate legal frame works for intergovernmental fiscal transfer to reduce or correct the same. In comparison, the system established to correct horizontal fiscal imbalance have a nature and approach to correct the same given its limitation but careful and immediate action is required to act on vertical fiscal imbalance. Absence of specific grant which is required to ensure minimum national service provision standards on some basic services is another crucial limitation of intergovernmental fiscal transfer in Ethiopia.

Conclusion

This paper has examined legal and practical issues of intergovernmental fiscal transfer in Ethiopia in general and particularly its current performance at sub-national level under framework of Ethiopia's fiscal federalism. It is evident that fiscal decentralization in Ethiopia has resulted in severe vertical and horizontal fiscal imbalance at sub-national level in Ethiopia due difference in revenue generation capacity; assignment of unproductive and none buoyant revenue sources to sub-national governments; mismatch between revenue and expenditure decentralization; difference in expenditure needs; difference in economic and business activities and difference in natural resource endowment among sub-national government in Ethiopia. The nation does not place appropriate and adequate legal framework or system to close vertical and horizontal fiscal imbalance.These problems resulted in more fiscally dependent and none autonomous sub-national governments with severe vertical & horizontal fiscal imbalance in the nation. These limitations are systemic and fundamental in nature and if not properly and immediately addressed, would result in poor local service provision and weak citizen based local accountability and undermine healthy existence and sustainability of sub-national governments in the country.

Recommendation

At this juncture, it is most crucial to examine ways and means to strengthen Ethiopia local governments to enable them to appropriately carry out their widened and numerous functional responsibilities with which they are legally assigned. If local governments in the nation are to remain

fiscally healthy and sustainable, there should be positive political will and administrative commitment on the part of governments to urgently carry out the following recommended policy direction.

- Revise division of revenue; enforce legal & formal assignment; enforce constitutional legislative power of the states and local governments and also make sure that each assigned revenue sources are appropriate for each level of government. In revising revenue division, reassign such revenue sources as betting, gambling and lottery games to states and local governments and also expand new sources of revenue for local governments through research. Reassign none assigned power of taxation to different level of governments. Give legal and formal revenue assignment for rural local governments through proclamation or regulation or directives and make sure that such assignment is clear and precise. Enforce states constitutional power to set tax base and rate and also give such power to local governments too so that they can exercise it for its assigned revenue sources.
- Redesign intergovernmental fiscal transfer:Emphasis should be given to three areas in redesigning intergovernmental fiscal transfer. First, utilization of ad hoc method to determine the aggregate or total subsidy to minimize vertical fiscal imbalance should be abolished and instead most commonly used tax sharing method should be instituted. Tax sharing method should be made based on the amount of tax collected within each states and local governments on specified tax revenue at national level. Second, to correct horizontal fiscal imbalance, either increase the level of expenditure gap which is covered by federal government (currently only 50%) or gives adequate weight for revenue effort performance in the formula at national level. Third, introduce legal and sustained specific none matching grant at federal and or states level to finance very essential services such as health, education, drinking water supply, roads or other important areas to enforce minimum national service provision standards.

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