THE NEW FEDERAL GRANT DISTRIBUTION FORMULA

1. Why Fiscal federalism?

Fiscal federalism in Ethiopia is a response to the multi-faceted governance problems that had entangled the country for almost a century. During this period, the country had been ruled under centralized authoritarian regimes. The diverse peoples of the country had been politically marginalized, socially dominated and economically deprived. One of the coercive features of these regimes was economic inequality. The nations, nationalities and peoples of Ethiopia had been deprived of an opportunity to equal development. Their right to equally benefit from the development outcomes of the country had also been denied. Rather, the ruling elites and their representatives had been the only beneficiaries.

The year 1991 marked a fundamental transformation of the political structure of the country, from a formerly highly centralized and oppressor unitary state to an extremely decentralized federal system. As per the FDRE constitution, the principal objective of the new federal arrangement is to building one political and economic community capable of ensuring a lasting peace, guaranteeing a democratic order, and advancing an equitable economic and social development. The vision to establish such a community was conceptualized through a decision made by all nations, nationalities and peoples of Ethiopia in full and free exercise of their right to self-determination. This momentous decision aims at rectifying historically unjust relationship established by the previous regimes and creating a democratic political union and economic integration based on the principles of equality, mutual respect and shared interests.

One of the basic reasons for the need to establish a common political and economic community is to ensure the equal rights of the peoples of Ethiopia. The constitution proclaims that this can be realized only if the rights of individuals and groups are fully recognized and respected. It is in view of this principle that the constitution required the free will and consent of the diverse nationalities to establish a strong democratic union. If the union is to be further strengthened, it is indispensable to respect citizens' human and democratic rights.

The other fundamental cause for a common political and economic community is the need to guarantee each nationality an equal opportunity to development and a right to equally benefit from the fruits of the country's development. One way of guaranteeing this right is to provide the diverse peoples of the country with an equal right to self-administration. It was in cognizant of this fact that our constitution grants each nationality the right to self-administer itself. The other key issue in assuring equal rights of people is to ensure that the development activities of the federal as well as regional governments are, as much as possible, benefitting the people equally. In this respect, a number of provisions are provided in the constitution.

2. Why Federal Grant?

Like most federations, the need for intergovernmental transfer in Ethiopia emerges as a result of fiscal imbalances that exist among the different levels of government. There are basically two types of imbalances: vertical and horizontal imbalances. A vertical imbalance occurs when the expenditure responsibilities of sub-national governments do not match with their revenue raising powers. It is generated as a result of the assignment of expenditure and revenue responsibilities. The horizontal fiscal imbalance implies the differences in the ability of individual regions to raise revenues.

As can be evidently observed from the constitution, the lucrative sources of revenue in Ethiopia are assigned to the federal government while a wide range of expenditure responsibilities are reserved to the regions. This resulted in significant vertical fiscal imbalance between the federal and regional governments. The launch of the federal system has created autonomous regions that vary enormously in area, population size, infrastructure, human and institutional capacity and socio-economic status. As a result, there is an extensive difference in the fiscal capacities of regions.

Recognizing the inevitability of fiscal imbalances resulting from the division of powers in the constitution, the unfortunate legacy of the past and the disparities in population, natural resources as well as human and institutional capacities among regions, the Constitution lays down legal basis for fiscal transfer. There are two fundamental provisions that are directly related with intergovernmental transfer. The first one states that unless otherwise it does not deter the balanced development, the federal government may provide states with grants in the form of assistance or loans (Article 94). This article also gives the federal government the power to conduct auditing and inspection on the utilization of the grant. The other provision is related with the concurrent powers of taxation. As indicated in Article 98, there are certain revenue-sources from which the two levels of government jointly levy and collect. Therefore, it can be understood that the constitution provides two types of revenue sharing mechanisms: the sharing of concurrent taxes and the sharing of federal revenue.

The constitution bestows the House of Federation the power to determine the division of the federal subsidies among regions (Article 62 sub 7). Until now, the House has prepared and made use of more than seven grant distribution formulae. All of these formulae have been developed based on the constitutional principles and objectives. They all aimed at correcting the vertical as well as horizontal fiscal imbalances. They strived to equalize the fiscal capacities of regions so that they can provide a comparable level of public services to their electorates. Through time, however, the House has been improving the formulae to better reflect the ever-changing realities of the countries. Particularly, the framework of the grant transfer has been altered many times using our own practices and other countries' experiences to finally arrive at the best framework that most federal systems use.

