

EXECUTIVE SUMMARY

1. The current draft report on **Prototype Formula Manuals** is a contracted output of the study on ‘**Developing a Model Fiscal Transfer Formula for District Level Fiscal Decentralization**’ commissioned to an Individual International Consultant (IIC). This study is a product of **DLDP - PSCAP**, which forms part of a sub component titled “**Woreda Fiscal Transfer and Own Revenue Enhancement**”. This initiative is implemented under the auspices of the Ministry of Capacity Building (MCB) supported by the World Bank under Contract REFERENCE PROJECT NO. PSCAP/DLDP/IC-4-2005 (CR. 3899-ET) contracted to Dr. Ludovick Leon Shirima (IIC), KONSULTecon Institute International, 910 17th Street, N.W. Suite 419, Washington, D.C. 20006 USA.

The specific objective of this study is to review and develop a prototype intergovernmental grant transfer formula to allocate funds from the Regional States to the district governments popularly known as Woreda in Ethiopia. Two manuals are produced in sections 4.3.1 and 4.3.2 as part of recommendations to be used by relatively and less developed regions.

The methodology applied to this study is participatory in nature and adopted three key elements that include literature review and field visits to regions and woredas for consultations. Finally, data collection and analysis is conducted to allow for informed recommendations based on facts and figures.

- Literature review – we gathered relevant documents that covered the study areas previously done for FDRE and supplemented the review by including a carefully selected international best practices.
- Field visits to regions and woredas for consultations – secondly, all regional offices were visited with an object to collect their views on the whole issue of transfer formula design and implementation. In order to have a structured interviews and consultations a checklist of questions was developed and faxed to the bureaus before the visits. In every region at least one woreda was selected at random and visited with the same aim.
- Data collection and analysis – to support they study findings data was collected at each field visit and other federal level agencies such as Central Statistical Agencies (CSA) and Ministry of Finance and Economic Development (MOFED) to be used for the new proposals. Aside, as part of the analysis, the regional current formula in use were examined from the mathematical specification to data application based on the proxy variables used to establish their strengths and weaknesses.

2. Therefore, the report is divided into seven main Parts. In part I it examines the background to the assignment and at the same time expounds its objectives. Further, the methodological approach is laid down as detailed above.

3. Part II reviews the previous studies on the subject for Ethiopia and provides International Best Practices. The following countries were carefully selected since their experiences fits well study objectives ranging from developing to developed countries:

- a) Latin America – *Chile, Colombo, Mexico and Brazil.*
- b) Africa – *Nigeria, South Africa and Rwanda.*

- c) Asia – *Indonesia, China and Bangladesh.*
- d) The Developed Federations - *Canada and Australia.*

These country experiences have been examined in detail where lessons and caveats have been drawn with reference to the Ethiopian context. Moreover, examples from other countries are used as specific examples to augment the selected case studies.

4. We discuss each of the study areas in turn in the sections that follow.

Fiscal Vertical Imbalances (VFI) - Countries all over the world try to do the best they can to ensure that revenues and expenditures of each level of government are equivalent (Bird, 1986; Bird and Smart, 2002). Both studies defined VFI as the difference between expenditure and own source revenues (OSRs) at different levels of government. The difference between the two is christened ‘fiscal gap’, which is one of the main rationale for grant transfers from one level of government to another. Other studies (Bird, 2001; Chernick, 2000; Broadway and Hobson, 1993) have cited several ways to close the gap:

- They argued that Central governments may transfer revenue raising powers to local governments
- or transfer expenditure responsibilities to the centre
- or reduce local expenditures, and;
- or raise local revenues.

The FDRE has adopted partially some of these measures but it is too early to make a serious assessment of the outcome of this initiative. However, enforcement is lacking especially in the SNLGs due inexistence of appropriate institutional set up and regulatory framework.

Horizontal Fiscal Imbalances (HFI) - Nonetheless, the same studies (Bird, 1986; Bird and Smart, 2002) refer to HFI as the difference between the resources available to governments at the same level, that is, regional inequalities. Still HFI remains controversial both because different countries have very different preferences in this respect and because it is a concept with many different interpretations. As such, the existence of the resource gap between same levels of government necessitates the allocation of grant transfers between the various tiers of governments, to at least bring them to the same levels of service delivery. There are two main ways to accomplish this.

