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SUDAN
State-level Public Expenditure Review

Meeting the Challenges of Poverty Reduction and Basic Service Delivery

Synthesis Report - Summary for Policymakers

May 2014

Poverty Reduction and Economic Management Unit
Africa Region

The World Bank

CURRENCY EQUIVALENTS

Currency Unit = Sudanese Pound (SDG)

US$1 = SDG5.7

FISCAL YEAR

January 1—December 31

WEIGHTS AND MEASURES

Metric System

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ABBREVIATIONS AND ACRONYMS

BHU Basic Health Units
CBOs Community Based Organizations
CBoS Central Bank of Sudan
CCT Conditional Cash Transfer
CEM Country Economic Memorandum
CHW Community Health Worker
CIFA Country Integrated Fiduciary Assessment
CPA Comprehensive Peace Agreement
CPI Consumer Price Index
DHS Demographic and Health Survey
FFAMC Fiscal and Financial Allocation and Monitoring Commission
FMoH Federal Ministry of Health
GDP Gross Domestic Product
GCT Government Cash Transfer
GFS Government Financial Statistics
GNI Gross National Income
HI Health Insurance
HTRS Hard to Reach and Stay areas
IMF International Monetary Fund
ICT Information and Communications Technology
INC Interim National Constitution
MDTF Multi-Donor Trust Fund
MFIs Microfinance Institutions
MFPs Microfinance Providers
MFU Microfinance Unit
MMR Maternal Mortality Ratio
MoFNE Ministry of Finance & National Economy
NBHS National Baseline Household Survey
NGOs None Governmental Organizations
NHIF National Health Insurance Fund
NRF National Revenues Fund
NSWF National Students Welfare Fund
OECD The Organization for Economic Co-operation and Development
PER Public Expenditure Review
PETS Public Expenditure Tracking Survey
PHC Public Health Center
PRSP Poverty Reduction Strategy Paper
SBDs Standard Bidding Documents
SBP Single Business Permit
SCoT Sudan Chamber of Tax
SHHS Sudan Household Health Survey
SMDF Sudan Microfinance Development Facility
SMoF State Ministry of Finance
SSP Social Support Program
STRs Student- Teacher Ratios
TOT Training of Trainers
VAT Value Added Tax
UN United Nations
UNICEF United Nations Children’s Fund
URT United Republic of Tanzania
USAID United States Agency for International Development
WDI World Development Indicators

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Key findings and agenda for policy reforms

Decentralization is right, but implementation process is an imperative

Key messages

*1- **Limited progress on fiscal decentralization***. The vision of fiscal decentralization remains a key aspect for a peaceful post-secession Sudan, potentially addressing inequalities and effective provision of basic services, marginalized areas and the root causes of conflict. After almost two decades of its implementation, fiscal decentralization in Sudan remains a work in progress and requires additional reform and capacity building efforts. Development imbalances and variations in poverty levels are still significant across states. Progress in addressing the wide regional disparities in access to basic service outcomes remains limited, with little evidence of improvements in social indicators such as educational enrolment or infant mortality. These regional imbalances are mirrored by very significant differences in the revenue-generating capacity of states, and differences in fiscal spending allocations across in states.

2- **Key four priority reform areas for policymakers to boost the efficacy of fiscal decentralization, respond to the diagnostic work in this PER**. These reforms remain more imperative as increased central funding has been delivered to states, which shoulder the bulk of expenditure responsibility for service delivery to the poor. Actions in these areas will address key shortfalls that hamper fiscal decentralization to achieve the goals of improved inter-regional equity, sub-national autonomy and accountability and regional economic development that were sought. This is not a complete list of needed reforms, given important areas were not covered in this report especially the political dimension of decentralization.

- **Address regional imbalances by reforming the intergovernmental transfers system to better target poor and under-served regions and ensure more predictability in allocations.** While fiscal decentralization has brought considerable extra resources to the states and substantially increased overall per capita social spending over the past ten years, these additional resources have not been adequately allocated and used in ways to smoothen the social and financial imbalances observed. Key policy consideration includes segregation of the federal transfers into a need-based and a performance-based allocation.

- **Strengthen revenue mobilization at state level, through streamlining both tax and non-tax measures, with due emphasis on the cost-effectiveness of revenue collection.** This would need to take into account not only the direct costs of tax administration, but also the overall costs to the economy, including the compliance costs to the taxpayers. Key considerations include:
    - shift the focus in revenue mobilization from fees to tax policy and

administration in order to reduce dependency on user charges on services, particularly social services, which adversely impacts on user access;
  - prioritize investments in infrastructure, in particular electricity and roads, to promote a more conducive business environment and social service delivery; (iii) Revise the tax incentive and exemption regime to eliminate their negative impacts on revenue mobilization; and
  - abolish unsatisfactory local taxes, especially those revenue sources which generate little revenue or no revenues.

- **Reinforce performance-based budgeting systems to better link budgets to planning processes and make the flow of public expenditures more predictable and transparent.** There are several critical challenges in budget preparation, budget execution and audit/oversight that must be addressed to improve the budgeting practices of state and local governments. Urgent consideration is needed in the following areas:
  - strengthen the credibility of the budget as a fundamental requirement of effective PFM. A medium-term expenditure framework is required to ensure that adequate resources reach responsible spending units and levels of government;
  - improve accountability and effective public expenditure planning and management to build good governance and budget management at subnational level, which are currently hampered by limited information and monitoring;
  - Shift the focus of sub-national governments from achieving fiscal discipline to effectiveness and efficiency of local service delivery in order to accomplish broader poverty reduction;
  - increase budget transparency and civil society participation. Financial data including annual audit reports is often not available to everyday people; especially in the case of localities; and
  - build capacity for more effective resource allocation and use, including in the states where responsibility for front line service delivery lies.

- **The federal government SSP seems to be overly ambitious in scope and poorly designed and implemented**. The involvement of too many agencies complicates program management and hampers coordination, leading to issues such as multiple targeting and frequent overlap of the different programs. A number of households have access to multiple transfers, while others receive none.

A. Why this report?

1. **Fulfilling the vision of fiscal decentralization and increasing state-level development remain paramount to the effective provision of basic services in post-secession Sudan**. States have increasingly become the nation's key administrative level to deliver basic public services. The path to successful fiscal federalism in post-secession Sudan would therefore depend heavily on the quality and direction of development, in particular at the state-level. There can be no sustained economic development without major public development commitments to social sectors and improvements in major infrastructure (e.g., ports, airports, telecommunications, internet, electricity, large-scale water and sanitation facilities, and major roads) in order to promote large-scale private investments needed for economic growth[1].

2. **Sudan boasts a wide variety of natural endowments and has the potential to become a dynamic economy and a bread basket for the Arab world and East-Central Africa** (World Bank CEM, 2009). Success requires addressing technical issues and good management of resource endowment, both to encourage economic diversification and growth and to invest in the people as "owners of the resources". However, resource endowment is not sufficient to bring about sustainable growth and prosperity. Sudan faces several development challenges, including regional conflict and issues relating to peace, poverty and unemployment, as well as severe disparities across the country in income and access to socio-economic opportunities.

3. **The financial potential of states to deliver on their responsibilities is tenuous, especially giving consideration to the fiscal crisis**. Sudan is forced to take a number of measures to address the declining oil revenues and the simultaneous jump in demand for safety net services, including extensive fiscal adjustments – a large part of which is likely to entail shrinking federal transfers to States. With the secession of the South on July 9, 2011, Sudan suffers from large oil revenue losses and significant economic instability. Beginning in fiscal year 2011, Sudan experienced a steep decline in oil revenues by roughly 75 percent of its previous oil revenues.

4. **This state-level Public Expenditure Review (PER) continues a series of analytical works**, including a Public Expenditure Review (PER) in 2007, a Country Economic Memorandum (CEM) in 2009, a Country Integrated Fiduciary Assessment (CIFA) in 2010, and a Public Expenditure Tracking Survey (PETS) in 2011. The objective is to offer policy insights on vulnerabilities and challenges faced by Sudan's federal system as it relies on the sub-national level to deliver services to the people, and highlight priority reform areas for policymakers. In this light, reviewing the fiscal capacity of states to deliver on their responsibilities is a crucial endeavor to ensure or at least mitigate the impact of the fiscal cut on delivery of basic services.

[1] Jeffrey D. Sachs and Nirupam Bajpai (2001) "*The Decade of Development: Goal Setting and Policy Challenges in India*" CID Working Paper No. 62, Center for International Development at Harvard University.

5. **This report follows a similar methodology to that of the first Sudan's Public Expenditure Review (PER) and the PETS case studies**. This combines workshop discussions with state ministry of finance representatives together with the federal ministries including the MOFNE, through field visits to four selected states (River Nile, North Kordufan, Kassala, and Khartoum states). For synergies, three of the PETS states are selected to facilitate parts of the PETS follow-up to feed into this PER. The criteria for the state selection process are linked to government priorities, and in a view to ensure overlap to the PETS sample. Overlap of the PER states with the PETS sample is important to allow synergies in policy advice.

6. **This Synthesis Report is based on the assessment carried out by the World Bank in collaboration with the Government of Sudan**. It provides an integrated view of meeting the challenges of poverty reduction and basic service delivery as the final part of the State-level Public Expenditure Review Report (PER). A complete elaboration of the topics covered in this summary can be found in this Synthesis Report and in the underlying background papers (Volume II of this Report).

