Public Policy and Administration Research
ISSN 2224-5731(Paper) ISSN 2225-0972(Online)
Vol.5, No.8, 2015

Fiscal Decentralization in Ethiopia: Achievements and Challenges

Deribe Assefa
Lecturer, Ethiopian Civil Service University

Abstract
As one of the major dimensions of decentralization reform program, fiscal decentralization has been a worldwide phenomenon since the 1980s and since 1991 in Ethiopia. The major purpose of this study was to assess the achievements and challenges of fiscal decentralization in Ethiopia. The study mainly employed quantitative approach based on a panel data on revenue and expenditure assignments between the federal government of Ethiopia and regional state of governments. It applied two standard measures of fiscal decentralization: Expenditure Ratio (ER) and Revenue Ratio (RR). The finding shows that there is mismatch between expenditure and financial autonomy of sub-national governments in the devolution process, which in turn creates vertical imbalances. Another major finding of this study is that intergovernmental fiscal transfers are a major source of revenue for regional states of governments which shows heavy dependence on federal government subsidy. The author concludes that fiscal decentralization is promising in Ethiopia since it encourages sub-national governments to assume additional responsibilities. However, special attention must be given to enhance the fiscal autonomy of sub-national governments so as to realize the benefits of effective fiscal decentralization.
Keywords: Decentralization, Fiscal Decentralization, Revenue assignment, Expenditure assignment, fiscal inequity.

1. Introduction

A number of scholars argue that the existing global politics urges the need to bring economic and political systems closer to local communities. Still, others argue that the collapse of central political systems in many developing countries encourages regional and local governments to participate in politics and economic processes (Bird & Vaillancourt, 2008; Ter-Minassian, 1997). There are rationales behind decentralized governance which are classified as economic and non-economic arguments. Among economic arguments efficiency in resource allocation, priority to local preferences, equity and poverty concerns, enhance tax efforts and sustainability of services provided, improve competitiveness among sub-national governments, and increase access to service delivery are the most important. And among non-economic reasons political values, instrumental values, and indicator of good governance and a means of accommodating diversity are the most important (Smoke, 2001; Ter-Minassian, 1997).

Decentralization reforms have been entered into the agendas of many countries since 1990s as the result of disappointing progress in meeting national goals through centralized processes which created unaccountable and corrupt governments (Kundishora, 2009, p. 12). As one of the major dimensions of decentralization, fiscal decentralization has been a worldwide phenomenon since the 1990s. Oommen (2008) notes that fiscal decentralization which is an indispensable subset of decentralization assumed significance because without its proper functioning decentralization becomes inoperative and meaningless.

According to (Chanie, 2009; Gebre-Egziabher, 2007), the 1991 government change in Ethiopia has created an opportunity for the introduction of decentralized system of governance in the country. So far, two phases of decentralization have been put in place in the current government administration: The first wave of decentralization (1991-2001) and devolution of powers and responsibilities at the *Woredas* level since 2002. The first wave of decentralization was aimed at creating and empowering national and regional state of governments where as the second phase of decentralization was concerned about devolution of powers at *Woreda* levels-lower levels administration.

This research paper, thus, explores the achievements and challenges of fiscal decentralization in Ethiopia since 2002 with reference to federal-regional interface and regions-*woreda* context.

2. Statement of the Problem and Research Questions

There is a great consensus among politicians, academicians and researchers that effective fiscal decentralization would promote the efficiency and accountability of sub-national governments. For instance, Halder (2007) explains that fiscal decentralization, as one of the reform packages, is believed to improve efficiency in the public sector, to increase competition among sub-national governments in delivering public services and stimulate economic growth.

The theory of fiscal federalism argues that effective fiscal decentralization requires assignment of significant revenue powers to sub-national governments (Rao, 2001). The analysis of Smoke (2001) reveals five basic elements of an effective decentralized fiscal system. These include (1) an adequate legislative and institutional enabling environment, (2) assignment of an appropriate set of functions to sub-national governments, (3) assignment of an appropriate set of local own-source revenues to sub-national governments, (4) the establishment of an adequate intergovernmental fiscal transfer system, and (5) establishment of adequate access of sub-national governments to development capital.

As noted by Ramakantan (2009), effective implementation of decentralization would at least demand two important preconditions: massive capacity building efforts to empower local governments, and devolution of adequate financial resources to local governments to exercise the powers and responsibilities vested in them. The study by Oommen (2008) shows that unless sub-national governments are provided with adequate financial resources it will be difficult to realize effective service provision in attaining economic growth.

According to Smoke (2001), fiscal decentralization in developing countries is characterized by limited revenue responsibilities along with the tendency to pushdown expenditure responsibilities to sub-national governments by federal government. Hence lack of independent sources of revenue constraints sub-national governments from influencing the allocation of public expenditures. Kee (2003)argues that whenever there is a mismatch between expenditure responsibilities and revenue responsibilities of sub-national governments in the devolution process, the side effect would be vertical imbalances.

Therefore, the availability of financial resources at both regional government and lower levels administration would matter the effectiveness of decentralization. Gebre-Egziabher (2007) highlights that decentralization in Ethiopia was at infant stage which was characterized by limited fiscal autonomy of sub-national governments. Even though there have been a number of research works on decentralization in Ethiopia, little has been done on fiscal decentralization in recent years. So, this study tries to assess the achievements and challenges of fiscal decentralization in Ethiopia since the year 2002.

Given the above problem, this paper seeks to address the following basic research questions related to fiscal decentralization in Ethiopia:

i. What are the major achievements of fiscal decentralization in Ethiopia?
ii. To what extent are sub-national governments in Ethiopia fiscally independent from national government?
iii. What are the challenges of fiscal decentralization in Ethiopia?

3. Theoretical Framework

3.1. Concept of Fiscal Decentralization

According to Bland (2006), decentralization is a process of transferring power to popularly elected local governments. Transferring power involves providing local governments with greater political authority (e.g., convene local elections or establish participatory processes), increased financial resources (e.g., through transfers or greater tax authority), and/or more administrative responsibilities.

Fiscal decentralization, one of the forms of decentralization, generally refers to the devolution of taxing and spending powers from the control of central government authorities to government authorities at sub-national levels (regional, provincial, municipal, etc). In highly decentralized system, local governments have considerable power to mobilize resources, through taxing authorities accompanied by strong tax bases (Bird & Vaillancourt, 2008).

3.2. Indicators of effective fiscal decentralization

Several scholars such as Kundishora (2009), Halder (2007), Smoke (2004) and Giugale and Webb (2000) underline that the effectiveness of fiscal decentralization depends on: (i) an adequate enabling environment (ii) appropriate expenditure assignments- (iii) appropriate revenue or tax assignments, (iv) the efficient design of a system of transfers and its proper implementation, and (v) Developing adequate local access to investment capital.

