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Analysing Fiscal Federalism in Global South: South Africa, Kenya, Ethiopia and Nepal

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Abstract

This paper examines the fiscal federalism processes in four countries in the global south – viz., South Africa, Kenya, Ethiopia and Nepal – focussing on their revenue and expenditure assignments and intergovernmental revenue sharing mechanisms. The significance of focussing on federations in global south is that the processes are still dynamic in terms of "optimal concurrency" in the expenditure and revenue assignments; and "revenue sharing" norms. The common feature of all these federations is the vertical and horizontal fiscal imbalances emanating from the asymmetric revenue and expenditure assignments and in turn identifying and restating the role of intergovernmental fiscal transfers to arrive at economic convergence across jurisdictions.

Introduction

Why do nations "federate"? Or, why do units "hold together" as an optimal political area? Empirical analysis of such questions are highly confined to advanced countries, for instance, Alesina et al (2017) have examined 15 European Union countries and Norway from 1980-2009 to determine if "Europe" – formed on the basis of economic integration - as a political project was "too ambitious." However, the federalism in global south is an area that has not been extensively analysed.

This paper examines the fiscal federalism processes in four countries in the global south – viz., South Africa, Kenya, Ethiopia and Nepal – focussing on their revenue and expenditure assignments and intergovernmental revenue sharing mechanisms. The significance of focussing on federations in global south is that the processes are still dynamic and the federal fiscal relations are still undergoing transformation in terms of "optimal concurrency" in the expenditure and revenue assignments; and in terms of "revenue sharing" norms. For instance, Nepal became a federation after a long unitary rule only in 2015 with the promulgation of the Constitution, and still mapping out an optimal revenue sharing formula based on inter-jurisdictional expenditure needs. The House of Federation in Ethiopia has been continuously revising the federal grant sharing formula and also grappling with the elements of multi-ethnic federalism. The CRA in Kenya is tackling the issues relate to revenue allocation across jurisdictions especially in the context of sharing natural resources taxation. South Africa is a peculiar "hour glass" fiscal federal model with a few tax handles at the Provincial level.

The common feature of all these federations is the vertical and horizontal fiscal imbalances emanating from the asymmetric revenue and expenditure assignments and in turn identifying the role of intergovernmental fiscal transfers to arrive at economic convergence across jurisdictions. The methodology followed in this paper is a judicious mix of secondary literature, inferences from the multiple field level meetings in the countries, especially with the House of Federation in Ethiopia and the international meeting with the experts and policy makers from Kenya, South Africa, Nepal and Ethiopia, organised by NIPFP.

The paper is organised into sections. Section 1-4 analyses the specific country experiences in terms of revenue and expenditure assignment and intergovernmental transfer mechanisms in South Africa, Kenya, Ethiopia and Nepal respectively. Section 5 uses general government data from Government Finance Statistics (GFS) published by the IMF to understand the revenue and expenditure by function and economic classification across these four countries. Section 6 concludes.

1. Federalism in South Africa

South Africa has a unitary system of governance, but, in practice, it is highly decentralised with three tiers of government. It has, besides the national government, nine provinces and 284 local governments. In the reorganisation of sub-national units of government, race has been an important consideration rather than fiscal imperatives. In the post-apartheid era, four white provinces and nine black homelands were reorganised into nine provinces; while 843 transitional municipalities were consolidated into 284 local governments by combining the black and white areas (Chakraborty and Bagchi, 2006). There are, however, no rural local bodies unlike panchayats in India.

The constitution assigns revenue powers and functions to the three levels of government (Table 1). The asymmetry between the revenue powers and expenditure functions across the tiers of government have made provinces and local governments dependent in varying degrees on transfers from national government flowing through a revenue sharing model.

In terms of revenue assignment, local governments — all municipalities — have access to some substantial tax powers unlike the provinces. While the national government is vested with all broad-based taxes such as income tax, corporation tax, VAT, excises, fuel levy, and customs, constituting around 80 percent of total revenues, sources of revenue for provinces are very few and insignificant (Chakraborty and Bagchi, 2006; Fourie and Valeta, 2008). These include gambling taxes (betting tax on casino and horse race), motor car license fees, and user fees on hospital services.

Revenue assignment in South Africa, the revenue assignment follows an "hour glass" model, with thin tax handles with the provincial government. it is the national government that raises the bulk of the country's revenue through instruments such as corporate tax, value added tax, fuel levy, pay as you earn, customs and excise duties (Table 1). The provinces, on the other hand, have very limited tax instruments like gambling licencing, tourism levies and toll roads levies. Municipalities have a more significant tax base where they can raise revenue from sources such as municipal rates and tariffs and property taxes. (Fourie & Valeta, 2008).

According to the Republic of South Africa Budget Review, provinces raise about 3 per cent of their budgets from own revenue that comes mainly from vehicle and gambling licences, and service fees. On the other hand, the municipal governments are largely able to finance much of their budgets from local revenues. This may be attributed to the fact that are allowed to exclusively levy high-yield

taxes such as property tax and surcharge for services like water and electricity. Consequently, they require less of inter-governmental grants (Kabru, 2013). In 2015-16, only 30% of budgeted municipal revenue was derived from transfers and subsidies. (2016 Budget Review).