B. Why does decentralization matter for post-secession Sudan?

7. **The vision of decentralization has been formulated in Sudan as a means to address inequalities and overcome the legacies of long years of internal violent conflicts.** Sudan has undertaken political decentralization reforms since the early 1990s, in a federal government system with three tiers: federal, state and locality levels, with elected legislatures at each level and elected states' governors. At the sub-national level there are now seventeen states, each with several localities. As Sudan is an extremely diverse and dispersed country, successful decentralization will be of paramount importance in overcoming disparities, improving the quality of governance, and promoting development outcomes (Article 1-1, INC of 2005).[2] Fiscal decentralization is expected to redistribute resource to match public service delivery responsibilities, and thus improve inter-regional equity, responsiveness in public services to local level demand, sub-national autonomy and accountability and regional economic development more generally. It also promises to help ameliorate continued and potential conflicts such as in Darfur, Blue Nile, and South Kordofan by supporting the near term peace dividend through poverty reduction and economic growth.

8. **The Interim National Constitution (INC) and the Comprehensive Peace Agreement (CPA) of 2005 represented critical milestones for Sudan's efforts towards decentralization in an institutionalized system, especially for fiscal decentralization.** The two legal documents define the institutional framework and the normative principles for decentralization in the country (Box 1). Both documents commit to fiscal decentralization, to empower sub-national governments to align the use of resources more effectively with the need to address wide regional disparities and trace the root causes of conflict. The INC provides the legal framework for state and locality legislative assemblies

[2]2INC 2005, Article 1-1: "The Republic of the Sudan is an independent, sovereign State. It is a democratic, decentralized, multi-cultural, multilingual, multi-racial, multi-ethnic, and multi-religious country where such diversities co-exist".

in each state to oversee the functioning of the various levels of sub-national government. The CPA established that decentralization and empowerment of all levels of government are cardinal principles of effective and fair administration of the country. At the same time, the CPA provided for a major reform to fiscal decentralization by the creation of the Fiscal and Financial Allocation and Monitoring Commission (FFAMC) to ensure a formula-based intergovernmental transfers system, though it remains unclear how this system is used in practice.

Box 1: Sudan's decentralized system of governance and devolution of powers

(Article 24, INC for 205):

Sudan is a decentralized State, with the following three levels of government: -

(a) The national level of government, which shall exercise authority with a view to protecting the national sovereignty and territorial integrity of the Sudan and promoting the welfare of its people;
(b) The state level of government, which shall exercise authority at the state level throughout the Sudan and render public services through the level closest to the people; and
(c) The local level of government, which shall be established throughout the country.

Source: The Interim National Constitution (INC) of 2005

C. *Has Fiscal Decentralization Helped Narrow Regional Imbalances?*

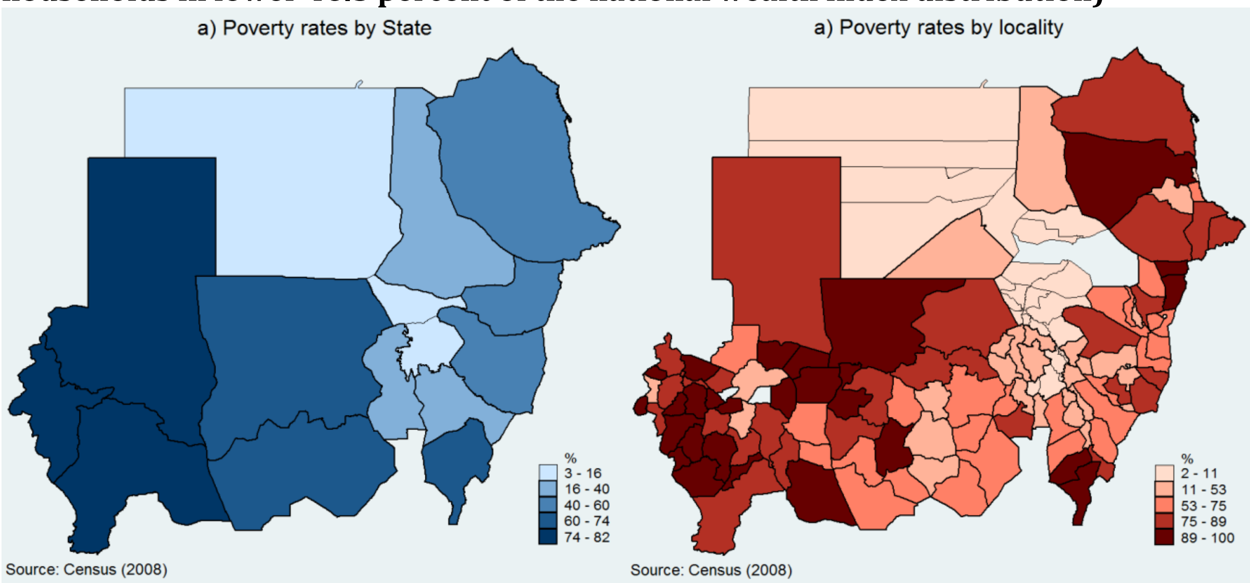
9. **Political and fiscal decentralization, which coincided with a decade of economic growth fueled by oil revenues, opened tremendous opportunities to accelerate progress toward the Millennium Development Goals and address the wide regional disparities in access to basic service**. However, this chance to smoothen disparity was largely missed and progress on many social indicators has been disappointing (Box 2). These regional imbalances are mirrored by daunting challenges in basic service delivery and poverty reduction outcomes; very significant differences in the revenue-generating capacity of states; and allocations of public finance between states.

Box 2: Sudan had missed a chance to build the foundations for a vibrant non-oil economy

Looking back at the oil boom of 1999–2010, Sudan missed a chance to build the foundations of a vibrant non-oil economy. The size of the Sudan's economy, measured by nominal gross national product, has grown fivefold—from $10 billion in 1999 to $53 billion in 2008. Overall revenue, measured as a percent of GDP, has grown threefold—from 6 percent of GDP in 1996 to 20 percent of GDP in 2008. Per capita income, a summary measure of the living standard of average citizens, has increased from $334 to $532 (constant 2000 USD) over the same time period. This is in sharp contrast to the pre-oil period when real per capita income kept mostly within the $200–300 range during a four-decade period (Sudan CEM 2009). However, oil reserves were not converted into equivalent public investments in education and infrastructure. During the oil boom, Sudan was heavily reliant on the oil sector and failed to diversify its economy. The value of oil extracted far outweighed the resources used for public investment. After adjustment for the value of oil depletion, environmental degradation and education expenditures, national net savings were highly negative, averaging -7.4 percent of GNI for the period 2000 – 2010, which means the country as a whole was consuming away a large fraction of its wealth. In short, the oil boom masked the fact that the economy was geared towards consumption and imports, rather than production and exports, an unsustainable growth path. (World Bank: *Sudan Economic Brief*, January 2013.)

10. ***Poverty rates vary widely across states.*** Poverty in Sudan is widespread and varies significantly across states. 46.5 percent of Sudan's population lives below the poverty line and cannot afford to purchase the minimum consumption bundle (Figure 1). Poverty rates are substantially lower in urban centers (e.g. Khartoum: 26 percent; River Nile: 32 percent) as compared with the more rural and remote areas of the country (e.g. North Darfur: 69 percent; North Kordofan: 58 percent).

Figure 1: Poverty rates vary widely across states and Localities (Percentage of households in lower 46.5 percent of the national wealth index distribution)



Note: Primary sampling unit identifiers are not available in the Census data and, therefore, estimates are not fully adjusted for sampling design (i.e. they are computed using sampling weights only). Poverty rates are calculated as the percentage of households in the bottom 45th percentile of the national household wealth index distribution based on the 46.5 percent official poverty rate estimate (National Baseline Household Survey, 2009). The boundaries shown do not imply any judgment on the part of the World Bank concerning the legal status of any territory or the endorsement or acceptance of such boundaries.

11. ***Daunting challenges to basic services access.*** Progress in addressing the wide regional disparities in access to basic service outcomes remains limited, with little evidence of improvements in social indicators such as educational enrolment or infant mortality.

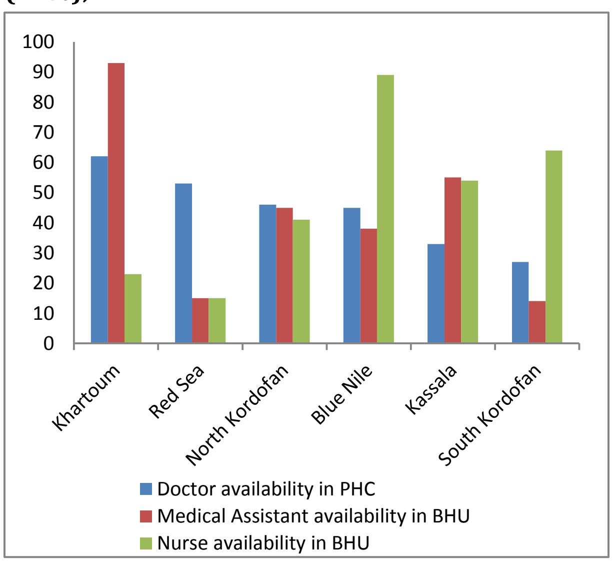
– Education outcomes vary significantly across states and localities. The observed variance is most likely related to the fact that responsibility for education is at the sub-national level, and thus education sector allocations follow the overall imbalances observed in the fiscal system.

– While the commitment of sub-national governments to improving the health sector has led to significant progress in reducing both maternal and under-five mortality rates, large discrepancies between states still remain. The under-five mortality rate in poor performance states is almost twice that of the best performance states. Similarly, official estimates of the Maternal Mortality Ratio (MMR), based on the 2006 Sudan Household Health Survey (SHHS), ranged from 94 in Northern State to over 1000 in West Darfur, South Darfur and Kassala.

– The imbalances apparent in the allocation of public spending are highlighted in the analysis of health inputs. In 2008, state per capita health spending in three of the poorest states was on average less than half the level reported in Khartoum: in South Darfur it was 7 SDG, in North Darfur 9 SDG, and in South Kordofan 10 SDG, compared with 28 SDG in Khartoum. This imbalanced health investment pattern translates directly into significant differences in the per capita number of health facilities available across states and high turnover of medical staff (Figure 2). The observed variance is most likely related to the fact that the health sector is financed through a mix of federal and state spending, with the former disproportionally biased towards richer and urban centers which service multiple states (the whole of Sudan in the case of Khartoum).