Adequate enabling environment: it can begin with constitutional or legal mandates for some minimum level of autonomy, rights and responsibilities for local governments. This provides a foundation on which to build decentralization,

Expenditure assignment: this refers to decisions about which level of government has responsibility for a particular public service. The division of functions among different levels of government assumes the comparative advantage or the principle of subsidiary. Spending and service-delivery assignment among levels of government is usually decided by the basic criteria of fiscal performance, namely, efficiency, income redistribution, and macroeconomic stability. Efficiency implies the extent to which the public service delivery satisfies the needs and preferences of taxpayers at the lowest possible cost for both service providers and users. Income redistribution and macroeconomic stability criteria calls for equity and fairness issues in a given country so as to avoid both vertical and horizontal fiscal imbalances.

For the successful functioning of the decentralized system of governance the clear assignment of functional responsibilities among different levels of government is highly essential. Failure in doing so may lead to instability in intergovernmental relations and to the inefficient provision/production of public services.

Furthermore, lack of clarity in the assignment would lead to the under provision of public services.

Revenue Assignment: This considers which level of government should tax what (the tax base) and how including the type of non-tax revenue sources. The purpose of revenue assignment is to provide sub-national governments with revenues that they control and thus to decentralize the control of public spending. For decentralization to be viable, sub-national governments must have their own revenues to cover their current expenditures, including debt services.

Transfers and system integration: Federal system is characterized by formal (constitutional) division of powers between central and sub-national governments. These powers can be assigned in the forms self rule and shared rule. In fiscal decentralization, there are two sorts of fiscal balance (or transfer) issues arise in federal systems-vertical fiscal imbalance and horizontal fiscal imbalance. Vertical fiscal imbalance relates to the misallocation of revenue-raising capacity relative to expenditure responsibilities. The vertical fiscal imbalance, the revenue shortfall of sub-national governments, would be addressed through intergovernmental grants. On the other hand, horizontal fiscal imbalance shows the fiscal capacity variation across the sub-national governments. This would be addressed through equalization transfers and programs.

Debt and Borrowing system: the proper policies for sub-national governments are straightforward-they should only borrow to fund an activity (investment) that will yield a rate of return to society above the interest rate and sufficient to service the debt. In practice, sub-national governments may borrow without considering the minimum criteria for borrowing and thus the higher level of government may establish and enforce rules that prevent the local government from borrowing imprudently.

3.3. Intergovernmental fiscal Decentralization

Intergovernmental fiscal transfers are an important tool of public sector finance in both industrialized and developing countries for at least three principal reasons (Kim & Smoke, 2003). First, central governments have advantages over sub-national governments in raising revenue from many types of particularly productive sources, while sub-national governments have advantages in providing many types of public services. This reality invariably results in a mismatch between the costs of expenditures that sub-national governments are expected to undertake and the resources locally available to them.

Second, there are often substantial disparities in revenue-raising capacity across decentralized levels of government. If sub-national governments are left to rely exclusively on their own resources, wealthier jurisdictions would be able to spend more on public services than lower-income jurisdictions. Such a situation has not only equity implications but efficiency implications as well. If decentralized governments are responsible for infrastructure and services that are essential production inputs, areas with lower resource levels may be unable to support local economic development.

Third, resources from the central level can be used to ensure that basic national priorities will be met in all sub-national jurisdictions. Typical priority sectors include health and education, but often extend to roads, water, and other services. Providing these services may promote both efficiency (if externalities are involved) and equity, and also support poverty reduction efforts.

Like many other countries, some portions of sub-national governments' expenditures are financed through fiscal transfers. Currently there are two types of inter-regional budgetary support transfer instruments in Ethiopia, the unconditional/General Purpose Grant (GPG) and conditional/Specific purpose Grant (SPG).

The transfer scheme incorporates the principle of equity and efficiency of public resource distribution and utilization and it is also meant to address the vertical imbalances in revenue versus expenditure assignments between the federal and regional administrations. The formula for federal transfer has undergone a number of revisions since 1995. The old formula was based on three parameters: 65 percent account for population size, 25 percent for poverty and development gap level, and the remaining 10 percent for an index of revenue collection effort of regions and sectoral performance(Garcia & Rajkumar, 2008). According to Garcia and Rajkumar (2008), the weaknesses of the formula used until 2007 include: (i) the subjective nature of the variables and the weight assigned to them; (ii) the bias toward capital needs; and (iii) the use of actual rather than potential revenue which is against strong revenue efforts by regions.

The new formula introduced in 2008 has three basic principles: (i) ensure that all Ethiopians are entitled to a similar range and level of service delivery; (ii) make the transfer independent of regional tax efforts or expenditure level (effort neutral); (iii) ensure that regions that are forced to spend more than the standard expenditure. Variables incorporated in the formula are population, difference in relative revenue-raising capacities, difference in their relative expenditure needs, and performance incentives. This new approach strives for equal per capita distribution of grants, while considering the needs or capacities of regions (Garcia & Rajkumar, 2008; Negussie, 2006).

There are also transfers in the form of block grants from regions to *woredas* after 2002 particularly in four regions: Amhara, Oromiya, SNNP, and Tigray. The aim was to replace the incremental budget allocation method with a transparent general purpose grant that gives autonomy to local governments (Garcia & Rajkumar, 2008).

3.4. Overview of fiscal decentralization in Ethiopia

Ethiopia has been enjoying the federal and decentralized system of governance since the end of 1990s almost after the overthrow of unitary 'Derg' regime. The country follows a federal system where the government power is divided between central government and nine [1] regional states of governments as well as two special administrative cities. The regions are divided into *zones, woredas*/urban administrations, and *kebeles* (village areas, with an average population of 5,000). The city administrations of Addis Ababa and Dire Dawa have different structures but are considered equivalent to regions.

The *zones* in most regions are considered as the arms of the regional states of government where as the *Woredas* are considered the key local government units in each region, with significant responsibilities for providing basic services. In connection with local governments, Article 50(4) of the Ethiopian constitution requires the regional states of government to grant adequate power to lowest level units of government as to ensure direct participation of the people (Negussie, 2006).

In 2002/03 the government of Ethiopia initiated the second phase of decentralization with a series of legal, fiscal and administrative reforms beginning with four of the largest regions (Amhara, Oromia, SNNP, and Tigray), which together account for 87 percent of Ethiopia's population. It was during this phase that *Woreda* administrations and eventually urban administration with *Woreda* status became autonomous as local governments in Ethiopia (Garcia & Rajkumar, 2008; Gebre-Egziabher, 2007). This phase of decentralization seeks to empower communities to engage in development interventions, improve local democratic governance, and enhance the scope and quality of delivery of basic services at the local level.

4. Methodology of the study

Although the topic of fiscal decentralization has been the concerns of politicians, government agencies, civil society, academicians and researchers, little has been done about its achievements and challenges in Ethiopia. Thus this research is important for a number of reasons. Firstly, the study will enrich literature on fiscal decentralization. Secondly, this study will have a valuable contribution in examining the outcomes of fiscal decentralization which would in turn pave the way for excellent approach in optimizing the potential benefits of decentralization for the prosperous of local democratic governance. Furthermore, undertaking an academic research on one of the most important reform tools, decentralization, will have great significance in disseminating information and philosophies about this reform.