Table 1: Revenue and Expenditure Assignments

Level of Government	Expenditure Functions	Revenue Powers
National	Defence and Intelligence	Income tax (personal)
	External Affairs	Income tax (corporate)
	Criminal Justice (Police, Prisons, Justice)	VAT
	Home Affairs	Fuel levy
	Higher Education	Excise
	Welfare	
	Housing	
	Health	
	Education	
	Communications	
	Science and Technology	
	Culture	
	Art	
	Land Affairs	
	Environment and Tourism	
	Minerals and Energy	
	Trade and Industry	
	Water Affairs	
	Public Works	
	Transport (National roads and bus subsidies	
Provincial	School Education	Tax on gambling
	Provincial Roads	Hospital fee
	Housing	License fees
	Welfare	Motor car
	Health (academic, Hospitals, primary)	
Local	Electricity Reticulation	Property tax
	Garbage Collection	Regional levies
	Administration	Electricity/ Water user Charges
	Municipal	
	Fire fighting	
	Municipal Infrastructure (Streets)	
	Water	
	Sanitation and Waste	
	Water Reticulation	

Source: Chakraborty, 2021

Expenditure assignment analysis reveals that nearly 80 per cent of provincial budgets are spent on health, basic education and social welfare, according to the 2019 Budget Review by the Treasury of republic of South Africa. Rising level of unpaid bills and medical negligence claims puts pressure on the health budgets of the provinces. However, cost-containment measures in the much recent years have enabled provinces to reallocate R 5.7 billion to education and health, as per the 2018 Budget Review. It has also been seen that underspending has stabilised across national and provincial governments (National Treasury, Republic of South Africa, 2018).

The intergovernmental fiscal transfers, as per the South African Constitution (section 214) in 1996 provided for two types of transfers to the devolved units. The first being the "equitable share" of nationally collected revenues. Accordingly, since 1998 certain shares of national revenues (after national debt servicing needs and contingency reserve for emergencies) have been allocated to subnational governments as their "equitable share". This enables the other two lower governments to provide basic services to poor residents. Under the system, nationally raised revenue is divided among the three levels of government, after national debt-servicing needs are met and a contingency reserve for emergencies is taken into account. The second is a set of conditional and unconditional grants to accomplish different purposes such as staff salaries, water services subsidy and capacity-building initiatives. (Kaburu, 2013).

As per the latest estimates, provincial governments receive 69.0 percent of national revenue as "equitable share" in 2019-20 while local governments receive 8.6 percent of the national revenue (Medium Term Budget Policy Statement, 2019). The division of revenue is made for three years under the multi-year budgeting system in South Africa. The estimates of recent division of revenue till 2022-23 are given in Table 2.

Table 2: South Africa: Medium term Estimates of "Equitable Share"

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
R billion	Outcome			Revised	Medium-term estimates		
Division of available funds							
National departments	555.7	592.7	634.4	742.8	757.4	766.2	796.2
Provinces	500.4	538.6	572.0	612.8	651.5	694.8	731.1
Equitable share	410.7	441.3	470.3	505.6	541.0	576.7	607.6
Conditional grants	89.7	97.2	101.7	107.3	110.5	118.2	123.5
Local government	102.9	111.1	118.5	127.2	132.4	143.0	152.2
Equitable share	50.7	55.6	60.8	69.0	74.7	81.1	87.2
General fuel levy sharing with metropolitan municipalities	11.2	11.8	12.5	13.2	14.0	15.2	16.1

Conditional grants	40.9	43.7	45.3	45.1	43.7	46.8	49.0
Provisional allocations not assigned to votes	-	-	-	-	21.2	34.9	33.1
Projected underspending				-3.2			
Total	1159.0	1 242.3	1324.9	1 479.6	1 562.5	1638.9	1712.6
Percentage shares							
National departments	48.0%	47.7%	47.9%	50.1%	49.1%	47.8%	47.4%
Provinces	43.2%	43.3%	43.2%	41.3%	42.3%	43.3%	43.5%
Local government	8.9%	8.9%	8.9%	8.6%	8.6%	8.9%	9.1%

Source: Medium-Term Budget Policy Statement 2019

According to the Medium-Term Budget Policy Statement 2019, all direct conditional grants have been lowered in the recent past, except for the early childhood development grant and the learners with profound intellectual disabilities grant. (National Treasury, Republic of South Africa, 2019).

The "Provincial Equitable Share" allocation to each province is determined by a formula that takes into account the population growth, economic activity, poverty, and demand for services like education and healthcare. Smaller provinces are also compensated for the fixed costs of maintaining provincial institutions. (2016 Budget Review). To ensure fair funding allocations to each province, the provincial equitable share formula is updated annually to reflect demographic changes related to the demand for services provided by provinces. (Medium-Term Budget Policy Statement, 2019).

According to 2018 Budget Review, Provinces, which depend on transfers from national government for over 95 per cent of their budgets, face substantial spending pressures to provide health, education and other services to growing populations. In this context, most of the reductions in transfers to provinces have been made on infrastructure grants. The provincial equitable share, which accounts for over 80 per cent of transfers and funds operating expenditure covering the salaries of teachers and nurses, is reduced by R4.7 billion over the MTEF period. Provinces are expected to absorb the impact of these reductions by reducing the spending on non-core items such as travel and consultants, and on non-priority programmes. (2018 Budget Review).

The "local government equitable share" enables the municipalities to provide basic services to poor households, enable municipalities with limited own resources to afford basic administrative and governance capacity and perform core municipal functions. The "local government equitable share" formula has been updated recently to account for projected household growth, inflation and estimated increases in bulk water and electricity costs over the MTEF period. Large urban municipalities continue to underinvest in infrastructure, primarily

because of poor programme and project preparation practices, leading to long delays, higher costs and breakdowns in service delivery. While public and private capital funding is available, these weaknesses translate into low levels of effective demand from the municipalities. To address these problems, from 2020-21 government will introduce dedicated grant funding for large urban municipalities (Medium-Term Budget Policy Statement,2019) (National Treasury, Republic of South Africa, 2019). According to the 2016 Budget Review, poor and rural municipalities, which have much lower tax bases than big cities, rely more heavily on national transfer. There are challenges, for instance, some form of financial distress in South Africa is evident from the fact that 81 municipal councils had voted in 2017/18 to adopt budgets which they knew were not funded. (2018 Budget Review). Section 100 of the constitution requires the ministry or even the cabinet to take a decision to go to parliament, to get parliamentary approval before an intervention to be taken. Fiscal Finance Commission has no significant powers.