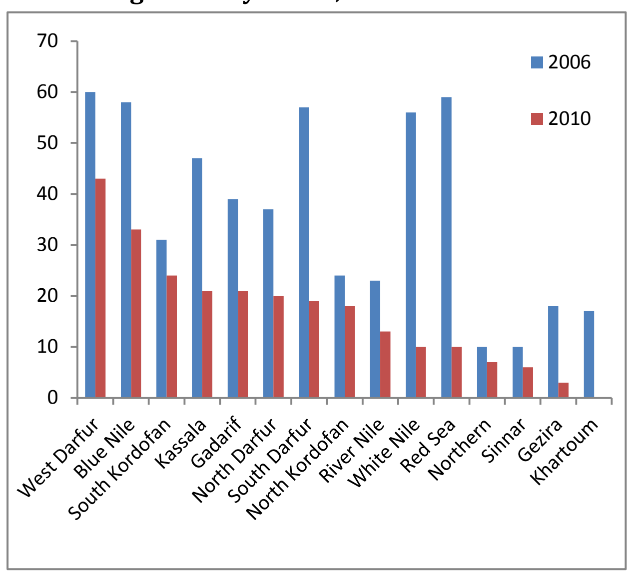
– Similar patterns are observable for access to clean drinking water sources; while this has significantly improved, access still remains low, with large discrepancies across states (Figure 3). Rates of access to improved drinking water in the three poorest states are close to five times lower than in the three wealthiest states. The observed variance is most likely related to the fact that water supply is under the responsibility of sub-national level governments and, thus, water sector allocations follow the overall imbalances observed in the fiscal system.

Figure 2: Percentage of health facilities with at least one qualified health staff in selected states (in %), 2011



Source: Health care financing and service delivery Report, Federal Ministry of Health, 2012.

Figure 3: Percentage using un-improved sources of drinking water by states, 2006 and 2010



Source: World Bank, A profile of maternal and child health in Sudan, 2012.

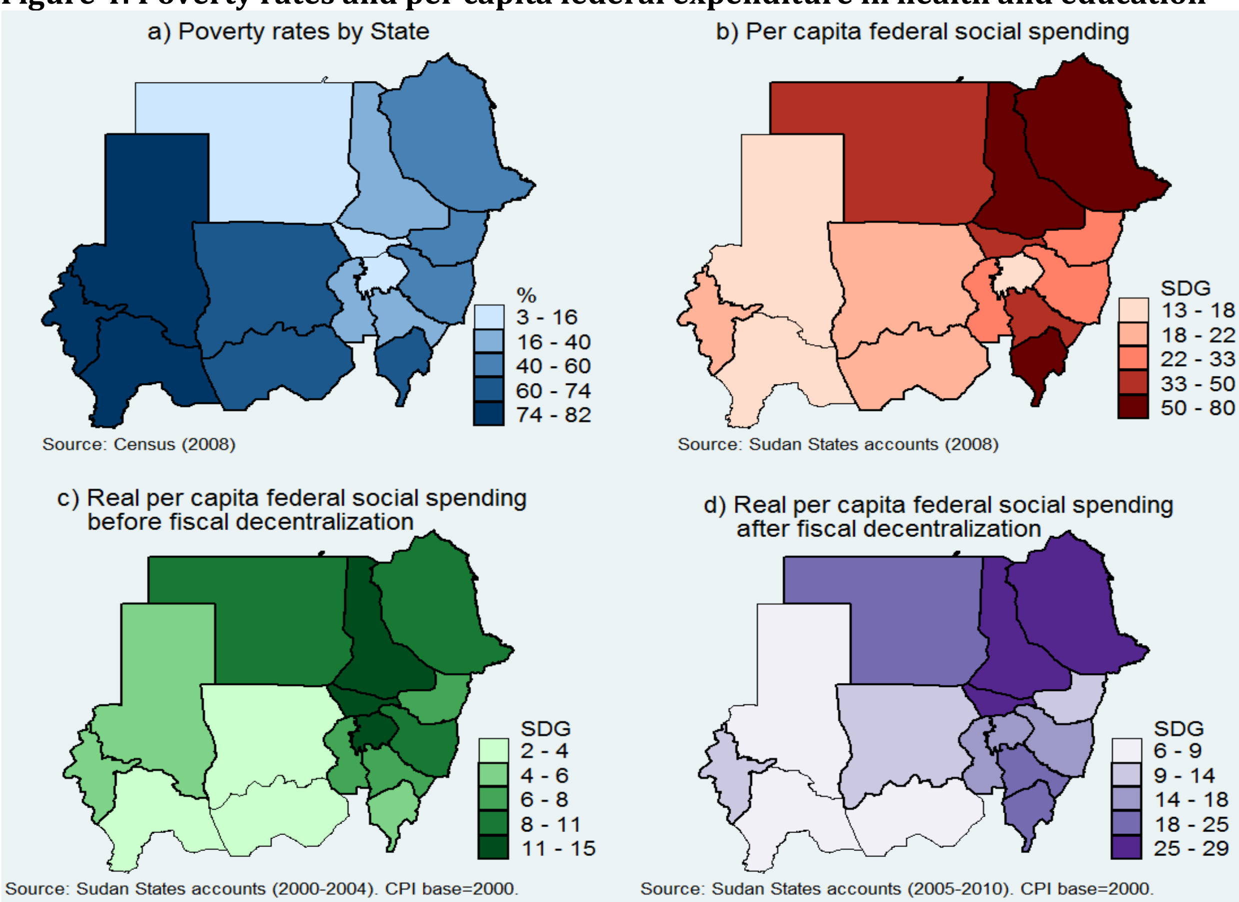
Note: Calculations were based on the 2006 and 2010 SHHS and 2008 Long Form Census.

States ordered based on largest average percentage point improvement in access to improved drinking water sources in 2010.

12. ***Differences in fiscal spending allocations across in states.*** Fiscal decentralization has brought extra resources to the states and substantially increased overall per capita social spending over the past ten years, but the distribution of real spending growth shows large

imbalances. Moreover, the observed increase in social spending has not translated into a more balanced distribution of resources to address inequality across states and reduce poverty gaps (Figure 4). In real terms, and after adjusting for population growth, education spending as per school-age population has grown by an average of 22 per percent per year, from 697 SDG in 2000 to 2,242 SDG in 2010. Per capita health spending has also followed a very similar trend; grown by an average of 26 per percent per year, from 229 SDG in 2000 to 829 SDG in 2010. This suggests the government has put substantial efforts into expanding public health and education and increasing enrollment among school-age children. However, it appears that fiscal decentralization has not had any observable effect in the way in which federal resources are allocated towards social investments by the states. Figure 5 (panels (c) and (d)) show the average real per capita spending in health and education before and after fiscal decentralization, with allocation patterns seeming to have remained largely unchanged.

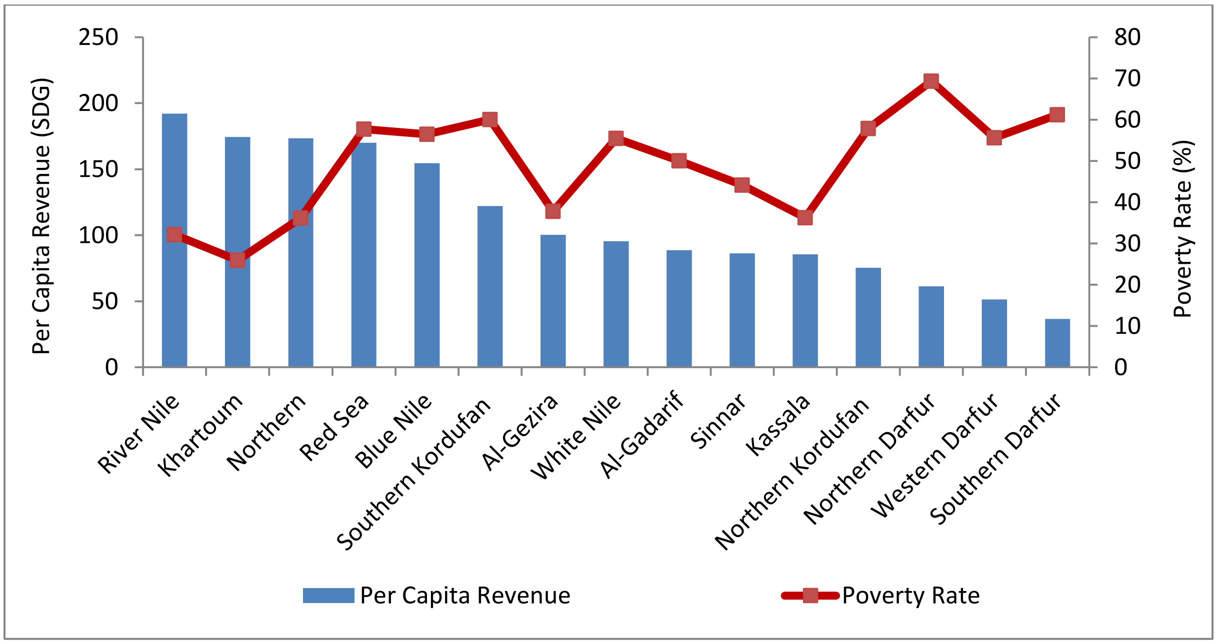
Figure 4: Poverty rates and per capita federal expenditure in health and education



Note: Poverty rates are computed using the Sudan Census (2008). Poor households are defined as those in the lower 45% of the national wealth index distribution. Primary sampling unit identifiers are not available in the Census data and, therefore, estimates are not fully adjusted for sampling design (i.e. they are computed using sampling weights only). Poverty rates are calculated as the percentage of households in the bottom 45th percentile of the national household wealth index distribution based on the 46.5 percent official poverty rate estimate (National Baseline Household Survey, 2009). The share of federal spending in health and education includes all federal money paid in the form of block grants to the States allocated to health and education wages and salaries, goods and services, and development by the States.