The study employed both qualitative and quantitative approaches. The conceptual framework, data sources, data collection instruments, and data analysis methods employed are presented as follows:

4.1. Conceptual framework of the study

Fiscal decentralization involves the transfer of fiscal authority (public functions, expenditures, and revenues) from a central government to sub-nation levels of government. On the basis of the contribution by Ebel and Yilmaz (2002), two important models are worth mentioning in the domain of fiscal decentralization: the system principal-agent and the system local public election.

Under the system principle-agent model, the national government (principal) decides on priorities in the public sector, but recognizes the higher implementation efficiency of the sub-national governments (agents). In this case, the agents are accountable towards the national government and not to their constituents. Under the second model, the system local public election, sub-national governments have high degree of autonomy in determining revenue and expenditure assignments. This model assumes for greater part of financing of the sub-national expenditure through own-revenue sources in the forms of sub-national tax and non-tax revenues. In such a system, the sub national governments are accountable to their constituents and the expenditure is financed and the priorities are set by the local people.

Based on the work of Halder (2007), there are two standard measurements of fiscal decentralization: Expenditure ratio (ER) and Revenue ratio (RR). Expenditure ratio is the ratio of total sub-national governments' expenditure to the total government expenditure. Here, sub-national government expenditure is the sum of regional expenditure and local public whereas total government expenditure is the sum of sub-national and central governments' spending. In order to avoid double counting, subsidies given to sub-national governments are not included in the federal government expenditure. The reason is that when a certain level of government gives subsidies to a lower level of government, it accounts for that as an expense. However, the lower level of

[1] The member states of the Federal democratic Republic of Ethiopia are: (1) The State of Tigray, (2) The State of Afar, (3) The State of Amhara, (4) The State of Oromia, (5) The State of Somalia, (6) The State of Benshangual/Gumuz, (7) The State of the Southern Nations, Nationalities and peoples, (8) The state of Gambela Peoples, (9) The State of the Harari People (FDRE 1995)

government, up on spending that money, also records it as an expense. Hence subtracting the subsidy ensures that the expenditure is recorded only once. The mathematical expression for ER is:

ER= Total Sub-national expenditure / Total government expenditure

Revenue ratio (RR) as a measure of fiscal decentralization, on the other hand, is expressed by the ratio of sub-national revenue to total government revenue. Sub-national government revenue is the summation of all sources of revenue at sub-national government levels excluding the subsidies received from other governments and intergovernmental grants while total government revenue is the sum of sub-national and central government revenues. Mathematically RR can be explained as:

RR= Total Sub-national revenue / Total government revenue

In both ER and RR cases, the closer the ratio to one or 100 percent, the higher the degree of fiscal decentralization (Halder, 2007). For the purpose of this study, ER and RR measures of fiscal decentralization are adopted in order to explain the status of fiscal decentralization in Ethiopia.

4.2. Data sources and Data collection tools

The study aims to pinpoint the achievements and challenges of fiscal decentralization in Ethiopia by taking the fiscal interface between federal government and regional states of governments. In addition to this, fiscal decentralization at *woreda* level for the largest and pioneering regions (Amhara, Oromia, SNNP[1], and Tigray) was considered. The study was undertaken by assessing the implementation and practices of fiscal decentralization in Ethiopia mainly on the basis of panel data since 2002-the time when the second phase of decentralization has begun in the country. Some aspects of fiscal decentralization such as horizontal fiscal imbalance among regions and the so called emerging regions' *woreda* level fiscal decentralization were not included because of paucity of data.

Both primary and secondary data sources were employed for this study. The Ministry of Finance and Economic Development (MOFED) and World Bank (WB) documents and reports were used as important sources of secondary data. Panel data on budget allocation, subsidies, actual expenditure and revenue were obtained from these sources and thoroughly analyzed in this study. Also the constitution of FDRE and other scholarly written works were used. In order to strengthen and substantiate the data obtained from secondary sources, structured interview was held with experts, who are in charge of fiscal decentralization issues, drawn from MoFED, Oromia Regioinal State Government and Addis Ababa City Administration.

4.3. Data Analysis Method

Data obtained from MOFED and WB documents reports were arranged in logical order in such a way that they reflect the components of fiscal decentralization mainly in the forms of expenditure ratio and revenue ratio. After raw data were converted into the expenditure ratio and revenue ratio at different government levels, tables and graphical presentation tools such as bar charts and line graphs were employed for descriptive analysis purpose. Thus, based the conceptual framework results were interpreted. In some cases, the fiscal decentralization of Ethiopia was compared with international standards.

5. Findings

This section presents the findings in line with the objectives of the study.

5.1. The existence of enabling environment for fiscal decentralization

Article 51 and Article 52 of Ethiopian constitution specify the powers and functions of federal government and states respectively. It also recognizes grassroots administration system or the lowest units of government in Article 50(4) so as to make the government closer to citizens (Gazeta, 1995). This can be realized by empowering sub-national governments through appropriate and adequate expenditure responsibilities and taxation power/revenue assignment power.

The expenditure assignment among different levels of government in Ethiopia is not explicit like that of revenue assignment. Instead the expenditure assignment emanates from power and responsibilities given to federal and regions in article 51 and 52 of the constitution. Particularly, spending assignment between states level and *woreda* administration is vague and open to subjective judgment. This was also confirmed by the work of Negussie (2006) that the expenditure assignment in the Ethiopia fiscal decentralization lacks specificity and no single law that governs the system. Such ambiguity in the expenditure assignment and the lack of clear,

[1] Southern Nations, Nationalities and Peoples

formal assignment of responsibilities tends to destabilize intergovernmental relations.

With respect to revenue assignment, the constitution (in the Articles 95 up to 99) delineates the exclusive revenue sources for federal and states as well as the concurrent power of taxation though it lacks clarity for shared responsibilities. As information obtained from key informants, the concurrent taxation power of federal and regional governments is shared in the ratio of 50:50 for direct tax revenues and 70:30 for indirect tax revenue sources respectively. Borrowing as other sources of sub-national governments, the constitution does not allow both domestic and foreign borrowing for states unlike other federal systems (Smoke, 2004).

One of the salient features of fiscal decentralization in Ethiopia is the existence of institutional mechanism for coordination and conflict resolution among levels of government usually through house of federation, MOFED, federal affairs ministry and other institutions at all government levels.

5.2. Fiscal decentralization trend using Expenditure Ratio (ER)

One of the indicators of fiscal decentralization is the amount of expenditure at sub-national government level from the entire government's expenditure. It is not accidental to precede expenditure assignment from revenue assignment because logically in order to decide revenue sources between levels of government one needs to be clear about functions to be undertaken by each of them. As table 1 indicates, the expenditure ratio of sub-national governments in Ethiopia including the two special cities administration was stagnant from FY 2004/05-2006/07 with almost 35 percent ratio and then the expenditure ratio of the regions is getting improved from FY 2007/08 to 2009/10. In 2009/10 FY, the ratio rose to 47.26 percent from 43.26 percent in 2008/09. There is gradual increment in the share of expenditures that take place at sub-national government level which shows that the size of sub-national governments in Ethiopia and their relative importance have been increased from time to time. This achievement is very significant when compared with the 20.5 percent expenditure ratio of regions in 1993/94 (Chole, 1994).