2. Federalism in Kenya

The constitution of 2010 established a two-tier government in Kenya with a national government and 47 county governments. According to Article 216(1) of the Constitution of Kenya, the Commission on Revenue Allocation (CRA) is mandated to make recommendations determining the basis for the equitable sharing of revenue raised by the National Government between the national and county governments, and among the county governments. Article 216(2) further mandates the Commission to make recommendations on other matters relating to the financing of, and financial management by, county governments and to encourage fiscal responsibility (Wangome, 2016). However, those recommendations of the CRA are not binding.

Table 3: Revenue and Expenditure Assignments In Kenya

Level of Government	**Revenue Functions**	**Expenditure Functions**
National Government	income tax	National defence
	value-added tax	Police services
	customs duties	Judicial services
	and other duties on imports and exports,	National public works
	excise duty	Promotion of sports and sports education.
	Fees and charges	Disaster management
		All other functions not included under county government

County Government	Property rates	Agriculture
	Entertainment taxes	County Health Services
	Fees and charges	Control of air pollution, noise pollution, other public nuisances and outdoor advertising
		Cultural activities, public entertainment and public amenities
		County transport
		Animal control and welfare
		Trade development and regulation,
		County planning and development
		Pre-primary education, village polytechnics, homecraft centres and childcare facilities
		Implementation of specific national government policies on natural resources and environmental conservation,
		County public works and services,
		Firefighting services and disaster management
		Control of drugs and pornography.
		Ensuring and coordinating the participation of communities and locations in governance at the local level and assisting communities and locations to develop the administrative capacity

Source: Kenya Law Reform Commission, accessed from http://www.klrc.go.ke/index.php/constitution-of-kenya/167-schedules-schedules/fourth-schedule-distribution-of-functions-between-national-and-the-county-governments/447-1-national-government

Revenue assignment reveals that in Kenya, to the extent that county's own-source revenues are meagre, county governments will virtually be fully dependent on national revenues and any potential (implicit or explicit) strings attached. In this regard, the Constitution explicitly assigns property rates and entertainment taxes to the county level, in addition to a number of non-tax revenues (fees and charges). While further tax sources may be assigned to the county level by national legislation, all major revenue sources (the value-added tax, income taxes, and excise taxes) are exclusively assigned to the national level. The constitutional assignment of taxes and revenue powers leaves county governments with a limited own-source revenue base from which to make autonomous fiscal decisions. (Boex & Kelly, 2011). Silas(2018) noted that the share of county own revenue in total county revenue ranged from 0.759 per cent to 90.17 per cent with a mean of 37.72 per cent. The proportion of own source revenue collected by the county governments is low compared to overall revenue. This is below the UN recommendation of 50 per cent plus or minus 10 per cent of the total sub national

government financial resources. This could be attributed to weak local revenue base and weak revenue administration in most counties in Kenya. Therefore, county governments in Kenya have very little control over their revenues (Silas, 2018).

Expenditure assignment analysis reveals that the Constitution assigns 14 functions to the county government and 35 functions to the national government and allows for voluntary transfer of functions or powers of government from one level to the other by agreement between the governments. However, there may be overlaps in these functions between the two levels of government. For instance, the national government is granted control of national betting, casinos and other forms of gambling, whereas the county governments are also granted control of county betting, casinos and other forms of gambling. This may cause conflicts in determining national casinos and county casinos. Similarly, the national government is in charge of promotion of sports and sports education with the county governments being in charge of sports and cultural activities and facilities. This may cause conflicts over management of stadia already under the Stadia Management Board. (Kaburu, 2013). Moreover, there is no clear demarcation on how expenditure related to these functions is generated and spent. To cure the overlaps, the Constitution provides that functions conferred on more than one level of government are within the concurrent jurisdiction of both, and functions not assigned to the County Governments remain to be functions of the NG. (Kaburu, 2013). On the side of expenditure decentralization, the share of county government expenditure in total government expenditure ranged from 0.006 per cent to 1.424 per cent with a mean of 0.145 per cent over the study period of 2002 to 2013. The wide range between the maximum and the minimum values for all the variables suggests a large heterogeneity across the counties (Silas, 2018).

Article 202(1) of the Constitution stipulates that revenue raised nationally shall be shared equitably between national and county governments. More so, Article 216(1) (a) mandates the Commission to recommend a basis for the equitable sharing of revenue. Shareable revenue is defined in section 2 of the Commission on Revenue Allocation Act, 2011 to mean: "all taxes imposed by the national government under Article 209 of the Constitution and any other revenue (including investment income) that may be authorized by an Act of Parliament, but excludes revenues referred to under Articles 209 (4) and 206(1) (a)(b) of the Constitution".

The Commission prepared and submitted a recommendation on vertical sharing of revenue for FY 2016/2017: Ksh.331, 600 million for counties and for national government. The recommendation for counties equals to 35.4% of audited approved accounts in line with <u>Article 203(2) which requires that at least 15% be allocated to counties.</u> The latest audited accounts available are of 2013-

14. (CRA Report 2016-17). The second revenue sharing formula was prepared by the Commission in FY2015/2016 and approved by Parliament at the end of June 2016 for the horizontal dissemination (Table 4).

Table 4: Equity in the sharing of revenues: Second Amended Formula

	Parameters	Percentage Weights
1	Population	45%
2	Equal Share	26%
3	Poverty	18%
4	Fiscal Effort	2%
5	Land Area	8%
6	Development Factor	1%

Source: CRA Annual Report of 2016-17

The sharable pool has declined from 18 per cent of GDP to 14 per cent of GDP in the recent past. Four per cent of GDP is a whole loss of resources. The Commission on Revenue Allocation has recently presented the recommendation on the third basis for equitable sharing of revenue among county governments (Table 5). The basis is expected to be used for sharing of revenues for financial years 2019/20 to 2023/24. (CRA, 2019).