13. ***Significant differences in the revenue-generating capacity of states***. Sudan's inability to provide equal economic opportunities to its citizens is reflected in the large disparities in the revenue-generating capacity of sub-national governments. Average state per capita revenue varies from about 192 SDG in the highest revenue-generating capacity states, to 37 SDG in lower revenue-generating capacity states. Disparities in revenue-generating capacity across states have actually increased since the 2005 CPA and INC strengthened decentralization efforts. These imbalances also reflect a wide variation across states in natural endowments, economic opportunities and levels of development. States that have lower revenue-generating capacity tend to be hardest hit by poverty (Figure 5). The relationship between poverty and fiscal revenues is significant, with negative strong correlation (coefficient -0.54). This suggests the need for a more targeted intergovernmental transfers system, to balance the effects of lower fiscal revenue in some states**.**

Figure 5: State's poverty rate and state's average per capita revenue, 2000-2010



Source: Final Accounts Report, MoFNE

D. Why has decentralization not improved regional inequality?

14. In general, decentralization has been a disappointment for Sudan over the last two decades. The vision of decentralization that began with much enthusiasm and hope has not achieved the goals of improved inter-regional equity, sub-national autonomy and accountability and regional economic development that were sought, and perhaps expected. These shortfalls are likely explained by such problems as:

- less clear cut division of responsibilities across different levels of government;
- a complex revenue assignment system;
- lack of simplified and more transparent formula transfers system that better targets poor and under-served states; and

- weak state-level budget and fiscal management that better links budgets to planning processes and makes the flow of public expenditures more predictable and transparent.

Box 3: What is required for decentralization to lead to greater accountability and hence to increased regional equality?

Decentralization has not always been effective in improving regional inequality. This is mainly because of lack of commensurate revenue assignments, inadequate access to financial markets, and lack of necessary administrative capacity at subnational government levels. Decentralization can also reinforce inequalities if resources are concentrated in the richer regions, and poor areas are unable to mobilize the funding needed to deliver basic services. To counter such tendencies:

- Clarity of roles and responsibilities between different levels of government. Clarity, transparency, stability and well-defined rules of the game are paramount for achieving accountability that efficient and sound decentralization requires. Given the interdependence among the various components of the system of intergovernmental relation, this requires a clear and effective delegation of functions by central government, with revenue assignments that are transparent, unambiguous, and commensurate with sub-national governments' expenditure responsibilities. It also requires transfers that are based on stable principles and specified by legal formulas that support hard budget constraints.
- The intergovernmental transfer system and revenue assignment powers need to be carefully designed to ensure adequate funding to correspond with service delivery responsibilities across different levels of governments. Ultimately this will be the only way to address vertical imbalances between the center and sub-national levels of government with respect to revenues and responsibilities (as expenditure responsibility for basic services shifted to state and local levels), as well as horizontal (interstate) imbalances due to differing own-revenue potential and differing needs. International experience suggests that it is important to evaluate the impact of an intergovernmental transfer system in terms of its incentive effects on sub-national governments (Sudan PER, 2007). These include: (i) the overall efficacy of sub-national public service delivery and accountability; (ii) sustainable fiscal policies; and (iii) own source revenue mobilization.
- A sound revenue system for sub-national governments. In Sudan, own revenues are one of the three sources of funding for states and localities, in addition to federal transfers and shared revenues. Adequate revenue is needed by sub-national governments to provide local services, but Sudan's fiscal decentralization reforms that began in 1995 have led to a gap between revenues and spending needs. In fact, decentralization of spending has gone further than the assignment of revenue responsibilities.
- For decentralization to lead to greater accountability and hence to increased equality, it is important to strengthen the institutional capability at the subnational level. Institution building is a prerequisite for successful decentralization. Sub-national governments require administrative and technical capacity to effectively carry out their assignment responsibilities. Supporting institutions, including democratic representation, sound budget processes, sub-national revenue collection capacity, and mechanisms to ensure coordination and cooperation between different levels of government – both at the political and the technical level – are crucial for the functioning of a multi-tier system of government.

Less clear cut division of responsibilities across different levels of government

15. **Decentralization has devolved a number of key responsibilities to the sub-national governments** (Table 1). The INC of 2005 defines the responsibilities of different levels of government. According to Article 24-B, obligatory responsibilities for sub-national governments include provision of social services (e.g. education, health, and registration of persons); regulation of business; management of land, etc. The National Government has overall responsibility for functions such as foreign policy, defense, security, immigration, monetary affairs, etc.

Table 1: The Key Responsibilities of Sub-national Governments

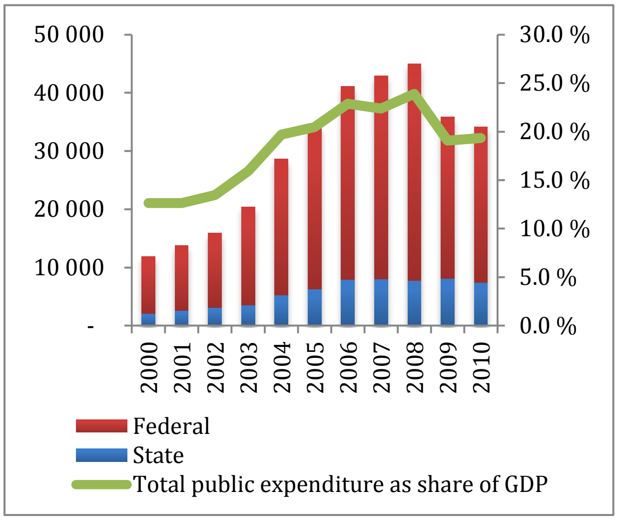
Economic management and planning provisions – State borrowing – Taxation and Revenue raising – Budget and finances – State Constitution – State Courts and the administration of justice – Traditional and Customary law	*Service provision* – Police and prisons – Reformatory Institutions – Airports and airstrips – Museums and heritage sites – Cultural matters within a State, libraries – State archives, antiquities and monuments – State Irrigation and Embankments – Service provision – Information, publications, telecommunications and regulations – Social welfare, including State pensions
Education service – Pre-schools – Basic schools – Secondary schools – Administration of schools – Tertiary – Education policy	*Health service* – regulation – hospitals – other health institutions – ambulance services – health policy – epidemics control – drug quality
Natural Resources – Agriculture – Animal and livestock control, diseases, pastures and veterinary services, animal drug quality – Natural Resources (incl. Forestry and quarrying)	*Regulatory Activities* – Public Utilities – Regulation of religious matters – Regulation of business, trade licenses.

Source: The Sudan Interim National Constitution of 2005

16. **In reality, the division of responsibilities is sometimes less clear cut.** For example, in health and education the National Government is involved in funding service delivery in specific geographic areas (hard-to-reach), or to specific population groups (e.g. mothers and under five children). While the Federal Ministry of Finance has a revenue generation and financing mandate, it also has coordinating, monitoring and support functions (i.e. for poor performing states), though it seems to have largely relinquished service delivery functions to lower levels of government. The result is that no-one is held accountable for results and ultimately the burden of service provision falls much too often on the intended beneficiary (PETS, 2011). Therefore, it is very important to build an understanding of respective responsibilities within a federal system.

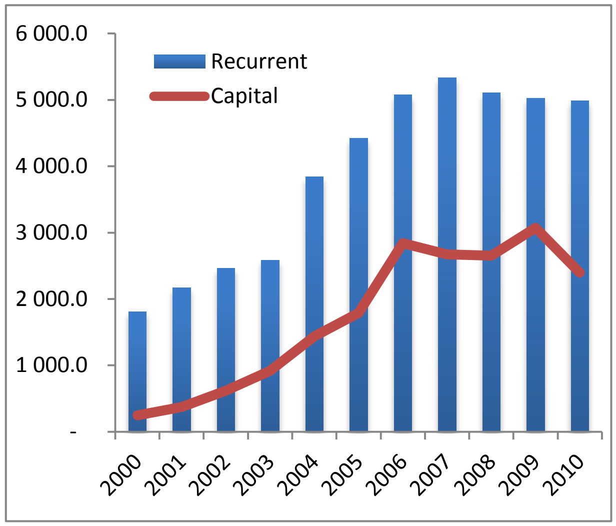
17. **State level expenditure trends are impacted by the volatility of federal and state level revenue performance.** Total public expenditures increased significantly in real terms, from 12.6 percent of GDP in 2000 to 23.9 percent of GDP in 2008, but subsequently declined to 19.4 percent of GDP in 2010. The share of state level expenditures to total expenditures has increased, though centralized management persists. This slight increase indicates a modest shift in the assignment of fiscal responsibilities to state levels (e.g. social sector expenditures and investments in state level infrastructure). State level expenditures fluctuated between 17-18 percent of total expenditures during 2000 -2005, but then increased in the years that followed to 21.6 percent of total expenditures in 2010 (Figure 6).

Figure 6: Federal and State level expenditures in SDG million at 2011 prices and share of GDP



Source: State final accounts, MoFNE

Figure 7: Total state level expenditures in SDG million at 2011 prices



Source: State final accounts, MoFNE

18. **Public investment reached its peak in 2009, constituting 37.9 percent of total expenditure, although with significant disparities between states.** Partly driven by large scale federal investment, such as the Merowe Dam in River Nile State, this very high level of investment, as compared with the resources for operation and maintenance, raises questions as to future sustainability and utilization efficiency. In a situation of volatility of public revenues, and federal transfers in particular, the ability to utilize these high levels of investments effectively might be at risk. For example, some recent social sector surveys appear to indicate that investments in education and health are not fully utilized, as evidenced by lack of staff to fill vacant positions at facility levels and limitations in non-wage inputs for effective service delivery.