Though the Central government transfers to regions first begun in 1992/93, when grants were ad hoc in nature, based on approved projects of the regions, the formula based grant system was introduced after two years in 1994/95. Both the vertical and horizontal imbalances are dealt with simultaneously through an integrated system of equalization grant. The system of fiscal transfer has always taken the form of unconditional grant with limited exceptions such as the Road Fund, Capacity Building Program, HIV/AIDS, food security and so on.

3. Basic Constitutional Premises/ Principles

Like all other policies and strategies of the government, the preparation of the grant distribution formula should follow the basic principles of the Ethiopian constitution. The following five constitutional principles are used in the development of the new grant distributions:

- Article 41(3): Every Ethiopian national has the right to equal access to publicly funded social services.
- Article 89(2): Government has the duty to ensure that all Ethiopian get equal opportunity to improve their economic conditions and to promote equitable distribution of wealth among them.
- Article 89(4): Nations and Nationalities and Peoples least advantaged in economic and social development shall receive special assistance.
- Article 94(1): The Federal Government and the States shall respectively bear all the financial expenditure necessary to carry out all responsibilities and functions assigned to them by law. Unless otherwise agreed upon, the financial expenditures required for carrying out of any delegated function by the state shall be borne by the delegating party.
- Article 94(2): The Federal Government may grant the States emergency, rehabilitation, and development assistance and loans, due care being taken that such assistance and loans do not hinder the proportionate development of States. The Federal Government shall have the power to audit and inspect the proper utilization of subsidies it grants to the States.

4. Framework for Designing the Grant Allocation Formula

The federal grant which is distributed to the regions is an equalization one. The main objective of the grant distribution formula is to equalize the fiscal capacities of regions so that they can provide a comparable level of public services to their electorates. It tries to equalize both the expenditure needs and revenue capacities of regional governments. Specifically, the objectives of the formula are minimizing the vertical fiscal imbalance; correcting the horizontal fiscal imbalance that exists among regions; compensating regions that provides public services with positive spill-over effects; and encouraging regions’ revenue collection efforts

The development of the grant allocation formula starts with the estimation of relative fiscal gap which involves estimation of the relative revenue potentials and expenditure needs of regions. In accordance with established international practice, the representative tax system (RTS) and representative expenditure system (RES) methodologies have been used to assess the revenue potential and expenditure needs of the regional states of Ethiopia. Based on these approaches, the basic procedures for determining the revenue potential and expenditure needs of each region are presented as follows:

4.1. Estimating Potential Revenue

The Representative Tax System (RTS) is used to assess potential revenue. This approach focuses on major revenue sources of regions and application of appropriate tax rates to arrive at potential revenue. It is characterized as 'Representative' because it picks up the most lucrative regional sources of revenue that account for a highly significant share of the total revenue collected by regions. The approach identifies an appropriate tax base and uses the applicable tax rate to arrive at potential revenue that can be derived from an identified source.

Estimating equalization entitlements using the representative tax system requires information on the tax bases, tax rates and revenues for each state or sub-national government. The basic steps used in estimating the potential revenue are: determination of revenue coverage, definition of standard tax bases, determination of average tax rates and the estimation of fiscal capacity.

The determination of the regional revenue coverage is made based on considerations of the revenue sources allocated to regions by the national Constitution and data availability to determine tax base and tax rate. Using revenue assignments given to regions, major tax types which constituted 85-90per cent of the regions' total revenue in the past 5 years, i.e., 1998-2002, have been selected. These are Pay roll tax, Agricultural Income Tax, Land Use Fee, Livestock Tax, Profit Tax, Turnover Tax and Value Added Tax (VAT).

The definition of the tax base is then done by identifying the relevant resource base. The representative tax rate is determined by using the tax base and the revenue collected from corresponding tax base. In situations where there are statutorily defined tax rates, these rates are used. The estimation of the fiscal capacity is made by applying the tax rate on the identified tax base for each revenue source. The aggregation of all the potential revenue from each revenue source yields the total potential revenue of each region. The potential revenue is adjusted by deducting federal VAT and federal profit from each region.

