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Restructuring IGFR in an African Country in Transition – The Case of Sudan

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Acronyms and Abbreviations

AfDB	African Development Bank
BPT	Business Profit Tax
CPA	Comprehensive Peace Agreement
FFAMC	Fiscal and Financial Allocation and Monitoring Commission
FGTFF	First Generation Theory of Fiscal Federalism
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GFSM	Government Finance Statistics Manual
HCR	High Council on Resources
HFI	Horizontal Fiscal Imbalance
HIPC	Highly Indebted Poor Countries
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
INC	Interim National Constitution
IPSAS	International Public Sector Accounting Standards
MDGs	Millennium Development Goals
MOFNE	Ministry of Finance and National Economy
MWSS	Ministry of Welfare and Social Security
NRF	National Revenue Fund
NSSF	National State Support Fund
PAU	Poverty Action Unit
PIT	Personal Income Tax
PRSC	Poverty Reduction Support Credit
PRSP	Poverty Reduction Strategy Paper
SDG	Sudanese Pounds
SGTFF	Second Generation Theory of Fiscal Federalism
SSA	Sub Saharan Africa
UNDP	United Nations Development Programme
VAT	Value Added Tax
VFI	Vertical Fiscal Imbalance

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1. Introduction

The turn of the twenty first century witnessed drastic changes in governance structure in developing countries. During the twentieth century governments were largely unitary and centrally managed. Government activities were significantly constraint by bureaucracy and red tape. The relationship with the rest of the world was limited due to the dominance of self-reliance doctrine. By the beginning of the twenty first century the developing countries moved towards federal and con-federal forms of governments. The role of the central government was gradually transformed from management to leadership in response to the requirements of globalization and localization of power. Focus on inputs was replaced by the focus on results as competition and accountability pushed the governments to be more open and dynamic.

Recent international experience focuses on the importance of evaluating the impact of intergovernmental transfer systems in developing countries in terms of its incentive effects on sub-national governments. These include the overall efficacy of sub-national pro-poor service delivery and accountability, sustainable fiscal policies, and own source revenue mobilization. The notion of community-driven development –which embraces the view that poverty is local and that poverty alleviation requires involvement at the local level- is increasingly gaining followers among policy practitioners and in the development literature. Nevertheless, the efficacy of decentralization in the provision of pro-poor public goods has been questioned by those who believe that decentralization may lead to “capture” of public resources by the elite and administrations at the local level. It is also feared that decentralization can also lead to fragmentation of society or exclusion of the poor in the presence of a local elite, and to corruption. Decentralization is also feared to induce political tensions between regions if they have significantly different income levels and natural resource endowments.

In common with the worldwide drive towards decentralization, the federal system of governance was adopted in Sudan in 1992 when three main levels of authorities were created: the federal government, the states, and local communities. The current federal system in Sudan consists of 18 states and 199 local communities. The system involves devolving more expenditure functions and revenue sources to the states. Accordingly, total revenue of the states witnessed substantial increases over the past two decades. Concurrently, states have increased their dependency on transfers to meet their responsibilities for the provision of basic social service delivery. Large increases in transfers to states have contributed to rapid growth in state spending and weakened incentives to raise state own revenue. The improvement of pro-poor public service delivery and the assurance that services are delivered in an equitable manner, take on even greater urgency. This paper aims at providing an assessment of the impact of intergovernmental transfers and various levels of fiscal decentralization on poverty alleviation. The overarching objective is to introduce proposals to policy makers at various levels of government and the international partners, which may assist in realizing the desired objectives. This includes the assignment of expenditure responsibilities, the assignment of revenue sources to sub-national governments, intergovernmental fiscal transfers, and local government borrowing. At the same time, the paper intends to uncover how poorly designed fiscal decentralization programmes may be harmful to the objective of poverty alleviation. Based on the analysis of Sudan's past experience with fiscal decentralization, the paper attempts to provide specific recommendations on how the central government, sub-national governments, donor support can interact to design fiscal decentralization reforms in a more pro-poor manner and how poverty reduction strategies can embrace a proactive solid role for central and sub-national governments.