Table 1: Expenditure at Federal and regional levels (in Millions) and Expenditure ratio

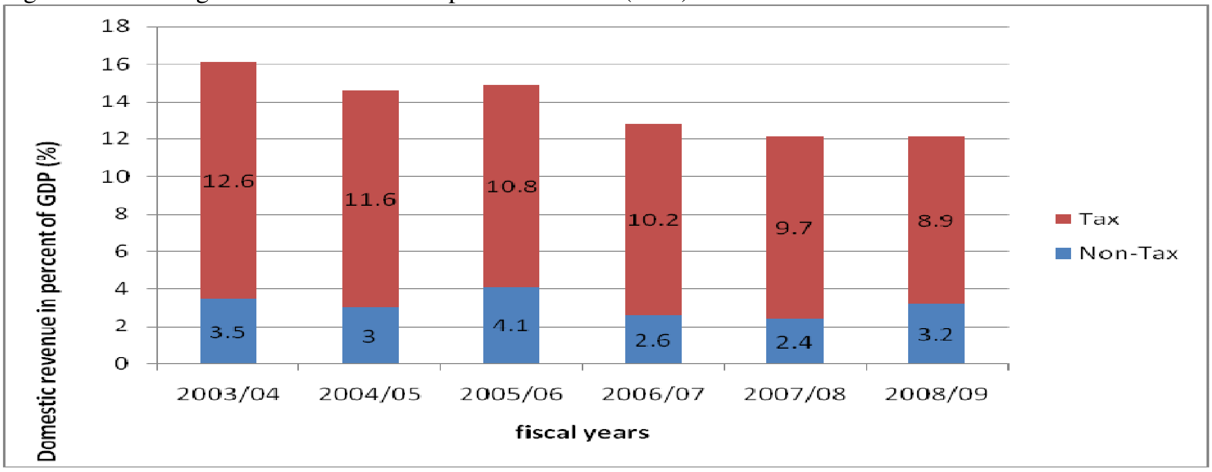
						Expenditure ratio (%)	
Fiscal Year	Federal (A)	Block grants to Regions (B)	Federal Expenditure (excluding block grants (C)	Regions' Expenditure (D)	Total (E) C+D	Federal (F) C/E	Regional (G) D/E
2004/05	22070.039	5,498	16,572	8839.614	25,412	65.21	34.79
2005/06	30043.634	7,071.00	22,972.63	12181.518	35,154.15	65.35	34.65
2006/07	35444.66	9,879.70	25,564.96	13386.34	38,951.30	65.63	34.37
2007/08	43947.67	14,261.22	29,686.45	19885.92	49,572.37	59.89	40.11
2008/09	54280.096	17,438.27	36,841.83	28271	65,112.83	56.58	43.42
2009/10	64508.429	20,932.96	43,575.47	39042	82,617.47	52.74	47.26

(Source: MOFED database 2011 and Garcia and Rajkumar (2008)

5.3. Fiscal decentralization trend using Revenue Ratio (RR)

Before directly moving to the revenue ratio of the central government and sub-national government, it is meaningful to assess the overall domestic revenue performance of the country. Since absolute figures are misleading, commonly the revenue performance is evaluated as a percentage of GDP (Smoke, 2004). Accordingly, the ratio of domestic revenue to GDP (see figure 1) is getting lower for last three years. For instance, there was a decline from 12.8 percent in 2006/07 to 12.1 percent in 2008/09. The performance of both tax and non-tax revenue is unsatisfactory when assessed in reference to GDP of the country.

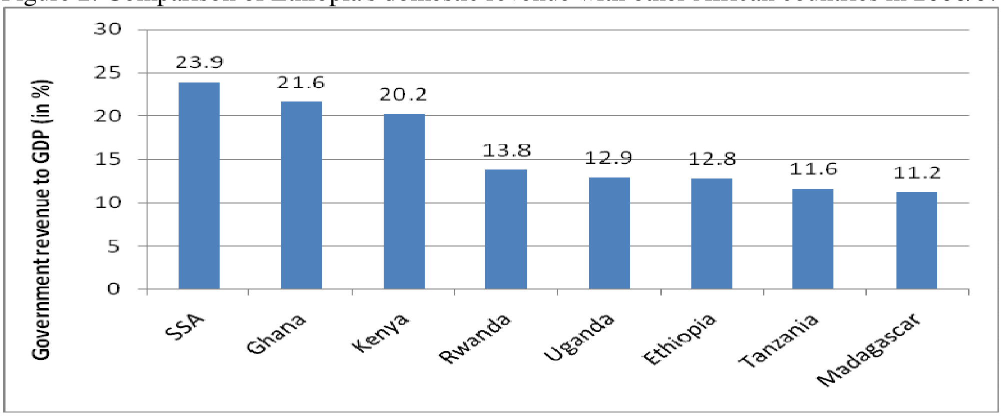
Figure 1: General government revenue in percent of GDP (in %)



(Source: MOFED data base May 2011 and World Bank (2009)

Ethiopia's performance ratio of domestic revenue to GDP is low when compared with other African countries and Sub-Saharan Africa (SSA) standard. As indicated in figure 2, the ratio of domestic revenue to GDP in Ethiopia is 8 to 9 percentage points lower than in Ghana and Kenya and 12 percentage points less than the SSA average. Studies indicate that Ethiopia's poor performance in the ratio of revenue to GDP are attributable to structural problems in tax policies and a weak tax administration system, over-valuation of the local currency and macroeconomic difficulties, such as a high inflation rate (World Bank, 2009).

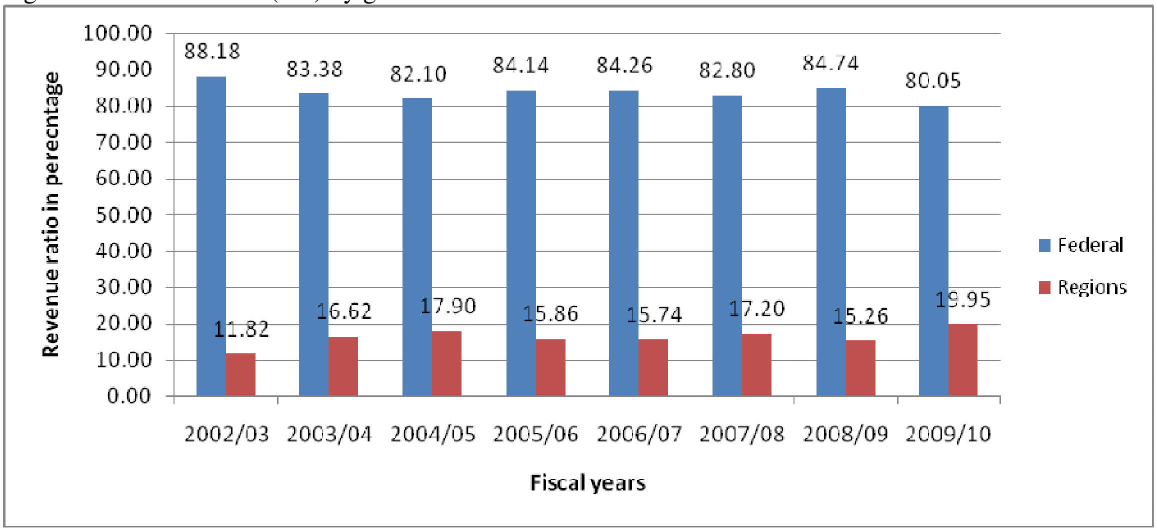
Figure 2: Comparison of Ethiopia's domestic revenue with other African countries in 2006/07