- First, some countries equalize the actual outlays of local governments in per-capita terms i.e. raising them to the level of the richest local government for instance in Germany and Russia (Baretti, Huber, and Lichtblau, 2000). This approach is criticized because it ignores local preferences in needs, tastes and costs. In addition, this would discourage both own-revenue raising effort and local expenditure restraint.
- Secondly, countries may equalize revenue generation capacity. The aim here is to provide each local government with sufficient funds consisting of OSRs and transfers to deliver a centrally pre-determined level of services. Critically, Smart (1998) argued that capacity equalization as is used in Canada, may drive local tax rates higher than is desirable from a national point of view. In Ethiopia, a crude method is used that attempts to address both revenue and expenditure equalizations (see sections on the review below).

Main Types of Grants in Practice

Several studies have identified four types of grants applicable in many countries as single, whole grant or composite mix of the various grants including; conditional grants, unconditional grants, matching grants and equalization grants (Fjedstad, 2001; Bird and Smart, 2002; Shah, 1994). We consider each in turn in the sub-sections that follow.

- **Conditional Grants** - these are 'tied grants' associated with some conditions as to how they should be spent by the receiving sub national level of government (SNLG). Empirically, in practice in many countries, CGs are seen to have become as detailed and onerous as to hamper effective SNLG. Nevertheless, it is argued by various proponents of intergovernmental relations that, central governments have two reasons for being interested in what SNLGs do in financing development projects such as infrastuctural. First, local infrastructure may involve significant externalities and spill over effects. Secondly, some such projects may constitute essential elements of national development programs.
- **Unconditional Grants** (UCGs) - these are alternatively known as 'untied grants' used for budget support that is mainly, for general purposes. Their prime object is to bridge the VFI discussed earlier. They are used at the discretion of the recipient, where sometimes ranges from recurrent as well as capital budgets funding. In FDRE they are famous at federal-regional transfers in the form of federal block grant of which they consist about 70% of the total grants. The same is true at Regional State-Woreda levels. In Indonesia, general-purpose grants form about 23% of the total transfers in 1990-93 (Shah and Qureshi, 1994). On the whole, per capita transfers in Indonesia seem to be positively correlated to poverty profile levels. The opposite is true for FDRE allocations perhaps due to the omission of plausible poverty proxy in the transfer formula (World Bank, 2006).
- **Matching Grants** - The importance of Matching Grants (MGs) arises due to the fact that money is fungible, in practice it is very difficulty to ensure that the recipient is conditional on performance and compliance is monitored in some way. In reality, local resource mobilization is an essential component of any successful fiscal decentralization initiative. Therefore, increased transfers must be coupled by matched local contribution of an agreed rate. The implication is that transfers are unlikely to have good incentive effects on local revenue mobilization unless these are linked to SNLG's revenue efforts.
- **Equalization Grants** (EGs) - These are intended to channel resources from relatively wealthy SNLGs to poorer ones, expected to address both existing HFI and VFI. This is not practical for FDRE, for instance, the towns of Addis Ababa and Dire Dawa, which are fiscally self sufficient in terms of mobilizing their OSRs do not receive transfers, yet they do not transfer resources to the poor regions.

Grant Formula Design Issues - Designing a good transfer system involves three main considerations. These include:

- **Transfer Pool (TP) Determination** - At first, a good transfer system is manifested in the way TP is determined. Its attributes are predictability, flexibility and stability. Several studies agree in theory and supported by empirical evidences that there are three traditional ways of determining the TP applicable in any country.

- a) As a fixed proportion of central government revenues; for instance in Rwanda only 7% is allocated for budget support (Shirima, 2004). In Philippines transfer pool is a function of the pre-determined share of national taxes. Also, in the developed countries of Austria and Japan the same is applied, where 12% of income and value added tax (VAT) in the former and 32% of income and alcohol taxes of the latter are respectively transferred to their local governments. In large federal countries of Nigeria and Brazil tend to use such systems. The same is true with Colombo and Argentina.
- b) On ad-hoc basis, that is, in the same way as any other budgetary expenditure. This is the approach that has been used by FDRE's MOFED since transfer allocation started in 1995/96 and inherited by the regional state governments in distributing grants to the Woredas.
- c) On a formula driven basis, that is, as a proportion of specific local expenditures to be reimbursed by the central government or in relation to some general characteristic of the recipient jurisdiction.