19. **State capital expenditures indicate significant variations between states and from one year to the next. This reflects differences in overall resource levels, but also differences in prioritization**. Since 2005 capital expenditure has been at a higher level in states such as Khartoum and River Nile as compared with North Kordofan and Kassala. The level of investment is closely correlated with the level of state revenue, including federal transfers.

A complex revenue assignment system

20. **The complex revenue assignment and management system poses a number of challenges to fiscal decentralization in Sudan**. Some of these are illustrated in the Public Expenditure Review (PER) 2006/07, prepared jointly by the World Bank and the Government of Sudan (World Bank 2007).[3] The PER argued that inadequate own-revenues at sub-national levels and unpredictable transfers from the central government pose serious obstacles to the fulfillment of the vision of decentralization. These challenges are still major constraints for the evolution of fiscal decentralization in Sudan. A sound revenue assignment system is an essential pre-condition for successful fiscal decentralization. In certain fragile states, such as Sudan, the soundness of the sub-national revenue stream is factor of the share of revenues collected by sub-national entities, given the poor reliability of the transfers from the central to sub-national governments (Box 4).

Box 4: Who levies what taxes?

There is no ideal assignment of revenue sources between central and lower levels of government. Still, a set of 'tax-assignment rules' has been developed in the traditional fiscal federalism theory (Oates 2005, 1972; Musgrave 2000; Bird 2010). These principles relate to the respective responsibilities of central and lower tiers of government in macroeconomic stabilisation, income redistribution, and resource allocation (Boadway *et al*. 2000). Furthermore, in developing countries the administrative capabilities of sub-national governments in revenue design (that is, deciding on revenue bases and setting rates) must be taken into consideration (Bird 1990). In large and diverse countries it is also important to address the issue of revenue harmonization between jurisdictions when assigning taxing powers.

The stabilization objective of the fiscal system calls for central control over the revenue instruments that may substantially influence central budget deficits or inflation. Thus, taxes on international transactions (customs duties) and a considerable share of income and general sales taxes (such as VAT) should be assigned to central government. If there are wide disparities in income and wealth across regions, as there are in many African countries, then local taxing powers may exacerbate these differences. Hence, the distributive function of government is an argument for centralized, progressive corporate income and wealth taxes. Sub-national governments by contrast require stable sources of revenue. Thus, lower-level governments should tax revenue bases with low mobility between jurisdictions. Property tax is therefore often labelled as the 'ideal' local tax. Moreover, if properly designed, user charges on services such as electricity, water, sanitation, and solid waste collection may be attractive local revenue instruments. The same applies to benefit taxes such as road and port tolls, and to various licenses, which also may have regulatory functions.

21. **Sub-national entities are empowered by the Constitution to collect own revenue**. Own revenues are one of the three sources of funding for states and localities, in addition to federal transfers and shared revenues. Table 2 summarizes the main types of revenues of States, ranked broadly by the level of autonomy sub-national governments enjoy over these revenues. Article 195 of the Interim National Constitution (RoS 2005) empowers states to collect own revenue from ten specific sources, and also allows them to introduce

[3] A central focus of the PER 2006/07 was on the role of intergovernmental transfers and fiscal decentralization in the wealth and power sharing arrangements following the 2005 decisions.

"any other tax as may be determined by law".[4] The states have the highest degree of autonomy in defining own revenues, including authority to determine rates. Localities are financed from transfers from the states and own source revenues, and each state assigns taxing powers to localities through local government legislation.

22. **Sub-national own revenues are a necessary, but not a sufficient, condition for fiscal decentralization**. In most states and localities in Sudan own sources are not sufficient to develop and supply adequate services for the fast-growing population. The reality is that many sub-national governments will continue to be dependent on fiscal transfers from the federal government. Only a few of the states, as well as some of the larger urban municipalities located in more affluent areas, will in the short run be able to finance a substantial share of their total expenditure from their own revenue sources.

23. **Overall, own revenue mobilization at state levels is relatively low and varies greatly among the states**. Moreover, large variations exist between states and localities with respect to the number of revenue sources and rates. In the last decade states have become more dependent on transfers from the central government to meet their responsibilities for service delivery. While transfers on average represented 25 percent of the states' total revenues in 2000, this share increased to 70 percent in 2010 (IMF 2012). This implies that, on average, less than one-third of the states' expenditures are funded by own revenue sources. However, there are large differences between states with respect to their dependency on federal transfers, varying from as low as 38 percent in Khartoum, to 86 percent in Blue Nile in 2010.

24. **Non-tax revenues, in the form of fees and user charges, are the main sources of state own revenue**. Among these the most important are user charges on public service delivery, including charges for education, health and other public services. Fees on public services have constituted about 74-81 percent of total state own revenue during the years 2005-2011, while tax revenue has had a share of 14-19 percent during the same period. The high dependency of states on user fees and charges can be attributed to their low tax revenue base. This can be attributed to the following: limited private sector development and informal trade activity; insecurity in some states; weak service delivery performance; and inadequate databases for the equitable imposition of taxes and management of collections.

25. **The extensive reliance on user fees might be a response to the abolishment in 1999 of one of the most revenue productive taxes for states, the agricultural products tax.** This was a sales tax imposed on farmers selling their crops in local markets. The purpose of removing this tax was to encourage agricultural production and trade of agricultural products, and to increase farmers' income by reducing their tax burden. The agricultural production tax used to be collected at 15 percent level of the crop value by locality governments. Agricultural compensation transfers were introduced to neutralize foregone revenue from the abolished agricultural tax. The historical levels of the agriculture tax determine the share of compensation transfers to each state. Normally, there is an annual

[4] Article 195 of the Interim Constitution also includes 'grants-in-aid and foreign aid', but since these are not 'own' revenues, they are not included in Table 4.1.

increase in the allocation, which was around 8 percent in 2012. However, the current allocation system of agricultural compensation transfers does not reflect the economic changes that take place across the state governments.

Table 2: Own revenue sources assigned to states

Revenue Type	Revenue Items	Determination of Collection/Allocation
Own Source Revenues	State land and property tax and royalties; service charges for state services; licenses; state personal income tax; levies on tourism; state government projects and national parks; stamp duties; agricultural taxes; grants-in-aid and foreign aid; excise duties; border trade charges or levies in accordance with national legislation; other state taxes, which do not encroach on National or Southern Sudan Government taxes, many other tax as may be determined by law.	Combination of fiscal base and effort by individual states Potential bases provided by Article 193 of the INC
Shared revenue	2 percent of petroleum revenues by derivation	State share of revenue based on derivation basis (and other criteria), established by CPA
Grants and Transfers	*Current earmark transfers*: – wages (Judiciary, Police, High Education) – operations (Judiciary, Police, High Education) – social subsidies transfers *Current block transfers*: – agricultural taxes compensation – Current transfers (largely for wages) – Emergency and Ad hoc transfers *Development transfers* – State development projects (local component) – State development projects (foreign component) *Development and Reconstruction Funds for war affected areas*.	May be determined by formula, existing establishment costs (e.g., wages), or are in a sense ad hoc and discretionary.
Borrowing	Loans/borrowing in accordance with the Constitution	

Source: The Interim National Constitution (RoS 2005) and Source: Sudan PER, 2007

26. **Localities have a large menu of potential sources of revenues to choose from**: (i) Seven major categories of taxes; (ii) Four major categories of licenses; (iii) Twenty-nine groups of charges and fees; and (iv)Three items listed as “other” revenue sources (Table 3). The large number of revenue sources creates ambiguities, both for the authorities and for taxpayers. The distinction between taxes, licenses, charges and fees is often unclear. A number of levies are referred to as “charges” although they are in reality taxes, since no service is rendered directly and exclusively to the payer. The use of taxes, licenses, charges and fees varies between localities and sometimes does not correspond to economic realities. For example, more than fifty types of own revenue sources are listed in the

accounts as being levied in Aroma, Kassala and Wad-al-Helew localities in Kassala State. Several of these revenue sources have not generated any revenue in recent years. This is also the situation in localities in North Kordofan.

27. **The large number of revenue sources creates ambiguities for both the authorities and taxpayers**. The distinction between taxes, licenses, charges and fees is often unclear. A number of levies are referred to as charges although they are in reality taxes, since no service is rendered directly and exclusively to the payer. In addition, a wide variety of fees for forms and permits exist. The primary purpose of such permits is regulation, although in many localities they have become mainly a source of local revenue rather than a control mechanism.

28. **In spite of the large number of potential revenue sources, only a limited number matter for local government revenue generation**. Fees represent the largest source of own revenue for localities. In 2012, for instance, fees contributed 75 percent of total own revenues in localities in North Kordofan. Animal sales fees and market services fees were the most important, from a revenue perspective. Many fees generate little revenue (e.g. residential land improvement fees, planning of agricultural land fees, cinema and entertainment fees, taxes on youth and sport, and water fees), and some fees do not generate revenues at all (e.g. fees on fruit producing trees, fees on forestry products and rain-fed agriculture services fees).