(Source: MOFED data base May 2011 and World Bank (2009)

In terms of revenue ratio as the measurement of fiscal decentralization, the share of sub-national governments including the two special cities administration (Addis Ababa and Dire Dawa) from the consolidated revenue sources is extremely small (Figure 3). For the fiscal years ranging from 2002/03 up to 2009/10, the maximum aggregate share of the sub-national governments was 19.95 percent in 2009/10. Even though the maximum share of sub-national governments' revenue was registered in 2009/10, the rate of growth was very small in the past eight years. Between FY07/08 and FY08/09, the regional revenue coverage from total national revenue dropped from 17.2 percent to 15.26 percent. Such trend would show the existence of vertical imbalance which could adversely affect the efficiency of resource allocations and the quality of service delivery at the sub-national government level. From revenue ratio measure of fiscal decentralization, one can say that the degree of decentralization is at low level and it requires intensive reform in raising the revenue-generating capacity of sub-national governments in the country.

Figure 3: Revenue Ratio (RR) by government levels from 2002/03-2009/10

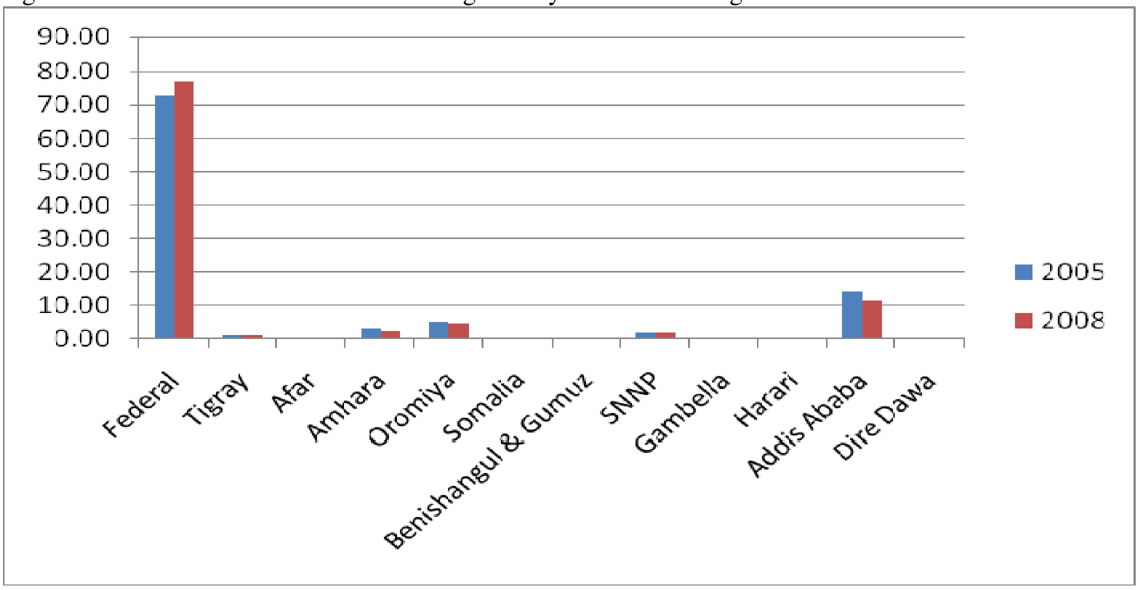


(Source: data provided from MOFED, May 2013

The above facts show that regions are heavily reliant on transfers from federal government because of their limited share of total government revenues. Thus from revenue ratio dimension, fiscal decentralization in Ethiopia is at infant stage and it challenges the fiscal autonomy of the regions.

In Ethiopia, Garcia and Rajkumar (2008) indicates that tax revenue accounts for three-fourth of total revenue in the country. The incapacity of sub-national governments in Ethiopia is boldly observed when taxation power of the two layers of government- federal and regional states is compared. The performance of actual tax collections by federal government and regional governments in 2005 and 2008 (figure 4) shows that there is extreme discrepancy between the two layers of government. While only Federal government enjoys 73 percent and 77 percent of the total tax revenue in the years 2005 and 2008 respectively, the smallest part of the total tax revenue (22.9 percent in 2005 and 22.9 percent in 2008) was collected by regions excluding Addis Ababa. The highest contributor of tax revenue was Oromia with 4.96 percent and 4.63 percent of the total national revenue in 2005 and 2008 respectively. Surprisingly, the contributions of almost all regions including the two special cities administrative declined in 2008 when compared with 2005. The aggregate contributions of all regions including Addis Ababa dropped from 27.2 percent in 2005 to 22.9 percent in 2008 where as excluding Addis Ababa this figures declined from 12.95 percent in 2005 to 11.5 percent in 2008.

Figure 4: Revenue collection from tax categories by Federal and Regions in Percent



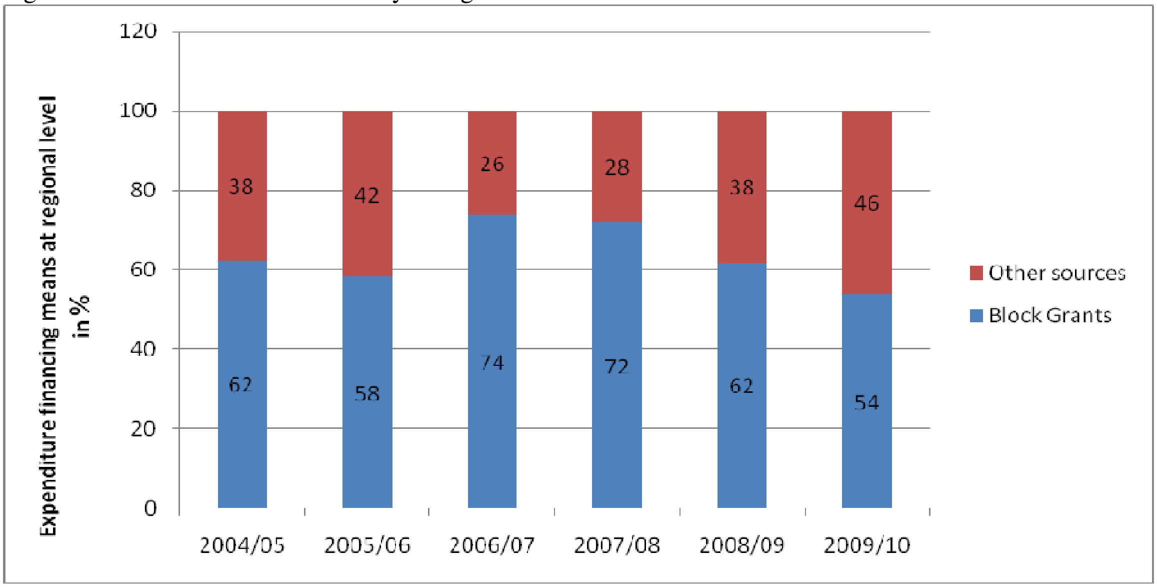
(Source: Based on data provided by MOFED, May 2013