The paper is organized as follows: section two lays the theoretical and conceptual framework of the study and discusses the relevance of fiscal decentralization theories to developing countries. Section three analyses the state of fiscal decentralization and poverty alleviation in Sudan. Following this, section four examines the trends in fiscal transfers and poverty reduction. Section five analyses the challenges and constraints to fiscal decentralization in Sudan. This is followed by section six which highlights the lessons learned from selected countries with respect to: vertical fiscal imbalance, horizontal fiscal imbalance, matching grants and poverty reduction. Section seven is devoted to present proposals toward a reformed pro-poor intergovernmental transfers system in Sudan.

2. Theoretical and Conceptual Framework

2.1 Definitional and Conceptual Issues:

2.1.1 Definition and Rationale of Fiscal Decentralization:

The economic literature points to three distinct dimensions of decentralization, namely political, administrative and fiscal dimensions (El Shibly, 1990). Each dimension has unique characteristics, objectives and conditions for success. While the political dimension refers to the transfer of authority from central to local authorities, the administrative component focuses on the transfer of functional responsibilities from central to local authorities and the fiscal dimension deals with the financial relationship between all levels of government. However, despite the usefulness of distinguishing between the different dimensions of decentralization, there is nonetheless considerable overlap between the three dimensions. (Boex *et al* 2006).

Fiscal decentralization, widely regarded as the core component of decentralization, can be defined as devolution of authority and responsibilities for public functions from the central government towards local governments with regards to spending and revenue collection. Fiscal decentralization refers to the public finance dimension of intergovernmental relations. It is defined today as allowing lower levels of government to raise and/or spend an increasing share of the state budget (Fritzen 2006). Fiscal decentralization specifically addresses the reform of the system of expenditure functions and revenue source transfers from the central to sub-national governments. Hence, it plays a pivotal role in any decentralization programme. Nevertheless, some economists like Tanzi (2000) advocate that while decentralization might be necessary from a political point of view, there are some possible adverse consequences of decentralization, such as increased corruption, excessive regulation, difficulties in introducing efficient tax reform and difficulties in maintaining macro stability. (Said *et. al.*, 2003).

2.1.2 Definition and Scope of Poverty:

Poverty reflects a condition of low income and failure to satisfy basic needs and manifests itself in the prevalence of risk, uncertainty about the future, vulnerability, powerlessness, lack of voice, representation and freedom. During the 1980s and 1990s, the concept of poverty gradually evolved from the notion of minimum *level of subsistence* to the notion of *relative deprivation*, which defines poverty as the failure to maintain the standards prevailing in a given society. More recent debates have added other elements to the poverty definition, including such intangibles as ‘capabilities’, dignity, autonomy, vulnerability, voice, empowerment and participation (Boex et al 2006). This broad definition of poverty had a direct bearing on the criteria for measuring it. Hence, the measurement of poverty has been widened to include, in addition to income, a broad set of non-income basic needs, such as primary education, basic health, and access to social services like clean water.

2.2 The Theoretical Framework:

2.2.1 First Generation Theory of Fiscal Federalism:

The first generation theory of fiscal federalism (FGTFF) began with the decentralization theorem by Oates. It was further modified by the work of Samuelson (1954 and 1955), Musgrave (1959) and Arrow (1970). Their contribution focused the nature of public goods, the conceptualization of the roles of the private and public sectors, and the active and positive role for the government sector in terms of correcting various forms of market failure, establishing an equitable distribution of income, and stabilizing the economy at high levels of employment with stable prices, as set in the Keynesian theory (Oates, 2005). The main focus of FGTFF was on the failure of market mechanism in providing public goods, which necessitated the intervention of the government to take the appropriate measures to handle the market failure. The first generation theorists investigating fiscal federalism tended to associate the process of fiscal decentralization with an enhancement in the overall degree of public sector responsiveness to a public demand and, ultimately, to an improvement in the economic efficiency of public economic activities by better linking resource allocation with public preferences. Musgrave (1959) introduced three different branches or categories of public finance: economic stabilization, income distribution and resources allocation. In the specific public finance perspective on federalism, the Musgravian branches of public finance proved useful in setting the constraints to fiscal decentralization, stabilization and distribution, and the potential benefits of fiscal decentralization, efficiency, (Vo, 2010).

At this juncture, a distinction between decentralization and federalism should be drawn. The decentralization theorem as presented by Oates, does not make this distinction. Fiscal federalism, according to Oates, deals with the degree of decentralization, not whether the system is unitary or federal (Oates, 1972). However, that does not ensure permanency in the assignment system, revenue and expenditure powers and functions. Therefore, according to Breton 2000, what distinguishes federalism from decentralization is the ownership of inextinguishable constitutional powers. There should also be sufficient checks and balances in the system to ensure that subnational powers are not extinguished.