Formula Architecture - This section surveys and summarizes approaches adopted in a number of countries developed as well as developing countries to gain the necessary exposure of the relevant issues and then finally use the same to construct a model applicable for FDRE. In literature, there are about four kinds of intergovernmental fiscal transfer formula namely.

- **Model 1: Seeks to equalize both revenue capacity and expenditure needs of different regions.**
- **Model 2: Attempts to equalize revenue capacities.**
- **Model 3: Formulas that distribute equalization transfers on an equal per capita basis.**
- **Model 4: Formulas that distribute equalization transfers based on some 'need indicators.**

The section investigates all in detail where caveats are deduced for FDRE.

5. Part III builds on the findings presented in Part II, outlining the proposed prototype formula applicable for both reforming and less developed regions. The section suggests two options prototype formula for intergovernmental fiscal transfer to be applied to distribute resources from regional states to woreda levels of government in FDRE. It also describes four possible structures of transfer schemes that may be proposed.

Besides, the section provides an account of the qualities – *“the Stylized Facts of a Good Transfer System”* of the proposed formula empirically based on the discussions provided such as: autonomy, revenue adequacy, predictability and efficiency consideration, simplicity and incentive.

6. The section proposes two *prototype formulas* as separate manuals (sub - sections) to give room for the regional governments to select the one that fits their context. It must be emphasized that the regional states have done a commendable role in tinkering with various models of transfer formulation. This has two positive effects to the governments: First, it has given them a good understanding of the main issues that surrounds the design of fiscal intergovernmental transfers. Secondly, and most importantly it has exposed the

BOFED and OFED officials to build a comprehensive data set especially on the expenditure needs determination.

- **OPTION 1: Reforming Regional States - Woredas Transfer Formula.** This formulation will be documented as manual no. 1 and requires BOFED and OFED to introduce revenue capacity in the determination of the woreda entitlements. It recognizes that the revenue effort proxy currently in use, does not sufficiently capture the actual woreda state of own source revenue (OSRs). To implement this formulation the respective bureaus requires short to intermediate time frames to collect data on their revenue capacity proxies. This may take 3 to 6 months perhaps in Afar and Benshangul Gumuz regions and 6 to 12 in the Gambela and Somali areas.
- **OPTION 2: Less Developed Regional States - Woredas Transfer Formula.** It considers a simple new formulation that applies proxies that may not be influenced by woredas as beneficiaries, who are also the data supplies mainly for the least developed areas. The compilation of option 2 will be documented as manual no. 2.

7. In Part V an account of regulatory framework and institutional set up is given. It seeks to elaborate briefly on the requirements of sound regulatory framework and institutional set up that is needed to implement a successful system of intergovernmental fiscal transfer formula to the lower levels of government. These two related issues are clearly provided in the FDRE constitution in Articles 47 and 57 respectively, pronounced in 21st August 1995. In addition, following the administrative layers of government; the various regional state governments in turn have solidified this in their constitutions also known as proclamations.

8. Historically, the mechanisms to share revenues between the central and the lower level of government in Ethiopia was by proclamation No. 33/1992 before the enactment of the FDRE Constitution. It was then adopted into the new constitution under Articles 94(2), 95, 96 up to 100. With the current legal framework arrangements it becomes very difficult for the lower levels of government to impose amendments based on the current evolution of changes needed to improve the fiscal and transfer allocation systems (see section 99 of the constitution).

9. Transfers, revenues and expenditures issues should have been guided by another law, preferably ‘Organic Law’ or ‘by laws’ supplemented by ‘regulations’ with some flexibility to invoke some changes whenever deemed reasonable by the relevant authorities. Obviously, constitutions are too rigid and amendments are very difficult to implement.