When the tax revenue share of regional states after second phase of decentralization compared with the first phase, the figures of 2005 and 2008 are relatively smaller than the early periods. Study by Chole (1994) shows that the share of tax revenue collection by regions was 14.1 percent in 1992/93 and 20.5 in 1993/1994. This clearly implies that fiscal decentralization in terms of regional revenue autonomy, which is the key for all aspects of decentralization, is still stagnant starting from earlier periods of decentralization in Ethiopia.

5.4. The vertical fiscal imbalance of sub-national governments

The mismatch between the expenditure responsibilities and the revenue capacity of regional governments represents vertical imbalance. It usually represents the degree to which sub-national governments rely on central government revenues to support their expenditures.

Figure 5: Vertical fiscal imbalance by intergovernmental transfer measure



(Source MFED, May 2013)

One of the approaches to measure the vertical fiscal imbalance is examining the portion of sun-national government expenditure covered by block grants or subsidies from higher level government. Thus in Ethiopia context, vertical fiscal imbalance can be measured by intergovernmental transfers as a share of sub-national expenditures. As indicated in figure 5, large portions of sub-national government expenditures (on average more than 63 percent) were entirely financed by federal transfer programs from FY2004/05 up to FY2009/10. This indicates that the sub-national governments in Ethiopia are highly dependent on the federal government transfers to undertake their functions and mandates. This implies that the fiscal capacity and autonomy at regional level is minimal.

The result obtained from interview with key informants shows that limited tax bases for the regions, regions' tax administrative incapacity, and taxpayers' unwillingness are the major attributable factors for such vertical fiscal imbalance. They also underlined the contribution of corruption is very high. In addition, revenue assignments with large potential revenue source are given to the federal government to ensure equitable finance resources among the regions. For instance, the major cardinal sources of revenue, such as customs duties and other charges on imports and exports, which account for up to 33 percent of the total revenue generated in the country, are the exclusive responsibility of federal government (Negussie, 2006).

The above discussions assert that there is vertical fiscal imbalance which also indicates that the central government dominates the fiscal power of the federation. When the vertical imbalance of Ethiopia in terms of sub-national governments' revenue autonomy (the maximum of revenue ratio is 19.9 percent in 2009/10 from figure 3) compared with many other federal systems such as India (28 percent in 2000), Brazil (24.3 percent in 2000), Nigeria (32.3 percent in 2000), the imbalance is the highest one (Negussie, 2006).

The implication of such greater imbalance would lead to problem of inefficiency where the expenditure assignments of the regions could not be realized appropriately. The second critical issue is that the fiscal autonomy of the regions would fall under the control of the central government which determines subsidies to the regions. This may imply that decentralized units do not have autonomy to determine priorities or change the composition of expenditures. Thus one can say that fiscal autonym of sub-national governments in Ethiopia is heavily dependent on the federal government which would in turn distort the expectations of decentralization as a reform.

Furthermore, interviewed experts revealed their hesitations on the commitment of the federal government towards fiscal decentralization because currently it took over the revenue responsibilities of Addis Ababa and land provision for more than 5,000 km^2 in all regions which would have adverse impact on fiscal decentralization.

Now a day, there is consensus among scholars that intergovernmental transfers are no more effective in enhancing sound fiscal decentralization. Rather emphasis must be given to empower the sub-national governments in generating their own revenue sources. Study by Dabla-Norris (2006) confirms that gap-filling nature of the intergovernmental transfers between central and regional governments in many transition countries provides disincentives for revenue mobilization by sub-national governments (they could either hide locally mobilized revenues sources or simply reduce their efforts to mobilize revenues locally) and the efficient provision of public services.

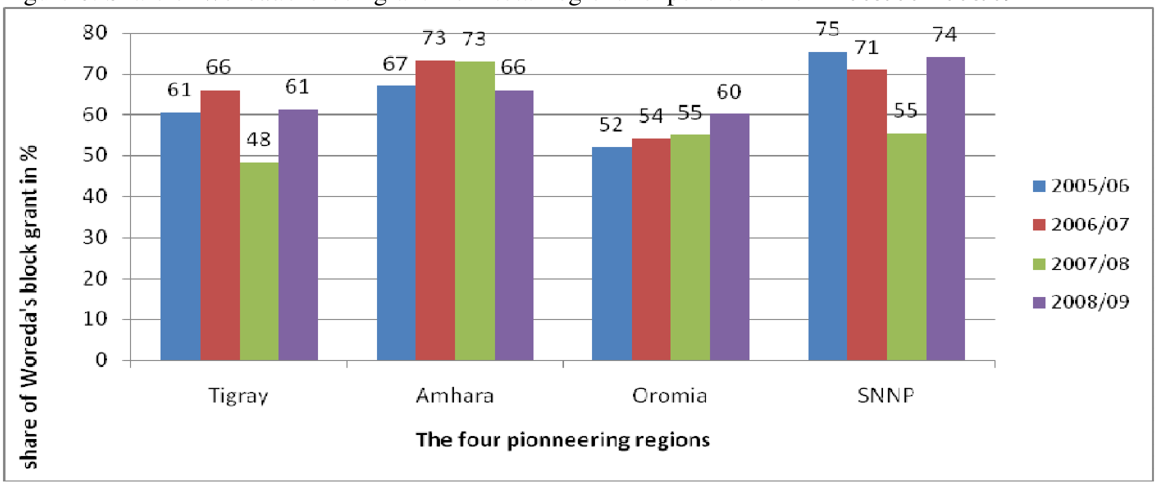
5.5. Fiscal decentralization at local government/*Woreda*/ level

Ethiopia has been exercising fiscal decentralization at local (woreda) level since 2002 so as to ensure popular participation in political, economic and developmental affairs. It was started by the four pioneering regions (Tigray, Amhara, Oromia and SNNP). Accordingly, expenditure and revenue ratios at local government level in each of the four regions are presented in figure 6 and figure 7.