Another aspect of FGTFF was introduced by Tiebout (1956). He suggested that consumer demand for local public goods can be revealed when citizens choose the jurisdiction which provides them with the best net benefit. Consumer-voter's preferences can be revealed and consumers will choose the point where their demand for impure public goods is met. Accordingly, Tiebout contribution to the study of fiscal decentralization can be summarized in introducing the notion that it is impure public goods that are provided by subnational governments, and his demonstration that mobility of taxpayers – voters – between jurisdictions represents the mechanism by which individuals reveal their preference for ‘impure’ public goods.

The main theoretical concern is whether fiscal decentralization influences economic stability. The first generation theorists postulate that fiscal federalism does achieve the macro stabilization objective. On the contrary, macro stabilization represents a constraint on the devolution of fiscal powers to sub national governments, (Oates, 1972).

As for income distribution, fiscal decentralization does not seem to be systematically helpful in this respect, as economic interdependences between the economies of sub-national jurisdictions act to reduce any diversity in the distribution of goods that would exist across lower level governments. As such, income redistribution has a greater chance of success if it is carried out by the central government (Oates, 1972). Hence, FGTFF produced a vision of fiscal federalism in which the central government took the lead in macroeconomic stabilization policy, introduced basic measures for income redistribution, and provided efficient levels of output of national public goods. Paradoxically, an aggressive local government program, for example, to redistribute income from rich to poor establishes undesired incentives for outmigration of the well-to-do and inmigration of low-income households.

The FGTFF regards the final branch of public economics, resources allocation, as the area in which fiscal decentralization can be most effective. The theory justified this by two main reasons. First, scarce resources should be more efficiently allocated under a decentralized fiscal system, due to the better position of understanding how to maximize benefits from the use of resources in their localities. Second, the character of ‘impure’ or local public goods adds a local congestion dimension to service provision that national governments may not be well placed to manage, (Vo, 2010).

2.2.3 Second Generation Theory of Fiscal Federalism:

It is to be stated at the outset that FGFF and SGFF approaches are complementary rather than competing. FGFF focuses on the optimal design of fiscal institutions in the context of welfare maximization without respect to the incentives of political officials. The main contribution of SGFF is that it extends and adapts FGFF lessons to the context of incentives and self-interested political officials. Along these lines, the turn of the twentieth century witnessed the emergence of the second generation theory of fiscal federalism SGTFF. The basis of this theory originates outside the sphere of public finance literature, namely, the theory of the firm, the economics of information, the principal–agent problem, and the theory of the contract (Oates 2005). The SGTFF has two main concerns. The first is the underlying political processes represented by the lack of commitment from government officials to maximize the welfare of their constituencies. This consideration has obvious links to public choice theory – which was the main ‘non-core’ stream of the first generation theory of fiscal decentralization (Volume, 2010). The second concern of SGTFF is the issue of asymmetric information and political agents, as some particular participants have more knowledge of local preferences and tastes and cost structure compared to the others. In dealing with this issue the second generation theorists introduced the framework of industrial organization and microeconomic theory. As such, SGTFF focus on the issue of balance between the degree of fiscal centralization and fiscal decentralization. In contrast with FGTFF, which acknowledges the general support of fiscal decentralization, SGTFF points to the dangers of going too far along this direction.

There are two main motives that characterize SGTFF, namely, incentives and information. The two motives are instrumental in the realization of economic efficiency. On the one hand, incentives are helpful in discouraging outward migration of people and firms from a jurisdiction. On the other hand, knowledge of local preferences and tastes is crucial to achieve economic efficiency when local public goods and services are provided by sub national governments. In common with FGTFF, SGTFF's logic for the design of fiscal transfers focuses on lowering the tax burden. But it also emphasizes allocating sufficient taxes to sub-national governments so that they have strong fiscal incentives to foster local economic growth (Weingast, 2006). The SGFF approach suggests that lower level governments are unable to foster local economic prosperity if they capture significant increase in revenue along with that prosperity. Hence, SGFF advocates the redesign of transfer systems so as to allow significant horizontal equity while providing high marginal incentives.