Table 5: Equity in the sharing of revenues. (Third Formula)

	Parameters	Percentage Weights
1	Health	17%
2	Agriculture	10%
3	Other county services	18%
4	Basic Minimum Share	20%
5	Land Area	8%
6	Roads	4%
7	Poverty	14%
8	Urban Services	5%
9	Fiscal Effort	2%
10	Fiscal Prudence	2%

Source: CRA Annual Report of 2016-17

According to the CRA report of 2016-17, the "Current Conditional Allocations" include hospitals, free maternal health care, compensation for user fees forgone, leasing of medical equipment, road fuel levy fund (15% of Actual 2014/15) and county emergency fund. The New Conditional Grants include personnel emoluments for devolved staff, construction of headquarters in five

counties, rehabilitation of primary and secondary schools, rehabilitation of village polytechnics. (CRA Report 2016-17).

Table 6: Conditional Allocations in Kenya

	2016/17 Actual	2017/18 CRA Recommendation	2017/18 Actual
Sub Total Current Conditional Grants	18,028	26,863	20,668
Sub Total New Conditional Grants	-	9,100	2,605

Source: CRA Annual Report of 2016-17

In recognition of the vast regional and other inequalities across the country, an Equalisation Fund was established consisting of 0.5% of all revenue collected by the National Government each year. This fund is to be used for providing, 'basic services including water, roads, health facilities and electricity to marginalised areas to the extent necessary to bring the quality of those services in those areas to the level generally enjoyed by the rest of the nation, so far as possible'. The National Government is also allowed to utilise the Equalisation Fund through conditional grants to Counties with marginalised communities. County Governments may be given additional allocations from the National Government's share of the revenue, either conditionally or unconditionally. (Kaburu, 2013). In a paper that used panel data collected from government and UNDP publications, it was shown that on an average from 2002 to 2014, each county received 2.127 per cent of total intergovernmental transfers, with a range of between 0.319 per cent and 15.412 per cent (Silas, 2018). While the weak assignment of revenues to the county level is offset to some extent by the block nature of discretionary grants received through the equitable share, transfers are not perfect substitutes for own revenue sources in the design of an intergovernmental fiscal system. (Boex & Kelly, 2011)

The Constitution of Kenya requires the State to ensure sustainable exploitation, utilization, management and conservation of natural resources, and ensure the equitable sharing of the accruing benefits (Art 69 (a)); and utilize the natural resources for the benefit of the people of Kenya (Art. 69 (h)). The Commission aims to provide technical advice and oversee implementation of strategies on effective natural resource exploitation and revenue sharing, promote local capacities in sustainable natural resources management and fiscal planning, and natural resource policy formulation/reforms. (CRA Report 2016-17).

The CRA would manage the cost of externalities arising from the extraction of natural resources. The national government can come in and use part of the proceeds of the natural resources and do the cleaning by itself or give the resources to the sub-national government where the extraction happened. The aim is to not disadvantage the county government as a result of the extractive activities when they are not benefiting from the revenue.

The challenges are as follows. There is really no policy or legal provision on how much if at all should be devolved to the lower level by the county government. This has been done randomly by county governments in the past. Yet another issue relates to the treatment of urban jurisdictions. Such a function was previously undertaken by the municipalities but after 2010, the vertical formula determines the quantum of resources which the two levels of government receive. If the function is not assigned in its due constitutional dispensation, it can lead to large problems as urban functions like urban infrastructure are quite expensive. How to deal with sub-national resource revenues is a matter of concern. The constitution didn't say anything, but has subsequent legislation that is now trying to deal with it and hence, this issue requires attention especially when Kenya is about to send the first consignment of oil. In the event that members of CRA don't agree among themselves, there is an intergovernmental mechanism for mediation. However, there is no clause in the constitution to arrive at some decision when this mediation collapses again.

3. Federalism in Ethiopia

The expenditure assignment in Ethiopia, as per Article 52 sub-article 1 of the Constitution include foreign affairs, defence and national security services, ensuring macroeconomic stability, development activities of national characters, for the federal government. Articles 96,97 and 98 of the Constitution guarantee the power of revenue mobilization and revenue sharing between the government and state government through constitutionally allocated tax bases to the tiers of government. The revenue assignment is given in Table 7. Many dynamic taxes are at the federal government level (Article 96); state governments are allocated tax bases with a local nature.

Table 7: Revenue Assignment of Federal and State Governments in Ethiopia

Federal (Article 96)	State (Article 97)
custom duties, taxes and other charges on imports and exports.	levy and collect income taxes on employees of the State and of private enterprises.
income tax on employees of the Federal Government and international organizations.	determine and collect fees for land usufractuary rights.
income, profit, sales and excise taxes on enterprises owned by the Federal Government.	levy and collect taxes on the incomes of private farmers and farmers incorporated in cooperative associations.
tax the income and winnings of national lotteries and other games of chance.	levy and collect profit and sales taxes on individual traders carrying out a business within their territory.
levy and collect taxes on the income of air, rail and sea transport services.	levy and collect taxes on income from transport services rendered on waters within their territory.
levy and collect taxes on income of houses and properties owned by the Federal Government; it shall fix rents	levy and collect taxes on income derived from private houses and other properties within the States.
determine and collect fees and charges relating to licenses issued and services rendered by organs of the Federal Government	collect rent on houses and other properties they own.
levy and collect taxes on monopolies	levy and collect profit, sales, excise and personal income taxes on income of enterprises owned by the States.
levy and collect Federal stamp duties.	levy and collect taxes on income derived from mining operations, and royalties and land rentals on such operations.
right to tax international trade	determine and collect fees and charges relating to licenses issued and services rendered by State organs
Right to tax international trade and a major share in domestic indirect taxes	fix and collect royalty for use of forest resources.

Source: Bekana, 2020

The combined regional share of revenue collection has remained fluctuating around 20 per cent of total revenue – slightly higher in recent years. As national government has 80 per cent of dynamic taxes, the vertical and horizontal inequality results from the assignment problem of tax power, the federal government has been providing a substantial amount of block and specific grants to state governments. The Ethiopian federal transfer system used grant distribution formula initially with equal weight in the grant distribution formula to three indicators – population, level of development and revenue generation. Later the poverty index was incorporated as a criterion in 2001, only to be dropped in 2004 (Table 8).