16. Nonetheless, due to the existing government structure and the division of roles among the differing levels of sub-national governments there is no formal ministry responsible for Local Governments (LGs). Therefore, no Local Government Act (LGA) that could have cemented the various fiscal needs of these levels.

10. Accordingly, when considering institutional set up three issues warrant mention in this section: Firstly, **institutionally** the above narrated layers of bureaux (MOFED, BOFED and OFED) responsible for administrating and distributing transfers work as extended levels of federal government. For instance, they collect federal taxes at their region and execute or supervise various federal level programmes in their regions. There should be clear separation of the roles of various levels especially on the fiscal relations.

11. Secondly, the inexistence of The Ministry of Local Government (MOLG). FDRE is cognizant of these anomalies and efforts at Federal and regional levels have already been initiated to find out how the current practice can be transformed into local government structures. The DLDP of the MCB have commissioned a study to provide suggestions on how the intended transformations may be carried on. The resulted draft proposals for both have already been used with some regional level governments for instance SNNPR to customize it to suit their local demands.

12. Thirdly, the Missing Transfer Watchdog Body. Until recently, the role of transfer design and distribution was under MOFED, which was contrary to the constitution we cited above. The practice was inappropriate when one considers the attributes of a good transfers system mentioned elsewhere in this study. Shifting, the responsibilities to HOF, is in line to the main law of the land. Nevertheless, countries with a good history of transfer allocation such as India, Malawi, Rwanda, Uganda and Australia have established an autonomous body to design, operate, update and monitor its performance.

13. The main weakness with this set up is the fact that since HOF draws members from each region, consensus building may be a huge problem. Moreover, this task requires technical abilities which may not be available within the members who are politically oriented. This study observes a creation of an independent body along the lines expounded in this report using either Rwanda or Australia as case study.

14. Part VI of the report presents recommendations and conclusions. It is expected that the study serves as an input into broader view of the GOE in improving the fiscal transfer mechanisms. Under **Federal - Regional Block Grant Formula** consideration it has been observed that most of the regions started the implementation of the transfer formula by initially adopting or replicating the federal formula. The main reasons for the observed practice are:

- a) mainly due to the lack of **technical know how** for the SNLGs to develop a transfer system that meets their local jurisdictional specifications.
- b) it is always logical to relate the federal transfer system to that of the region – woreda formulation.
- c) the data used at federal level comes from woreda.
- d) this may ensures uniformity in the proxies, which initially are the determinants of the tranfer entitlement first to regional level.

Therefore, the following reccommendations are in order.

- I. there should be a link between the two formulas starting from the design, specifications, proxy selection and the transfer administration.
- II. both should apply a simple formula based method in the determination of the transfer pool or finacial envelop. International experinces tells us that it is plausible to set it in a stable but flexible way, specifically as a percentage of the central government revenue for the Federal level and OSRs for the SNLGs.
- III. a data bank should be developed that serves the two grants system for consistency and reliability.
- IV. when the above three are observed then it becomes possible to harmonize the two levels of grant system, which is good for transparency, simplicity and

accountability. Later, this will facilitate coordination, auditing, monitoring and evaluation.

- V. A creation of Local Government Ministry (MOLG) forms a core ingredient to the decentralization process and therefore pave the way for a sound intergovernmental transfer application. The current structure fits deligation and not devolution, since the regional BOFED and woreda OFED are seemingly extensions of MOFED, a central ministry.
- VI. Following (5) there is an immediate need to reform the current institutional set up to the above direction and the legal framework by enacting a “Local Government Act” to guide the process.
- VII. At the same time, there is a need to separate the FDRE Constitution to the Regional Proclamations or Constitutions especially in the Articles and Sections responsible for revenues, expenditures and functions of the SNLGs. The main reason is to accommodate frequent changes as may deem fit.
- VIII. There is an immediate need for the DLDP unit to recruit a permanent “Fiscal Decentralization Expert” at least for one year to give the much needed expertise in the implementation of the formula proposed. The advisor should also play a major role in shaping the the revenue enhancenet strategy of the SNLGs which needs a complete overhaul.