Table 3: Own revenue sources in localities

TAXES	***NON TAX SOURCES***		
	Licenses	**Fees and Charges**	**Other Revenue**
1. Income tax on return 2. Property tax 3. Advertising board levy (trade banners) levy 4. Livestock tax/tax on herds 5. Tax on agricultural land 6. Tax on fruit producing trees 7. Tax on entertainment facilities/amusement parks	1. Business / commercial licenses 2. Commercial vehicle license 3. Building license and permit 4. Health license	1. Cinema and entertainment fees 2. Livestock sale fees 3. Slaughtering fees 4. Fees on pasture services 5. Wandering sheep/camel shed fee 6. Waste collection and removal fee 7. Fee for cleaning the villages 8. Town improvement fee 9. Village organization fee 10. Fee on non-multi-story buildings 11. Residential land improvement fees 12. Financial forms fees 13. Residential plan fees 14. Engineering fees 15. Health card fees 16. Health fees 17. Vaccination center fees 18. Veterinary services fees	1. Rental of state-owned cultivated lands 2. Rental of various gardens, parks, cafeterias, shops, kiosks and properties of the locality 3. Rental of river transportation vessels

		19. Veterinary medical examination fees 20. Planning of agricultural land fees 21. Crops services fees 22. Agriculture quarantine fees 23. Renewable activities fees 24. Village planning fees 25. Out-state departure fees 26. Administrative certificates fees 27. Labor permits fees 28. Investment fees 29. Water fees	

Source: Local government laws from various states.

29. **The ineffectiveness of the current sub-national revenue system is partly a result of tax design and weak administrative capacity for revenue collection, as well as poor coordination between the sub-national levels of government and between the federal and sub-national levels**. There are a number of main reasons for this:

– *High cost of tax administration*. The large number of taxes, fees and duties charged at different rates, indicates a significant effect on the business environment in terms of administrative obstacles and inconvenience. The costs of tax enforcement also vary between different revenue sources. Some revenues are relatively less costly to administer because there are clear methods to deal with defaulters. For instance, water services may be disconnected if the user fails to pay the water fees. Similarly, a license may be withdrawn if business people fail to pay a license fee. Many taxes are, however, relatively difficult to collect. High costs of revenue collection are also a main challenge in many localities in Sudan. According to the State Ministry of Finance in North Kordofan, the high collection costs are "due to long distance between the headquarters of localities and the administrative units and the capital of the state, increasing prices of fuel and spare parts, and rising depreciation of vehicles and means of transportation". These administrative costs seem to be largely unrecognized by localities.

– *Substantial difficulties in collecting state taxes*. Interviews with senior staff of SCoT in various states indicate that they often experience substantial difficulties in collecting state taxes. Some of the constraints include widespread resistance and evasion by taxpayers, poor business registers, and outdated databases of taxpayers and revenue bases. There are also weaknesses in tax policy design and frequent changes in the legal framework. The responsibility for the collection of state tax revenues is allocated to field offices of the Sudan Chamber of Tax (SCoT), while non-tax revenues are collected by other state institutions. The revenues collected are then transferred to the State Ministry of Finance (SMoF), or shared between the state and localities, depending on the nature of the taxes.

– *Nontransparent mechanisms of revenue collection*. The mechanisms of revenue collection vary between localities and states. At the locality levels several agencies, including service delivery agencies, collect fees. Many public entities seem to look for

ways and means of collecting their own revenue. There are no transparent guidelines clarifying roles and responsibilities among various government agencies involved in revenue collection at sub-national levels. This leads to a situation in which revenue collection and administration are non-transparent and uncoordinated.

– *Weak payment system and fiscal corruption*. Most taxes and fees are paid in cash. Some taxes, fees and duties are levied on a daily basis, while others are monthly, biannual or yearly. In addition, stamp duties are imposed on individual "transactions". Market fees are, in general, levied daily on people selling their goods at market places. Licenses are often issued on an annual or biannual basis. Spot-checks of businesses are used to control the payment of licenses. The combination of low wages, a non-transparent tax system and lack of controls promotes corruption. Revenue collection is characterized by a general lack of transparency in enforcement of regulations, which provides many opportunities for corruption and bribery. Studies from other countries in the region suggest that fiscal corruption may take many forms. Empirical literature shows that corruption varies by types of taxes, fees and charges, methods of revenue collection and location.

– *Higher number of fiscal incentives*. Tax incentives have been another factor influencing the revenue system at the sub-national level. Like many other countries, Sudan offers a number of fiscal incentives to investors. For instance, the *Company Act,* and more recently the *Investment Promotion Act* for Kassala State, provides "tax holiday" incentives to new investors. Tax exemptions impact the distribution of the tax burden by favoring new investors on account of existing and small scale enterprises. While there is some limited evidence that tax incentives are required to attract new investments in Sudan, tax exemptions have adverse impacts on revenue mobilization. The Chamber of Tax in North Kordofan estimated in 2010 that the revenue loss due to tax exemptions was 6-7 percent of total annual revenue collection in the state. These exemptions should not have been granted if the legislation had been followed.

– *Legal framework on taxation*. Another factor that has shaped the current revenue system in Sudan is the legal framework on taxation. Sub-national governments in Sudan have a high degree of autonomy in proposing tax legislation. Similarly, localities are also assigned broad powers to collect taxes and fees, through local government legislation. Some states are taking steps to "standardize" the tax system across localities. In Khartoum, the State Ministry of Finance aims to standardize the legislation on what sources of revenues localities can impose, without compromising the legal and constitutional rights of the existing administrative entities.

– *Low administrative capacity*. Many localities face a scarcity of revenue collectors to cover their major market centers. In such cases revenue collectors must travel between market sites, making collection more occasional and difficult to enforce. Taxing moveable tax objects, such as livestock and traders, are even more challenging. Presently there are limitations at the relevant decision-making levels in tax expertise and resources for designing an appropriate tax system. Due to limited capacity, and poor coordination between the state and localities, the questions raised at the state level on states' and localities' tax proposals are limited. As a result, the revenue systems in localities seem to have developed without much interference from the state level. At the locality level a

serious shortage of qualified staff in the Treasury and Planning Departments has been noted across most localities.

– *Resistance of taxpayers to meet their tax obligations*. Interviews with officials at state and locality levels in Kassala, North Kordofan and River Nile suggest that many taxes, fees and charges are difficult to collect, partly due to taxpayer resistance. Interviews with private sector associations in North Kordofan confirm the unpopularity of the revenue system. Taxpayers perceive the current tax system as unjust, which in turn reduces payment discipline. Although most taxpayers are unable to assess the exact value of what they receive from the government in return for taxes paid, it can be argued that they have general impressions concerning their terms of trade with the government.

– *Negligence or non-compliance by various government entities* paying taxes. A common administrative problem faced by states and localities is the negligence of some government institutions in submitting the taxes and charges they owe to the state and localities.

– *The prevailing gap between budgeted and actual revenues*. Nearly all states face large gaps between what they plan to collect (both from own sources and from the federal government) and what they actually collect. Keeping in mind that states have numerous pressing needs to address, the most important question is how to raise revenue collection up to its potential. Though the revenue gap has been declining over the last five years, it remains a significant challenge. The trend in reducing the gap is not uniform across states. For instance, in Kassala state budgeted revenues were 50 percent higher than actual until 2009, but then a sharp reduction in the gap followed, bringing it to 20 percent. North Kordofan has also recorded good progress in reducing the gap: from 120 percent in 2008 to around 10 percent in 2012.

30. **While Sudan continues to struggle with the weaknesses in its sub-national tax system, several other countries in Africa have conducted comprehensive reforms**. The main elements of these reforms have been: (i) Abolition of unsatisfactory local revenue instruments that were costly to collect from administrative and political perspectives; (ii) Improvements to remaining revenue bases by simplifying rate structures and collection procedures; and (iii) Strengthening of revenue administration and financial management.

31. **Fundamental issues to be addressed in sub-national fiscal reforms are redesign of the current revenue structure and strengthening of financial management.** In addition, measures such as improved public information on budgets and accounts are required, to enhance taxpayer compliance and to improve the accountability of revenue collectors and elected councilors. While the current potential for raising substantial own revenues is limited for most rural localities, urban localities have better potential for revenue enhancement.

32. **Greater emphasis is needed on the cost-effectiveness of revenue collection, taking into account not only the direct costs of tax administration, but also the overall costs to the economy, including the compliance costs to the taxpayers**. In addition, losses through tax evasion need to be reduced. To achieve these aims, there is a need to simplify the structures for business licenses, stamp duties and fees, by reducing the

number of rates and coverage. Moreover, sub-national taxes and licenses should be harmonized with the federal government's revenue bases, to avoid double taxation and conflicts with national development policies, such as job creation and private sector development. The establishment of one-stop-shop Single Business Permit systems can be promising for future reforms.

33. **The implementation of a well-functioning property tax system in Sudan will require reassessment of the basis of property tax in urban councils and implementation of a simpler and more coherent approach to the valuation provision.** Property tax has many attractions as a local revenue base, since it is imposed on immobile assets and is, therefore, in principle difficult to avoid. However, problems of valuation and tax enforcement often occur, due to political interventions and administrative weaknesses. In general, the capacity and capability of municipalities to administer property tax have proved to be inadequate. It has been difficult for municipalities in Sudan to maintain current property valuation registers, and to sustain property valuation initiatives.