4.2. Expenditure Need Assessment

As was done in estimating revenue, important expenditure sectors have been included in estimating expenditure needs of regional states. These sectors have been determined by taking the biggest sectors that cover for more than 95% of the regions' total public expenditure. Since they cover the lion's share of the expenditures of regional states, they can be considered as 'Representative tax categories'. This was done by using regional budget expenditure data obtained from the National Accounts Department of the MoFED. The sectors, which have been considered in the formula, are General Administration, Primary and Secondary Education (including TVET), Public Health, Agriculture and Rural Development, Environmental Protection, Drinking Water, Rural Road Construction and Maintenance, Urban Development and Micro and Small Scale Enterprise (MSE) Development.

Although the expenditure share of development of micro and small scale enterprises and urban development seem to be low, they are found to be crucial to address urban problems particularly unemployment and poverty reduction. Moreover, environmental protection is included in this formula for the first time as it is important to deal with local and global environmental problems in which Ethiopia is taking important steps. Recently these areas are getting more focus in the government's policy. All regions have also expressed their interest to include these three expenditure items in assessing their expenditure needs.

The expenditure share of the sectors to be included in the expenditure need is computed to determine the relative importance of sectors in the determination of expenditure needs of regions. The next step is estimation of unit costs for each sectors selected. The unit cost of each sector is adjusted with disability factors such as dispersion, hardship allowances, extreme weather condition, economies of scale, and spatial price differences to capture the unit cost differentials across regional states. Estimation of sectoral expenditure needs of regions is then done based on the 5 years Growth and Transformation Plan (GTP) of the country and the unit costs estimated. Finally, the total budget for each region (weighted sum of the estimated sector's expenditure need) is computed.

In adjusting the expenditure needs of regions with spatial price index, three scenarios of expenditure need estimates have been considered. These are:

- Expenditure need with full spatial relative price index applied to 100% of the estimated expenditure need
- Expenditure need with adjusted relative spatial relative price index applied to 100% of the estimated expenditure need
- Expenditure need with adjusted relative spatial relative price index applied to only 50% of the estimated expenditure need

Fiscal Gap and the Formula

The fiscal gap of each region is obtained by subtracting the potential revenue raising capacity of regions from their expenditure need. After subtracting the revenue raising potential from the three scenarios of expenditure needs, the following three type of estimated fiscal gap and three scenarios (types) of formula are obtained:

- A formula with full spatial relative price index applied to 100% of the estimated expenditure need
- A formula with adjusted relative spatial relative price index applied to 100% of the estimated expenditure need
- A formula with adjusted relative spatial relative price index applied to only 50% of the estimated expenditure need

The HoF after through discussion agreed to use scenario three with slight adjustment. The adjustment is found necessary so as to achieve the objective of predictability and stable regional budget. Based on mutual understanding they deducted 0.29 from SNNP, and 0.08 from Benshangul-Gumuz and add 0.04 to Harrai, 0.21 to Oromia, 0.08 to Afar and 0.04 to Gambella.

Table 1: The New (2005 – 2008) Grant Distribution Formula

Region	**Three Scenarios**			**Final Kemer Approved the HoF (by political negotiation from Scenario 3)**
	Scenario 1 kemer with Full RPI	**Scenario 2 kemer with adjusted RPI**	**Scenario 3 kemer with adjusted RPI applied to 50% of expend.**	
Tigray	7.61	7.25	7.18	**7.18**
Afar	3.22	3.07	3.07	**3.15**
Amhara	22.55	22.92	23.17	**23.17**
Oromia	32.70	31.94	32.29	**32.5**
Somali	9.07	8.64	8.14	**8.14**
B.G	2.15	2.15	2.18	**2.10**
SNNP	18.62	20.17	20.39	**20.10**
Gambela	1.57	1.49	1.46	**1.5**
Harari	1.12	1.07	0.96	**1.00**
Dire Dawa	1.38	1.31	1.16	**1.16**
Total	100	100	100	**100**