In terms of share of *woreda*'s expenditure from total regional expenditure (figure 6), fiscal decentralization at the local level from 2005/06-2008/9 was characterized by erratic nature except for Oromia with slight increases per every fiscal year. In this regard, the performance of SNNP and Amhara regional states in implementing fiscal decentralization at *woreda* level can be considered as exemplary role where as the proportion of local government's expenditure in Oromia is the smallest of the four regions.

The erratic growth of expenditure ratio at *woreda* level could indicate that there are no clearly defined responsibilities and power between regions and their local administration. However, significant responsibility in providing basic services to the local government level is consistent with one of the necessary conditions for efficient allocations of resources.

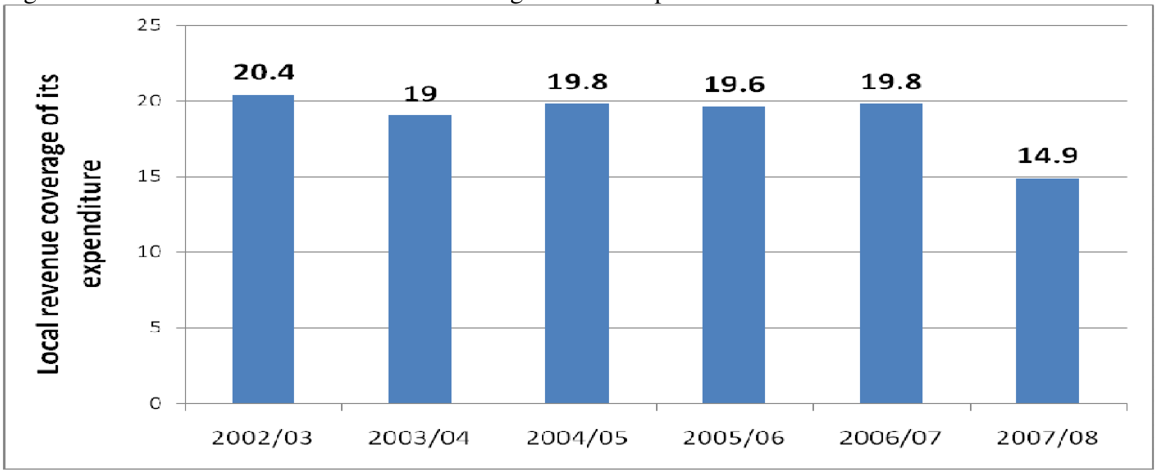
Figure 6: Share of *Woreda*s' block grant from total regional expenditure from 2005/06-2008/09



(Source: MOFED, May 2013)

The other measure of fiscal decentralization at *woreda* level is revenue ratio model. As a principle, effective implementation of decentralization is highly influenced by the extent to which the local governments are capable in generating their own revenue in addition to the block grants from the higher government level (Kundishora, 2009; Ramakantan, 2009; Smoke, 2004). Contrary to this principle, the ratio of woredas' revenue to their expenditure was almost stable throughout the periods (2002/03 to 2007/08 except for the year 2007/08 as figure 7 shows. In absolute term, there is a decline trend from 20.4 percent in 2002/03 to 14.9 percent in 2007/08.

Figure 7: The ratio of *Woredas*' revenue coverage to their Expenditure



(Source: World Bank (2009, p. 16)

6. Discussion

The main findings of this study are summarized based the major dimensions of fiscal decentralization which include the extent of enabling environment, expenditure ratio and revenue ratio of sub-national governments (regional level) with reference to the national level, vertical fiscal imbalance, fiscal decentralization at woreda /local government level by considering the performance of the four pioneering regions (Tigray, Amhara, Oromia and SNNP).

With regard to enabling environment, Ethiopia's constitution promotes fiscal decentralization and it has the provisions about expenditure assignment implicitly and revenue assignment explicitly between the central government and the states. There are also institutional arrangements to coordinate, execute and control its implementation. However, the constitution is not strengthened by specific laws that accommodate clear, specific and detail aspects of expenditure and revenue assignments among levels of government in the country.

In terms of the trend of fiscal decentralization at sub-national (regional) level in Ethiopia, two major measurement models were used: Expenditure and revenue ratio. With this regard, the expenditure ratio shows a gradual improvement from 34.79 percent in 2004/05 to 47.26 percent in 2009/10 while the revenue ratio of all regions in aggregate does not exceed 20 percent of the total national revenue (ranging from 11.82 percent in 2002/03 to 19.95 in 2009/10). As an indicator of fiscal autonomy at regional level, the contributions of regions in tax collection is also meager with 12.95 percent in 2005 and 11.5 percent in 2008 excluding Addis Ababa.

The performance of fiscal decentralization at local government (*woreda* administration) level in the four largest regions has a mixed result in terms of expenditure assignment and revenue assignment. In the period of 2005/06-2008/09 fiscal year, even though the rate of change is erratic, the expenditure ratio of the woredas was within the range of 48 percent (Tigray in 2007/08) to 75 percent (SNNP in 2005/06). Among the four regions, on average the expenditure ratios of local governments in Amhara (70 percent) and SNNP (69 %) are the highest whereas the expenditure ratio of Oromia's local governments (55%) is the lowest one. On the other hand, the *woreda*'s revenue share to cover the region's expenditure declined from 20.4 percent in 2002/03 to 14.9 percent in 2007/08 with significant horizontal fiscal imbalance among regions with the range of 9 percent up to 35 percent in these periods.

6.1. Limitations of the study

In this study getting reliable and consistent data was a serious challenge, where some data were in the form of budget while others were in the form of actual performance. Unavailability of internationally recognized standards on the measurements of fiscal decentralization made the analysis to use in relative terms (expenditure ratio and revenue ratio) by considering the rate of growth across fiscal years of Ethiopia.

The two models, expenditure and revenue ratios, used in this study have weaknesses in explaining the absolute changes over the years. In terms of analysis of data, the caveat of this study is that only aggregate data, without splitting expenditure into recurrent and capital, and total revenue without consideration of a number of sources, were used. In addition, the impact of inflation on the amounts of expenditure and revenue is not taken into account in the study.

6.2. Conclusions

The lack of specificity in expenditure and revenue assignments would create overlapping responsibilities which may breed conflict between federal-regional level governments as well as regions-*woreda* administration. The gradual improvement of expenditure ratio at regional level shows that government of Ethiopia is committed to devolve powers and responsibilities to lower government level. Contrary to this, the revenue ratio and fiscal autonomy of regions are extremely low which indicate the heavy dependence of the sub-national governments on federal government transfers. For that matter, the tax generating autonomy of the regional states in the early periods of FDRE was relatively larger than the periods after the second phase of decentralization in Ethiopia. This implies that the level of revenue decentralization has declined and sub-national governments are characterized by low fiscal autonomy.

As Ethiopia has launched the second phase of decentralization since 2002, the expenditure ratio of woredas in four largest regions showed significant improvement and the ratio accounted for more than 60 percent of each respective region in 2008/09 fiscal year. This can be considered as the greatest achievement in the country. Particularly, the fiscal decentralization performance of SNNP and Amhara regions at woreda level is highly promising that should be taken as best practices for other regional states. Yet, the challenging issue is the low capacity of woredas/local governments to generate their own revenue sources which affects the actual implementation of decentralization in service delivery areas.