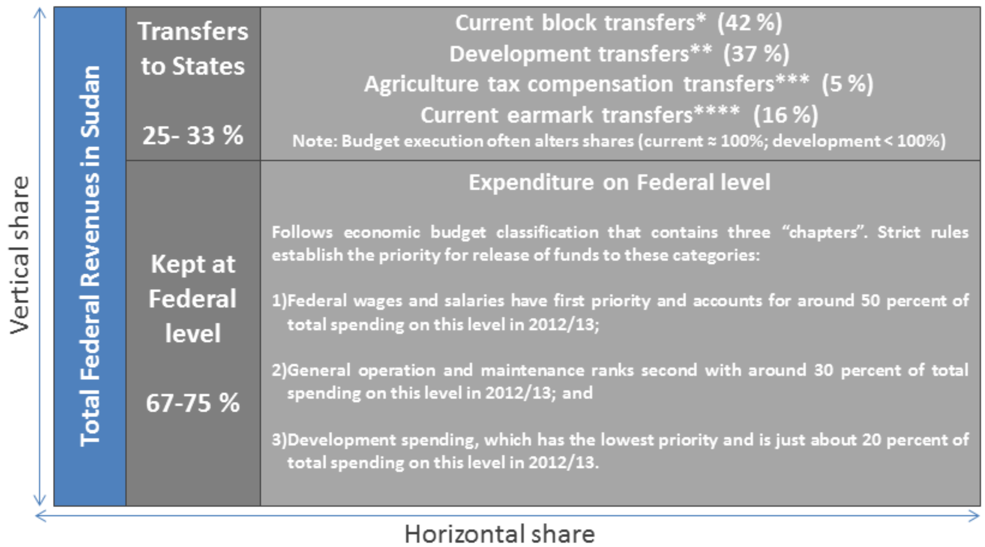
A complex and un-transparent intergovernmental fiscal arrangements system

34. **There is a complex array of intergovernmental resource allocation system**. Figure 8 summarizes the main types of intergovernmental transfers. The primary component of successful fiscal decentralization is a more equitable and transparent system of intergovernmental resource allocation between the federal and states governments, as well as across and within states. The specific objective of an effective transfer system is to address vertical imbalances between the centre and sub-national levels of government with respect to revenues and responsibilities (as expenditure responsibility for basic services shifted to state and local levels), as well as horizontal (interstate) imbalances due to differing own-revenue potential and differing needs.

35. **The Fiscal and Financial Allocation and Monitoring Commission (FFAMC) was established with the Comprehensive Peace Agreement (CPA) in 2005**. The Commission has the responsibility for both the vertical allocation of revenue between federal and state levels and the horizontal distribution of transfers among the states. The FFAMC replaced the National State Support Fund (NSSF) which was previously responsible for the allocation of resources to states.

36. **The amounts of vertical transfers are determined differently for the different types of transfers**. For the VAT transfer a fixed percentage, determined each year, is retained by the state. The amount transferred as agriculture tax compensation is based on the estimated agricultural tax loss of the state. The total amount allocated through formula based allocations is determined as a share of total federal revenues (excluding, among others, the federal share of VAT collected within each state). Other discretionary allocations are determined through a political process, and are allocated for specific purposes, such as special social transfers or transfers for emergencies.

Figure 8: Sudan's principal intergovernmental transfers



Source: World Bank staff own visualization and estimates.
Notes: * Theoretically based on formula with 8 criteria; actual allocation administered by FFAMC , but reflects some level of discretion.
** Theoretically based on formula with 7 criteria; actual allocation administered by MoFNE; formula not applied in practice.
*** Not based on formula, but historical levels of agriculture tax determine allocations; usually increasing annually (8 percent in 2012).
**** Used for police, higher education, free health care for children under 5, etc. Transferred directly from MoF to federal line ministries/agencies; amounts not reflected in state budgets.

37. **The states receive different types of federal grants and transfers, including the following: c**urrent earmark transfers; agriculture tax compensation, replacing agriculture product tax abolished in 1999; current block transfers; development transfers; discretionary allocations, such as special social transfers; and transfers for specific projects and emergencies.

38. **Horizontal allocation criteria vary across the different types of federal transfers**. The amounts for different types of transfers are determined on the basis of a number of criteria, ranging from the formula based to the purely discretionary. The formula based transfers are made for equalization purposes, taking into account for each state its expenditure responsibilities, own revenue capacity and reimbursement for certain costs. There is an additional Emergency Fund allocated to the states from the NRF, which is distributed by order from the Presidency or by recommendation from the FFMACC. However, while a formula based allocation appears to be underlying current transfers, it is not immediately possible to reproduce these allocation formulae.

39. **In 2010 the FFAMC revised its formula for horizontal distribution, so as to incorporate ten weighted criteria allowing for a more equitable distribution between the states.** However, political considerations still dominate the full implementation of the formula, which in turn jeopardizes the overall approach. For example, implementation of the formula would have implied significant cuts in the shares of the states of Khartoum and Gezira over recent years. This did not happen, indicating the current inability to implement existing rules.

40. **Analysis of the equalizing nature of grants and transfers to individual states shows that the different types of transfers have different impacts on equalization.** An increasing share of transfers is, however, guided by the FFMAC formula. Federal transfers have increased significantly over the years, in per capita terms measured in SDG at fixed prices. Furthermore, the composition of these transfers has also changed, from vertical discretionary allocations and tax/revenue sharing or compensation transfers, to the more transparent formula based allocation system.

41. **Disparities between the states in actual allocations per capita suggest that the current procedures for the distribution of federal transfers do not fully achieve equalization among the states.** This is an issue of both design of the formula and an implementation system in which discretionary decisions can alter the level of transfers to reflect the outcomes of political bargaining. In fact, actual allocations continue to vary between states and appear not to be linked to state level own revenue. The level of transfers has also varied significantly from one year to another for many of the states.

42. **This analysis simulates various simple alternative formulae, to illustrate the likely impact of changes in the federal transfer system.** Typically, fiscal allocations formulae take into account one or a combination of the following: (i) Distribution on per capita basis; (ii) Revenue capacity; and (iii) Needs, as reflected by poverty levels and social indicators, including per capita income, poverty incidence, unemployment rates, population densities, area, infant mortality rates, life expectancy, school enrollment rates, number of school age children, length of roads etc.

43. **The current distribution of federal transfers deviates from a distribution of equal transfers per capita, as well as from a poverty-adjusted allocation.** Using the latter as a criterion for distribution of transfers would significantly change the allocation for a majority of the states. Striving for equality in per capita transfers would suggest a major increase for states like North Kordofan, as well as North and South Darfur. Since Khartoum is a major beneficiary of VAT sharing, a simulation incorporating needs based allocations for "population" would increase transfers to the city over and above its current share of VAT. These, would, however, be downward balanced if a poverty criterion were assumed.

44. **This analysis argues that going forward a more simplified allocation formula is needed to enhance possibilities for implementation.** Such a formula might consider a segregation of transfers into needs-based and performance-based elements; this differentiation would help overcome some of the inconsistencies currently observed, where elements of the formula seem to neutralize each other. This would need to be part of a stable and predictable system, with full disclosure of the formula and the actual allocation process.

Sub-national public finance governance

45. **With increasing responsibility for basic service provision at the sub-national level, sound public financial management (PFM) systems are required to ensure**

effective service delivery and poverty reduction and to mitigate risks of corruption. As increased resources reach the sub-national levels of government, their institutional and administrative capacity in strategic budgeting and execution must be strengthened, to enhance the efficiency and accountability of resource use.

1- Budget Formulation and Approval Process

46. **Sudan has made reasonable progress in implementing a well-observed budget calendar, underpinned by an adequate statutory and regulatory framework at federal level.** The enactment of the INC of 2005 and state and local government legislation are significant steps towards bringing Sudan's budget preparation and approval processes into line with the most orderly and streamlined process practice in Africa.

47. **State assemblies have strong powers over ex-ante debate and approval of the annual budgets of sub-national governments, as well as involvement in the ex-post budget cycle.** In practice, the state assemblies debate the budget "line by line" and accept or reject each line item. In addition, the state assemblies have the power to change revenue forecasts and expenditure estimates, as well as the overall assumptions upon which the budget is based.

48. **Though each state has a dedicated time-period allowed for legislative scrutiny prior to budget approval, in all states there are problems over the allocation of adequate parliamentary time**. For example, in Khartoum State the Assembly usually gets a draft budget by early November and has until the end of December to debate, amend and sign the budget off, first by scrutinizing the budget in the five functional committees of the House, then by full debate in the Assembly.

49. **While the sub-national budget formulation and approval process is orderly, key deficiencies remain.** Severe challenges which explain the difficulties in efficient PFM include: (i) Weak strategic planning and budgeting; (ii) Compressed budget timetable for state assembly discussion; and (iii) Coordination problems between finance and planning functions. These have significant implications, and ultimately adversely affect the credibility of the budget.

50. **Across the jurisdictions visited it is clear that the on-going sub-national Five Year Strategic Plan priorities are not consistently linked to the availability of resources through a medium-term fiscal framework.** The strategic planning processes are largely paper exercises, with limited impacts on allocation decisions. The formulation process puts greater emphasis on control of inputs and less on the need to improve sectoral budgeting performance.

51. **There are some serious issues with development budgeting at state level.** It is not clear whether the recurrent implication of capital expenditure is properly factored into the budgeting processes at sub-national levels. Similarly, some capital expenditure has scant justification. The annual audits of state accounts are received by the state assemblies late in the following year, after the national accounts have been passed by the National Assembly at federal level. This delay compromises state assemblies in their oversight role.

52. **Project planning and implementation at sub-national levels is undermined by weak coordination and communication between the state and federal ministries (including functional line ministries).** This has been concluded by a series of analyses over the last five years (PER 2007, CIFA 2010, PETS 2011) and is reinforced by the current case studies**.** For instance, responsibility for providing basic services lies at the sub-national level, while the federal level still controls the majority of government resources and states have limited revenue-raising authority. On the other hand, the management of some development programs by federal bodies results in potential disconnect between the federal and state levels in planning and supervision of the activities, and in subsequent operating of projects/assets. In some cases, state finance officials do not have knowledge of national development projects which are under implementation in their own states. This underscores the need for guidelines to clarify the specific roles of each level of government, in terms of the planning, execution and monitoring of development projects.

2- Budget Credibility and Comprehensiveness

53. **While the sub-national budget formulation process is orderly, budget credibility remains a major concern, increasing the risk of fiscal targets not being achieved.** In practice, sub-national revenue outturns have consistently deviated from budgeted levels, reflecting significant challenges in mobilizing the revenues forecasted by states. A comparison of total actual receipts against the original budgeted figures indicates that, in aggregate, sub-national budgets have not been successful in forecasting the actual revenue receipts and revenue projections are often unrealistic and are not collected as intended.