Table 8: Criteria and Weights of Federal Grant Formula in Ethiopia

Indicator	1994	1998	2001	2004
Index of population	33.33	60	55	65
Composite Inverted Index of Development	33.33	25	20	25
Index of Own-Revenue raising effort	33.33	15	15	10
Poverty Index	0.00	00	10	00

Source: Ministry of Finance, 2020

From 2009 the grant distribution formula was changed to the proportion of fiscal gap of the states in the total fiscal gap – the fiscal gap being estimated as the difference between revenue potential (not actual revenue) of the states and their respective expenditure needs. In this approach fiscal gaps are calculated by first estimating revenue- generating potential using a representative revenue system, and expenditure needs using a representative expenditure system. The fiscal gap of each state is calculated as the difference between potential revenue and its expenditure needs. Then the fiscal gap of all states is aggregated and the relative fiscal gap of each state to the total fiscal gap is determined. Available evidence indicates that the total financial resources available for grant – the pool – is always smaller than the total fiscal gap of regional states. The grant is distributed based on the relative fiscal gap of regional states.

In Ethiopia, Constitution lays down the legal basis for intergovernmental fiscal transfers - the sharing of concurrent taxes and the sharing of federal revenue. Article 94 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 98 deals with the concurrent powers of taxation, where two levels of government can jointly levy and collect certain revenue. Article 62 (sub 7) bestows the House of Federation the power to determine the

division of the federal subsidies among regions. There is a continuous revision in the grant distribution formula prepared by the House of Federation, with the objective to equalize the fiscal capacities of regions so that they can provide a comparable level of public services to their electorates.

Ethiopia has a highly centralized fiscal system. For the last 24 years (1986 – 2009 E.C.), the Federal Government has been raising 79.45% of total revenues but accountable for only 62% of total expenditures. This creates a large vertical fiscal gap (17.5%). The Federal General Purpose Grant (FGPG) is the foremost program to fill fiscal gap. It has financed about 78.33% of subnational expenditures during the period between 1986 – 2009 E.C.. The horizontal inequities are also bridged with this transfer. The FGPG is a formula based transfer program that takes into consideration both the revenue raising capacity of the regions as well as their expenditure needs.

The intergovernmental fiscal transfers first begun in 1992-93, however those grants were arbitrary and ad hoc based on approved projects of the regions. In 1994-95, a formula based grant system was introduced, with the objective to equalize the fiscal capacities of the regional states to enable them provide comparable level of basic services.

The objective of Federal General Purpose Grant Formula is to equalize the fiscal capacities of regions so that they can provide a comparable level of public services to their electorates. The development of the grant allocation formula started 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:

Assessment of 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. The RTS is carried out for six tax revenue sources, accounting for 75.2% of regional own source revenues. 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 as follows. (i) Identifying major revenue sources/defining major tax

bases of regions. (ii) Collect data on the selected tax bases from different sources including MoFED, CSA, regional government offices, BOFEDs etc. (iii) Determine the standard (representative) tax rates depending on the nature of the source of tax or compute the weighted averages of the tax rates on the basis of the variations in tax rates in progressive or other ways.

(iv) Calculate the RRC of each region using the following formula.

$$C_i = \sum_j B_{ij} * t_j$$

Where B_{ij} is the ith region's tax base and t_j is the weighted average tax rate on the jth tax base.

Here, this formula has made an improvement over the previous one in assessing the regional revenue capacity by using *weighted average instead of simple average tax rates*.

Expenditure Need Assessment: The representative expenditure system (RES) is used to estimate expenditure needs of the regional states. The formula used the simplest version of the representative expenditure approach to enable policy makers at different levels of the central government and the regional governments understand it easily. It can also be defended theoretically and on the basis of logical reasoning. According to this approach, the expenditure need of a region for a given expenditure category *i* is given by: -

Exp_need_i=Measurement unit*Representative Expenditure*Adjustment Index

That is, expenditure need of a region for expenditure category i is given by the unit of measurement or workload used (e.g., number of school age children for education, length of roads in kilometers for road, population, area, and specific age groups and sex for healthcare services, etc.) multiplied by the representative expenditure on category i, which is the national per unit average expenditure for each category. The representative expenditure is obtained by dividing national total actual expenditure (i.e. total of all regions for which the grant is to be distributed) to the unit of measurement of all regions, where recent one year or 3-5 years figure is used in both cases. Then, the result is adjusted by an index constructed from factors explaining unit cost differentials across sub-national governments (these must be factors beyond the control of the sub-national governments such as topography, agro-ecological zones, population density, high wage, for example, due to high relative cost of living, slope, etc.).

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 each regional state, 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, Drinking Water, Rural Road Construction and Maintenance, Urban Development and Micro and Small Scale Enterprise (MSE) Development.

It is worth mentioning here that expenditure for hardship allowances in some regions is estimated on ad hoc basis for the representative expenditure system is not applicable. There are other expenditure items such as security/defense and spill over costs for education and health that are raised by the regional states that need special treatment. Though these expenditure needs are very important in reality, they cannot be dealt with within the framework of representative expenditure system since they are not problems of all regions. As a result, it was decided via political negotiation for such expenditures to be estimated on ad-hoc basis but only for Dire Dawa administration and Harari region.

The challenges are as follows. *The FGPG inappropriately tries to achieve more than one objective.* On the one hand, the grant aims to equalize the fiscal capacities of regional states. On the other hand, it attempts to provide compensations for spill-outs of benefits as well as for additional security and defense related expenditures incurred by border regions affected by external conflicts. *Representative Expenditure System (RES) calculations use econometric procedures to estimate the extent of the adjustment index that explains unit cost differentials across sub-national governments.* This makes the formula a little bit complex for the policy makers to understand it adequately. *Capital expenditure needs are evaluated without any regard to infrastructure deficiencies*. The FOB approximates needs using macro indicators of lack of access but translating these into expenditure need for facilities requires a planning view and geographical mapping of facilities in relation to national minimum standard. The latter view is absent in the FGPG calculations. *The Capital Expenditure Needs for Education and Health were estimated without taking in to account the differences in coverage among the regional states.* For instance, capital expenditure for education is required to create access for those school age population who don't have access to education. However, the expenditure need for education is estimated based on the total number of school age population. This approach is used not only in education but also in health. *The way Inverse of Population Density is used as adjustment factor to capture the additional cost incurred by sparsely populated regions has resulted in exaggerated benefits*. In some of the regions, there are desert areas where one can hardly find people. Therefore, taking inverse of population density as adjustment factor requires caution not to wrongly consider such desert areas as factors compel regions to incur extra cost of administration and provision of services.