15. The study observed that Reforming Areas Block Grant Formula is at an advanced stage both by design and application. At present, have managed to construct useful data set for allocation, formulated a variety of trial formulas, established a working team of transfer experts within their institutions and instituted some kind of legal framework to guide the implementation. Moreover, they share their regional experiences from the design to implementation stages. The study recommends the following:

- IX. Since the coordination and consultations are informal, there is a need to formalize the sharing of experinces and practices. Regional Expert Group should be created to meet at least twice a year to discuss issues of practical experiences in their region.
- X. Their formulas should be linked to minimum standard service benchmarks and from (5) above establish regional comprabilty of the standards attained.
- XI. All good experinces from the advancements from these regions should be used as inputs to up grade the practice of the backward regions.
- XII. each of these regions have ambitios plans to subdivide their regions into more zones and/or woredas. This is an expansion of the admistrative structures that implies extra administrative costs. There should be a thorough exammination to justify such course of action beyond the requirements of the Consitution of the FDRE. For instance, the cost-benefit and situational analysises.
- XIII. Data and proxy selection should be studied further, restrict the number of proxies to be used into very few.
- XIV. Simplify the methodological approach to increase its correctness, avoid complex specifications such inverse functional form, use of mean of means, and unnecessary adjustments.

- XV. Avoid frequent modifications and shifts in the formula design. This creates confusion and leads to a loss of credibility in the whole issue of transfer process.
- XVI. There has been a good attempt in the creation of data set on the 'expenditure needs' but very little or nothing on the 'revenue capacity'. This is the main weakness of the current system observed by our study. We recommend the inclusion of the 'revenue capacity' information as we suggested elsewhere in this study. This will have an overall effect of improving the allocation mechanism.

16. Field visit for the *Less Developed Areas Block Grant Formula* revealed that they are backward both in design and application. As such concerted efforts are required to bring them up to speed and realize the benefits of decentralization. Thus, the following must be done:

- XVII. Initiate a comprehensive capacity building programs in the area of intergovernmental fiscal transfer. This will bridge the gap that exist in these areas to augment the gains mentioned in (8) above.
- XVIII. In some areas such as Gambela where there is no proper use of structured formula they should start by applying a simple formula like the one proposed by this study in the short-run. This may be implemented until such a time they develop the required skills and technical capabilities in the design and implementation of the transfer system (immediately without delay).
- XIX. In the medium term efforts should be directed into data set development and acquisition of the necessary skills and physical resources (in six to twelve months).
- XX. Then introduce gradually phase-wise the 'expenditure needs' in to the formulation by selecting few and simple proxy combination approach, replicating the developed areas practice, this may last for three years.
- XXI. Next start to introduce into the model information about 'revenue capacity' to complete the requirement of good equalization formula i.e. applying the proposed option 1 formula.

17. In summary the study draws conclusions from the international experiences and the preceding discussion as narrated below:

- A. As it stands now in the FDRE still there is a need to maintain both general purpose and specific purpose grants. This may be implemented until such a time that the intended purpose of the specific grants attains the established minimum standards for service delivery. A good example is the 'performance contract' initiated by the government of SNNPR.
- B. It is advisable for both levels of government to set the transfer pool as a percentage of their taxes; largely avoid dependency of foreign or external support, which may not be forthcoming.
- C. A good transfer system should use 'expenditure needs' as well as 'revenue capacity' in a realistic, simple, and transparent manner as much as possible.
- D. Since the FDRE has given SNLGs powers to tax and spend, including handling of transfers, the newly designed transfer formula that contains the elements contained in (3) above there is no need to introduce features to encourage additional tax effort proxy.

- E. FDRE is in the right track by relaxing the conditional ties of the block grant, that is, to be spent according to the needs and discretions of the recipient government.
- F. It has been noted that the specific grants must have a matching component, which should probably vary both with the type of expenditure and fiscal capacity of the woreda government. For instance, in Tigray it was noted that community based contributions in kind and monetary lowers their amount of expected transfers as is accounted for as part of higher service attainment.
- G. For any specific grants directed towards infrastructural development as roads, schools, water and hospitals, the recipient government must satisfy technical requirements for assessing public investments to ensure that the money is properly spent.
- H. Finally, all the SNLGs should be required to adhere to prudent financial regulations and standards such as to maintain adequate and current accounts, and to be audited regularly and publicly.