54. **Maintaining expenditures within the available resource envelope to finance the budget remains a challenge for states.** Some of the explanation is due to weak revenue forecasts and unpredictable federal transfers, which undermine the predictability of the budget as a tool for effective public expenditure management. In addition, sub-national expenditures reflect strict priority given to release of funds to recurrent spending categories, especially wages and salaries. Recurrent spending categories persistently enjoy better budget credibility in all the four selected states. Most notably significant variations in development budget execution remain a serious challenge, implying a lower likelihood of protecting development spending during resource envelope shortfall**s.**

55. **There are limitations to the comprehensiveness of sub-national budgets and instances where locally generated revenues are effectively off-budget.** For example, one locality in Khartoum State reported that some teachers are paid by local contributions, but these are not recorded anywhere in the books of the government. It also appears that revenues from in-kind charitable contributions are not consistently included in the state financial reports. Given the extensive involvement of NGOs in the delivery of services, sub-national budget records are often not a reliable indicator of the actual cost of "public service provision". In some states, particularly North Kordofan, funding gaps are severe.

3- Budget Execution

56. **The Government Resource Planning Financial Management Information System (FMIS) that has been rolled out at federal level has not yet had any sub-national roll-out.** Systems for recording transactions at state and locality level are in the main manual. States use spreadsheets, but these are less commonly used in localities. There appears to be adequate control of the government payroll. Personnel records and payment re**c**ords are maintained separately although in the case of some states, e.g. North Kordofan, they are not reconciled very frequently. The current study found that all additions and changes to the payroll data for the previous period needed to be verified and backed up with supporting documentation.

57. **One area of concern regarding controls relates to the formula to distribute collection incentives among revenue collection staff.** In all states revenue collectors are, as per local regulations, entitled to a percentage of total revenue collected. This can result in poor governance arrangements in the absence of **the** existence and following of clear rules.

4- Internal Audit

58. **While the internal audit function exists in all states and localities visited, it is very much an "inspection function".** This function is often imbedded in sectors, as it is, for example, in Khartoum. It is more focused on the ex-ante reviews of expenditures, with little or no effort in reviewing the systems and the operational efficiencies affecting the achievement of overall objectives. On the revenues side, attention seems to be more on comparing actual revenues with approved estimates.

59. **In terms of reporting, at state level the internal audit function falls under the State Minister of Finance**. Consolidated internal audit reports are produced and considered by a Financial Control Committee, as in North Kordofan, or a similar body, as in Khartoum, chaired by the Minister of Finance. At locality level, the internal audit function typically falls under the Executive Director.

60. **There is a need to modernize the internal audit function.** International good practice reflects a number of principles that might be taken on board: (i) Internal audit should be appropriately independent; (ii) The audit function needs sufficient breadth in its mandate, and access to information; (iii)The function needs to use professional audit methods, including risk-based audit.

5- External Audit and Scrutiny

61. **The National Audit Chamber of Sudan is responsible for auditing the final accounts of sub-national governments.** In some states, such as North Kordofan, staff of the Audit Chamber work as "implants" at both state and locality levels of government, facilitating a form of continuous audit process. However, closer discussion in the current study revealed that much of the focus of the external audit function, like internal audit, is on individual transactions.

62. **Audit reports for the consolidated state accounts, including locality accounting information, are sent to state legislative assemblies within six months of the closure of the financial year**. Common issues brought up in state audit reports relate to deviations from recognized procedures, subversion of general controls and lack of appropriate supporting documentation.

63. **In all states there is evidence of state assemblies debating the audit report and follow up of report recommendations by the state cabinets**. This is in line with good practice. However, audit reports at the locality level appear to go to the Locality Executive only.

E. An Agenda for more effective fiscal decentralization

64. **The following are four top reform agenda items for fulfilling fiscal decentralization in post-secession Sudan, emerging from this PER.** A more detailed elaboration on these key issues is presented in Chapter 5 of this report.

(i) Address regional imbalances by reforming the federal fiscal allocation mechanism to better target poor and under-served regions. Fiscal decentralization is an appropriate institutional set-up to further service delivery in Sudan, but its current implementation needs to be readjusted to improve the quality of governance and promote development outcomes. Key policy considerations should include the following:

- **There is a need to design appropriate policies to smoothen and equalize widespread imbalances in Sudan.** Poverty rates, social service outputs and fiscal resources available at the sub-national level vary significantly across the states and localities of Sudan. While fiscal decentralization has brought considerable extra resources to the states and substantially increased overall per capita social spending over the past ten years, these additional resources have not been adequately allocated and used in ways to smoothen the social and financial imbalances observed.

- **There is considerable scope available to improve the system of federal transfers to ensure more equality in distribution and predictability in allocations.** A starting point would be to subject all, or the majority, of federal transfers to the states to objective formula-based allocations. This would allow better accounting and compensating for differences in state level revenue potential and poverty levels. More importantly, segregation of the federal transfers into a need-based and a performance-based allocation should be considered. There is also a crucial need for wider dissemination and follow-through on the fiscal allocation formula, to improve the ability of states to make more realistic revenue forecasts.

- **Federal development transfers are discrete in their application, but have a strong impact on state-level development outcomes.** This is seen, for instance, in the case of River Nile State, host of the Merowe Dam project. This project was financed from the federal level, and brought roads with bridges over the Nile and electricity to large parts of the state, which in turn triggered a thriving cement industry. Such expenditures

should be aligned with other federal transfers, to ensure an overall equalizing nature of federal spending in states.

(ii) Strengthen revenue mobilization at state level, through streamlining both tax and non-tax measures, with due emphasis on the cost-effectiveness of revenue collection. This would need to take into account not only the direct costs of tax administration, but also the overall costs to the economy, including the compliance costs to the taxpayers. It is important, however, to note that in most states and localities in Sudan, own sources are not sufficient to develop and supply adequate services for the fast-growing population, and in reality many sub-national governments will continue to be dependent on fiscal transfers from the federal government. With this background, other key considerations include:

- **Shift the focus in revenue mobilization from fees to tax policy and administration.** This should reduce dependency on user charges on services, particularly social services, which adversely impacts on user access. More importantly, cost recovery through user charges should aim to establish clear linkages between payment and public service provision.

- **With increased revenues, prioritize investments in infrastructure, rather than increasing investments in general administration.** Investment in infrastructure, in particular electricity and roads, is needed to promote a more conducive business environment and social service delivery.

- **Abolish unsatisfactory local taxes**, especially those revenue sources which generate little revenue (e.g. cinema and entertainment fees, taxes on youth and sport etc.) or no revenues (including taxes on fruit producing trees, wandering sheep/camel shed fees).

- **Improve the remaining revenue bases;** in particular the stamp duty and business license systems need to be simplified by reducing the number of duties, licenses and fees and the rates applied.

- **Revise the tax incentive and exemption regime**. A high occurrence of tax incentives has negative impacts on revenue mobilization and creates loopholes for tax evasion. The benefits of investment tax incentives are generally exaggerated, while the costs are often underestimated or overlooked.

(iii) The federal government SSP seems to be overly ambitious in scope and poorly designed and implemented. The involvement of too many agencies complicates program management and hampers coordination, leading to issues such as multiple targeting and frequent overlap of the different programs. A number of households have access to multiple transfers, while others receive none. Other key issues to consider are:

- **Lack of key infrastructure, such as information and payments systems, jeopardizes the implementation of the social program.** These challenges include: (i) Lack of adequate information systems to allow for the identification of potential

beneficiaries; (ii) Lack of adequate funding for the construction of an appropriate sampling frame to be used as the basis for the targeting mechanism tool; (iii) Lack of transparency in the eligibility criteria and selection rules; (iv) Lack of adequate networks of payment centers; and (v) Lack of monitoring and evaluation tools that reduce incentives for capture by local elites.

- **Monitoring and evaluation of the social safety net need critical strengthening.** Problems relating to leakage and misallocation may go undetected because of inadequate program monitoring, stemming from both a lack of technical resources and the inadequacy of financial resources to cover administration costs, particularly in government institutions.

(iv) Reinforce performance-based budgeting systems to better link budgets to planning processes and make the flow of public expenditures more predictable and transparent. There are several critical challenges in budget preparation, budget execution and audit/oversight that must be addressed to improve the budgeting practices of state and local governments. To provide effective and efficient basic service delivery sub-national governments urgently need to ensure a sound PFM system that integrates long-term planning and focuses on results and outcomes. Urgent consideration is needed in the following areas:

- **The most pressing issue relates to strengthening the credibility of the budget.** A credible budget is a fundamental requirement of effective PFM. Work is required at federal, state and locality levels on better estimating resources to be used for transfers. A medium-term expenditure framework is required to ensure that adequate resources reach responsible spending units and levels of government. Budget links to the state's Strategic Plan should help in this regard, particularly in sectoral priorities.

- **Improve accountability and effective public expenditure planning and management, which are currently hampered by limited information and monitoring.** In this area, there are several significant deficiencies: (i) The current budget system does not provide a classification of expenditures according to their function and purpose; (ii) State expenditure data currently only captures Ministry of Finance releases to spending units, rather than actual use by spending units; and (iii) There is limited attention to budget execution and less to the outcomes of expenditures. Overcoming these challenges and achieving the basic information requirements should be at the forefront of expenditure management reforms.

- **To accomplish broader poverty reduction and effective and efficient local service delivery, sub-national budget cycles should have a logical sequence and timing and build on the planning framework**. The budget should also reconcile development goals and policy priorities with a realistic assessment of fiscal constraints, rather than encourage a "shopping list" approach. Sub-national governments often focus on achieving fiscal discipline at the expense of effectiveness and efficiency.

- **Particular effort needs to be given to transparency and civil society participation.** Financial data is often not available to everyday people. In the case of localities this includes annual audit reports. In addition, involvement of citizens' groups in the budget process, and in discussing budget performance, appears to be limited.