The FGPG enhances autonomy but weakens regional and local government accountability for service delivery performance to local residents as financing for regional expenditures depends on relative fiscal gaps and does not entail any monitoring reporting provisions. As long as the regions have wider fiscal gaps, they are entitled to get relatively better share from the federal grant. And no mechanism is there to monitor whether those regions who have received better share owing to their relative fiscal gap reduce their developmental gaps or not. *The FGPG provides incentives for higher operational spending and provides disincentives for overcoming infrastructure deficiencies.* This is because capital and operating grants are lumped together and given as a lump-sum grant and higher operating spending leads to higher expenditure needs in future whereas higher capital spending by regions would directly reduce their future expenditure needs entitlements[1].

4. Federalism in Nepal

In Nepal, it was only in 2015 Constitution came into being and Nepal has become federal. The Constitution – Schedules 5,6 and 8 explains the jurisdiction, powers and functions of three tiers of government . There are seven provinces and 753 local governments in Nepal. The Schedule 7 of the Constitution explains the concurrency in the jurisdictions, powers of the federal and provincial levels of government, and schedule 9 outlines the concurrent jurisdictions/powers of all three levels of government (federal, provincial and local). These schedules explain the finance and functions of the different levels of government.

In Nepal, National Natural and Fiscal Commission was constituted under Article 250. The Article 60 (3) of the Constitution gives the National Natural and Fiscal Commission the mandate to determine the magnitude of fiscal transfers to provinces and local governments. In India, 41 per cent of divisible tax pool is devolved to the subnational governments. Fiscal Equalisation Grants is one of the significant fiscal transfers in Nepal. As per the Article 60 (4) , the Fiscal Equalization Grants is determined on the basis of expenditure needs and revenue capacity of the subnational governments. As per the Article 251, the National Natural and Fiscal Commission is mandated to recommend the fiscal equalization grants, and also to recommend the criteria for conditional grants. The conditional grants are designed on the basis of Government of Nepal's policy and programs, standards and status of infrastructural development at the local level. The Commission also has to recommend the basis and formula for revenue sharing to subnational governments. The National Natural and Fiscal Commission is also mandated by clauses in Constitution to devise a formula for Fiscal Equalization

[1] These points are provided by the experts in the meeting at the House of Federation, Ethiopia in 2019.

Grants. The Fiscal Equalisation Grants is to minimize the fiscal gap between their expenditure needs and revenue potential.

In Nepal, since 2017-18, Fiscal Equalisation Grants constitute the significant source of subnational finances. The devolution formula for the Fiscal Equalisation Grants had only three components – area, population and cost adjusted development. There are ambiguities in the magnitude and criteria of devolution of Fiscal equalisation Grants. However, the periodic assessments of expenditure needs across jurisdictions and also the assessment on revenue potential are required to finetune the formula to devolve the Fiscal Equalisation Grants.

Nepal has entered a federal structure with the promulgation of the Constitution of Nepal on September 20, 2015, which are explained in Schedule 5, 6, and 8 which lays the explanation on the jurisdiction, powers and functions of three tiers of government. It has, besides the National government, seven provinces and 753 local governments. The Schedule 7 of the Constitution explains the concurrency in the jurisdictions, powers of the federal and provincial levels of government, and schedule 9 outlines the concurrent jurisdictions/powers of all three levels of government (federal, provincial and local). These schedules explain the finance and functions of the different levels of government. Table 9 explains briefly on the powers exclusively and concurrently assigned to the three-tiers of government.

Table 9. Functional Assignment in Nepal : Concurrency and Exclusive

<table>
<tr><th rowspan="2"></th><th rowspan="2">Exclusive Powers</th><th colspan="2">Concurrent Powers</th></tr>
<tr><th>Federal and Provincial</th><th>Federal, Provincial, and Local</th></tr>
<tr><td>Federal</td><td>Defense, central planning, foreign affairs, citizenship, passport, etc. (Schedule 5)</td><td rowspan="2">Civil and criminal procedure, supply and distribution of essential goods, population management, social security, casino, etc. (Schedule 7)</td><td rowspan="2">Cooperatives, education, health, agriculture, irrigation, mines, minerals, disaster management, environment, forest, personal events, archaeology, motor vehicle permits, etc. (Schedule 9)</td></tr>
<tr><td>Provincial</td><td>Provincial police administration, provincial civil service, higher education, provincial-level development activities such as electricity, irrigation, roads, land</td></tr>
</table>

	management, etc. (Schedule 6)		
Local	Town Police, management of local services, basic and secondary education, basic health, local roads, drinking water, etc. (Schedule 8)		

Source: Constitution of Nepal (2015) and Devkota (2020)

In Nepal, NNRFC (National Natural Resources and Fiscal Commission) was constituted under Article 250 of the Constitution of Nepal. Article 60(3) has further extended the mandate to determine the amount of fiscal transfers to provinces and local-level governments. Nepal's share of subnational spending in total general government spending of about 36 percent in FY 2018-19 Budget (IMF 2019), which shows a high dependence of subnational governments on transfers and shared revenues from the national government.