Overall, the current situation of fiscal decentralization in Ethiopia has both achievements and challenges. In terms of achievement there is gradual increase in the share of expenditures by regional and the local (*woreda*) governments. Whereas, the critical challenge is that regional and local level governments have limited control over their respective expenditure which is the reflection of limited degree of revenue autonomy.

6.3. Recommendations

Based on the findings, the following recommendations are suggested so as to further realize sound and effective fiscal decentralization in Ethiopia:

Enabling Environment

- In addition to the constitution, detailed expenditure and revenue assignments, particularly for concurrent responsibilities, need to be clearly defined at all levels of government
- Federal government needs to focus on enhancing the administrative and technical capacity of the regions in the areas of their revenue responsibilities.
- The existing shared revenue ratio of 50:50 for direct tax and 70:50 for non-direct tax between federal government and regional states need to be revised and entirely be given to regions to realize further progress in fiscal decentralization.
- The need to establish appropriate institutional arrangements as to ensure monitoring and evaluation of fiscal decentralization, and coordination and cooperation between different levels of government.
- The four large regions /sub-national governments/ should work on improving their administrative and technical capacity required to effectively carry out their assigned responsibilities
- Government should ensure the implementation of the existing tax reform packages as to make revenue collection system efficient, effective and free from corruption.

Fiscal decentralization at regional level

- Federal government should enhance further implementation of fiscal decentralization rather than emphasizing only on its own tax bases and revenue sources such as investment income, a lion share from VAT income and others.
- The regions have to broaden their tax revenue and non-tax revenue sources and regularly revise the tax rates on relevant information.
- Regions have to intensively work on awareness creation mechanisms to create honest taxpayers in their jurisdictions

Fiscal decentralization at *woreda* level

- The current progress on *woreda*'s fiscal decentralization should be further strengthened without any reservations by regions in order to ensure grassroots participation in development and political issues.
- Woredas have to broaden their tax revenue and non-tax revenue sources and regularly revise the tax rates on the basis of accurate information.
- They have to intensively work on awareness creation mechanisms to create honest taxpayers in their jurisdictions.
- Woredas' capacity building programs in terms of acquiring and retaining committed, professional and competent workforces including necessary infrastructures should be reinforced.

References

Bird, R. M., & Vaillancourt, F. (2008). *Fiscal decentralization in developing countries*: Cambridge University Press.

Bland, G. (2006). *Decentralization and democratic local governance programming handbook:*

Elections and the development of democratic local governance. Paper presented at the Paper delivered at the USAID workshop. Decentralization, local governance and democratization.

Chanie, P. (2009). Disconnect between public sector management system and decentralization reforms: An empirical analysis of the ethiopian situation. *Eastern Africa Social Science Research Review, 25*(1), 59-91.

Chole, E. (1994). *Fiscal decentralization in Ethiopia*: Ethiopian Economic Association.

Dabla-Norris, E. (2006). The challenge of fiscal decentralisation in transition countries. *Comparative Economic Studies, 48*(1), 100-131.

Ebel, R. D., & Yilmaz, S. (2002). *On the measurement and impact of fiscal decentralization* (Vol. 2809): World Bank Publications.

Garcia, M., & Rajkumar, A. S. (2008). *Achieving better service delivery through decentralization in Ethiopia*: World Bank Publications.

Gazeta, F. N. (1995). The constitution of the federal democratic republic of Ethiopia. *Addis Ababa*.

Gebre-Egziabher, T. (2007). *Decentralization in Ethiopia*: African Books Collective.

Giugale, M., & Webb, S. B. (2000). *Achievements and challenges of fiscal decentralization: Lessons from mexico*: World Bank Publications.

Halder, P. (2007). Measures of fiscal decentralization. *Department of Economics, Andrew Young School of Policy Studies, Summer Internship Program.*

Kee, J. E. (2003). Fiscal decentralization: Theory as reform. *VIII Cogreso Internacional del CLAD sobre la Reforma del Estado y de la Administración Pública. Panama.*

Kim, Y.-H., & Smoke, P. (2003). The role and challenges of intergovernmental fiscal transfers in asia. *Intergovernmental Fiscal Transfers in Asia: Current Practice and Challenges for the Future*, 1.

Kundishora, P. (2009). An overview of decentralization and local governance in eastern and southern Africa.

Negussie, S. (2006). *Fiscal federalism in the ethiopian ethnic-based federal system*: Wolf Legal Publishers.

Oommen, M. (2008). *Fiscal decentralisation to local governments in india*: Cambridge Scholars Publishing.

Ramakantan, N. (2009). Democratic decentralization and empowerment of local government associations in kerala. *Commonwealth Journal of Local Governance, 2*, 128-136.

Rao, M. G. (2001). *Challenges of fiscal decentralization in transitional economies: An asian perspective.* Paper presented at the Public Finance in Developing and Transition Countries: A Conference in Honor of Richard Bird. Georgia State University, Atlanta.

Smoke, P. (2001). *Fiscal decentralization in developing countries: A review of current concepts and practice*: United Nations Research Institute for Social Development Geneva.

Smoke, P. (2004). *Fiscal decentralization for good governance and effective service delivery.* Paper presented at the A presentation prepared for the Workshop on Decentralized Governance for Effective and Responsive Service Delivery: Prerequisites, Trends, Approaches, and Capacity Building Strategies. Palazzo Vecchio, Florence, Italy.

Ter-Minassian, M. T. (1997). *Fiscal federalism in theory and practice*: International Monetary Fund.

World Bank. (2009). Public finance review: Ethiopia, report no. 50278-ET. Washington Dc: World Bank, Poverty Reduction and Economic Management Unit, African Region.

The IISTE is a pioneer in the Open-Access hosting service and academic event management. The aim of the firm is Accelerating Global Knowledge Sharing.

More information about the firm can be found on the homepage:
http://www.iiste.org

CALL FOR JOURNAL PAPERS

There are more than 30 peer-reviewed academic journals hosted under the hosting platform.

Prospective authors of journals can find the submission instruction on the following page: http://www.iiste.org/journals/ All the journals articles are available online to the readers all over the world without financial, legal, or technical barriers other than those inseparable from gaining access to the internet itself. Paper version of the journals is also available upon request of readers and authors.

MORE RESOURCES

Book publication information: http://www.iiste.org/book/

Academic conference: http://www.iiste.org/conference/upcoming-conferences-call-for-paper/

IISTE Knowledge Sharing Partners

EBSCO, Index Copernicus, Ulrich's Periodicals Directory, JournalTOCS, PKP Open Archives Harvester, Bielefeld Academic Search Engine, Elektronische Zeitschriftenbibliothek EZB, Open J-Gate, OCLC WorldCat, Universe Digtial Library , NewJour, Google Scholar