Fiscal Equalisation Grants is one of the significant fiscal transfers in Nepal. As per the Article 60 (4) , the Fiscal Equalization Grants is determined on the basis of expenditure needs and revenue capacity of the subnational governments. As per the Article 251, the National Natural and Fiscal Commission is mandated to recommend the fiscal equalization grants, and also to recommend the criteria for conditional grants. The conditional grants are designed on the basis of Government of Nepal's policy and programs, standards and status of infrastructural development at the local level. The Commission also has to recommend the basis and formula for revenue sharing to subnational governments. The National Natural and Fiscal Commission is also mandated by clauses in Constitution to devise a formula for Fiscal Equalization Grants. The Fiscal Equalisation Grants is to minimize the fiscal gap between their expenditure needs and revenue potential.

Extending on the Revenue Raising Powers mandated to each level of government, the country follows both principle of separation and concurrence, which means that the taxation powers are assigned to all the tiers of government, with a noticeably overlap in powers. But, the provisions of revenue-raising rights among the three tiers of government under the federal structure is laid by the constitution and the Local Governance Operation Act (2017), which deals with the issue of power overlap. (IIDS 2020)

Table 10 shows the Revenue-Raising powers assigned to each tier of government according to the Constitution, divided across three categories i.e., Tax Revenue, Non-Tax Revenue, and other revenue.

Table 10. Revenue Assignment in Nepal

	Federal	Provincial	Local
A. Tax Revenue	. Custom Duty . Excise Duty . Value Added Tax . Corporate Income Tax . Personal Income Tax . Remuneration Tax	. House and Land Registration Fee . Vehicle Tax . Entertainment Tax . Advertisement Tax . Tax on Agricultural Income	. Property Tax . House Rent Tax . House and Land Registration Fee . Vehicle Tax . Land Tax (Land Revenue) . Entertainment Tax . Advertisement Fees
B. Non-Tax Revenue	. Passport Fee . Visa Fee . Tourism Fee . Service Fee . Gambling/Lottery . Fines and Penalties	. Service Fee . Tourism Fee . Fines and Penalties	. Service Fee . Tourism Fee . Fines and Penalty
C. Other Revenue	. Oher tax and non-tax raised/levied according to federal and other prevailing laws	. Other tax and non-tax raised/levied according to the provincial law and other prevailing law on the provincial jurisdiction.	. Other tax and nontax raised/levied according to the local law and other prevailing laws on the local government level jurisdiction.

Source: Devkota (2020)

In Nepal, since 2017-18, Fiscal Equalisation Grants constitute the significant source of subnational finances. The devolution formula for the Fiscal Equalisation Grants had only three broad components – area, population and cost adjusted development. There are ambiguities in the magnitude and criteria of devolution of Fiscal equalisation Grants. However, the periodic assessments of expenditure needs across jurisdictions and also the assessment on revenue potential are required to finetune the formula to devolve the Fiscal Equalisation Grants. Table 11 shows that the Fiscal Equalization Grant Allocation Formula has experiences several changes in order to incorporate parameters to better fulfil the fiscal needs across different tiers of government.

Table 11. Nepal - Fiscal Equalization Grant Allocation Formula for the Provinces and Local

S.No.	Criteria	FY 2018/19 & 19/20		FY 2020/21
		Province	Local	Province & Local
1	Multidimensional Poverty Index	15	-	-
	Human Development Index	-	15	10
2	Economic and social inequality	15	5	5
3.	Status of infrastructure	10	10	10
4.	Status of revenue	0	0	5
5.	Expenditure need	60	70	70
	Total	100	100	100

Source : NNRFC (2020) and Devkota (2020)

Table 12 presents a clearer picture on the revenue distribution among Federal, Provincial, and Local Governments, classified by the different type of taxes, including VAT, Excise Duty, and various other taxes.

Table 12. Revenue Allocation in Nepal

Taxes	Federal	Province	Local
VAT	70%	15%	15%
Excise (Domestic Collection)	70%	15%	15%
Royalty			
Expedition	50%	25%	25%
Hydrogen	50%	25%	25%
Forestry	50%	25%	25%
Mine & Minerals	50%	25%	25%
Water and Other Natural Resources	50%	25%	25%

Source: Subedi (2020)

5. A Comparative Analysis of General Government Revenue & Expenditure across Four Countries.

The data on general government is extracted from the Government Finance Statistics, published by IMF. The size of the government measured by the expenditure to GDP ratio among the four countries is highest for Nepal. The composition of expenditure shows that transfers between the levels of government is highest in South Africa, around 10.35 per cent of GDP, followed by Ethiopia at 6.21 per cent (Table 13).

Table 13: Expenditure, by Function in Nepal, Ethiopia, Kenya and South Africa, 2019 (as % of GDP)

Heads	Nepal	Ethiopia	Kenya	South Africa
Total Expenditure	31.42	15.11	27.86	31.18
Expenditure on general public services	4.07	7.26	11.98	16.17
Expenditure on public debt transactions	1.77	0.48	5.50	3.49
Transfers between different levels of govt	1.89	6.21	3.69	10.35
Expenditure on defence	1.63	0.63	1.58	1.09
Expenditure on public order and safety	2.15	0.30	1.66	2.88
Expenditure on economic affairs	10.59	3.11	5.94	2.92
Expenditure on agriculture, fishing, forestry, & hunting	2.95	1.33	0.49	0.32
Expenditure on mining, manufacturing, & construction	2.73	0.01	0.02	0.21
Expenditure on transport	3.52	1.41	3.72	1.33
Expenditure on communication	0.18	0.02	0.36	0.08
Expenditure on fuel & energy	1.20	0.12	1.01	0.32
Expenditure on environment protection	0.24	0.02	0.14	0.13
Expenditure on housing & community amenities	1.55	0.29	0.76	1.56
Expenditure on health	1.72	0.42	0.69	1.05
Expenditure on outpatient services	0.14	0.00	0.14	0.00
Expenditure on hospital services	0.62	0.09	0.23	0.52
Expenditure on public health services	0.96	0.29	0.08	0.39
Expenditure on recreation, culture, & religion	0.25	0.07	0.11	0.16
Expenditure on education	4.11	2.35	3.97	1.67
Expenditure on pre-primary & primary education	1.68	0.00	1.67	0.14
Expenditure on secondary education	0.44	0.00	1.14	0.01
Expenditure on tertiary education	2.00	1.91	0.98	0.96
Expenditure on social protection	1.45	0.65	1.02	3.55

Source : IMF (2019), Government Finance Statistics.

The expenditure by economic classification across four countries reveal that intergovernmental transfers in the form of grants constitute a significant component of expenditure. It is highest in South Africa at 16.55 per cent of GDP, followed by Kenya (10.39 per cent of GDP). The disaggregation of the grants to other governments by capital and current reveals that current expenditure is higher than capital expenditure, for instance in South Africa, within grants, current expenditure was 14.87 of GDP and capital expenditure was 1.68 per cent of GDP. However, in Nepal, capital grant and current were almost equal around 4-5 per cent of GDP (Table 14).

Table 14: Expenditure, by Economic Classification in Nepal, Ethiopia, Kenya and South Africa, 2019 (as % of GDP)

Heads	Nepal	Ethiopia	Kenya	South Africa
Compensation of employees	4.50	1.27	5.12	3.30
Wages and salaries	4.50	1.14		2.75
Employers' social contributions	0.00	0.13		0.56
Use of goods and services	2.16	2.13	2.52	1.31
Consumption of fixed capital				0.24
Interest expense	0.38	0.48	2.85	3.49
Interest expense to nonresidents	0.12	0.23	0.76	
Interest expense to residents other than gen govt	0.26	0.25	2.09	
Interest expense to other gen gov	0.00	0.00	0.00	
Subsidies expense	0.04	0.00	0.37	0.78
Subsidies expense to public corporations	0.03	0.00	0.37	0.67
Subsidies expense to private enterprises	0.01	0.00	0.00	0.11
Subsidies expense to other sectors	0.00	0.00	0.00	0.00
Grants expense	9.23	5.99	10.42	17.75
Grants expense to foreign govts	0.00	0.00	0.03	1.16
Grants expense to int orgs	0.01	0.00	0.00	0.04
Grants expense to other gen govt	9.22	5.99	10.39	16.55
Grants expense to other gen govt: current	4.52	4.06	6.08	14.87
Grants expense to other gen govt: capital	4.70	1.93	4.32	1.68
Social benefits expense	3.30	0.00	0.81	3.39
Social security benefits expense	0.00	0.00	0.81	2.37
Social assistance benefits expense	1.50	0.00	0.00	0.68
Employment-related social benefits expense	1.80	0.00	0.00	0.34
Other expense	0.00	1.53	0.06	0.68
Property expense other than interest	0.00	0.00	0.00	0.00

Expense on other transfers	0.00	1.53	0.06	0.68
Expense on other transfers, current	0.00	1.53	0.06	0.25
Expense on other transfers, capital	0.00	0.00	0.00	0.43

Source : IMF (2019), Government Finance Statistics.

The revenue analysis shows that tax-GDP ratio is relatively lower in Ethiopia when compared to other federations (Table 15). The revenue from indirect taxes is highest in Nepal. The non-tax revenue sources are not significant across four countries.

Table 15: Revenue (As a Percentage of GDP) in Nepal, Ethiopia, Kenya and South Africa

Heads	Nepal	Ethiopia	Kenya	South Africa
Total Revenue	24.38	10.43	17.09	26.97
Tax revenue	20.95	7.71	15.58	26.11
Taxes on income, profits, & capital gains	5.49	2.29	7.66	15.30
Taxes on income, profits, & capital gains: individuals	0.49	0.38	4.11	9.95
Taxes on income, profits, & capital gains: corporations	4.06	1.75	3.52	5.35
Taxes on income, profits, & capital gains: other	0.93	0.16	0.03	0.00
Taxes on payroll & workforce	0.16	0.00	0.00	0.34
Taxes on property	0.01	0.00	0.00	0.07
Taxes on goods & services, of which	11.22	3.47	6.44	9.35
General taxes on goods & services	6.78	2.75	4.14	6.70
Excise taxes	3.20	0.72	2.02	2.39
Taxes on int trade & transactions	3.90	1.95	1.38	1.05
Other taxes n.e.c.	0.19	0.00	0.10	0.00
Social contributions	0.00	0.00	0.01	0.00
Social security contributions revenue	0.00	0.00	0.01	0.00
Other social contributions revenue	0.00	0.00	0.00	0.00
Grants revenue	1.21	0.85	0.00	0.03
Other revenue	2.22	1.87	1.51	0.83
Property income revenue	1.03	0.79	0.38	0.27
Revenue from sales of goods & services	1.02	0.25	1.06	0.06
Revenue from fines, penalties & forfeits	0.03	0.02	0.02	0.01
Revenue from other transfers	0.14	0.82	0.05	0.49

Revenue from NI & SGS: premiums, fees & claims	0.00	0.00	0.00	0.00

Source : IMF (2019), Government Finance Statistics.

The "assignment problem" remained as a significant issue in the fiscal federal arrangements , which led to vertical and horizontal imbalances (Breton, 1977; Bird, 2000, Breton, 2000, Rao and Singh (2005; Oates, W E (2005):; Wheare, Kenneth (1964). However, the intergovernmental transfers are designed on less arbitrary ad ad hoc manner, which can reduce the volatility of the subnational fiscal space.

6. Conclusion

The political economy of the transfers revealed that the revenue assignment and revenue sharing are mandated through Constitution in the countries under study. The analysis shows that vertical and horizontal fiscal imbalances remain significant across all the four countries due to the asymmetry in the revenue and expenditure assignments. The dynamic taxes were assigned at the national level in these countries, leaving with no major revenue at local level except for South Africa. The formula of revenue sharing is dynamic and the countries are constantly improvising those indicators. The emphasis on fiscal equalisation is given in the revenue sharing mechanisms. The unconditional grants given on the basis of expenditure needs require meticulous analysis across jurisdictions. The natural resource taxation is in a state of flux and requires further attention in its role in offsetting fiscal disabilities across jurisdictions.

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