The most important difference between the first and second generation theories is that the former assumes that the governments are benevolent and the latter do not. That is precisely the reason why the decentralization theorem is about welfare maximization, whereas the second generation theories focus on responsiveness, accountability, strategic behaviour (principal-agent models) or intergovernmental competition.

2.3 Relevance of Fiscal Decentralization Theories to African Countries:

Economic theories generally involve abstraction, simplification and generalization. This is even more so with respect to theorizing fiscal decentralization, especially in African countries. Although context should never be ignored in public policy analysis, there are some relatively established practices and standard institutions that must be considered. Many economists advocate the case for centralization of the stabilization and distribution functions in African countries as the issues surrounding assignment of responsibility for both the expenditure and revenue dimensions of the allocation function in developing countries are considerably complex. On the one hand, a number of explicit and implicit assumptions underlying public finance theory in general and fiscal federalism in particular, may be violated in some African countries. This violation takes the form of: the relevance of individual preferences as the principal basis for defining demand; the potential role of mobility in generating an efficient spatial pattern service provision; the applicability of conventional models of public choice; and the existence of an adequate legal basis for an effective intergovernmental system. To the extent that such mechanisms and assumptions are not valid, some of the standard policy prescriptions of the theory may have to be discarded or adapted (Smoke, 2001).

On the other hand, even if basic principles are essentially valid, typical conditions in African countries can substantially affect the way they should be interpreted. Widespread poverty may make preferences more homogeneous across local jurisdictions, justifying greater centralization of some functions. This could be offset, however, by substantial spatial diversity in local environments and economic bases, and/or by the existence of widely dispersed and poorly linked settlements, both of which might suggest the need for greater decentralization. In addition, a wide diversity of socio-political and institutional conditions can also influence the need and prospects for fiscal decentralization.

Furthermore, the vast majority of African countries are essentially unitary states in which local governments are the creation of the centre. Typical federal states are created by virtue of a voluntary union of decentralized units, which agree to surrender certain powers to the central government. Most of the few African countries with semi-autonomous state governments are quasi-federal in that the state structure was at least partially imposed from above. As a result, local governments are greatly influenced by the state bureaucracy with few true autonomous powers. In extreme cases, the central government may appoint the members of local government councils rather than permit their election by popular vote. In contrast, some local authorities are independent legal entities with significant autonomy. In African countries there is a wide range of differences between levels of governments. First, systems differ in the number of levels of government that exist and the relationships among them. Second, local authorities differ in their degree of political decentralization and grassroots legitimacy. Third, local authorities differ in their degree of autonomy in revenue-raising and expenditure decision making. Fourth, local authority systems differ in the average degree of fiscal capacity relative to service responsibilities. Fifth, there are large differences across African countries in the way fiscal data are classified, to the extent that even if data were available, it could be difficult to compare them.

However, despite the institutional realities in the African countries and the nature and extent of decentralization needed for efficient provision of local public goods, it would be erroneous to entirely dismiss the relevance of the theories of fiscal federalism to these countries. The following are some of the ways through which these theories can be of help in addressing fiscal federalism in Africa: (i) there should be clarity in assignments and assignments should be according to comparative advantage; (ii) subnational governments should have sufficient assignment of revenue powers to enable them to ensure a link between revenue-expenditure decisions at the margin; (iii) subnational governments should be faced with hard budget constraints and bailouts should be avoided to ensure efficiency and accountability in the provision of local public services; (iv) equalization formula should be designed to offset horizontal and vertical imbalances, but it should not have adverse incentives on revenue effort and expenditure control; (v) the ideal transfer system should have a mix of unconditional (general purpose) and conditional specific purpose transfers; (vi) ensuring hard budget constraint is at the heart of ensuring efficiency and accountability and hard budget constraint is necessary to have an efficient land, credit and debt markets; (vii) it is important to set up policies and institutions to promote inefficient intergovernmental competition.

3. Fiscal Decentralization and Poverty Alleviation in Sudan

3.1 The Federal Fiscal System and Pro-poor Policy:

The analysis was done through dividing the period covered in the study in three intervals: 1981-2002, 2003-2010 and 2011-2012, with the later interval reflecting the developments after the session of the southern part of the country and the termination of the oil decade. It has been found that fiscal policy in Sudan during the period 1981-2002 was far from being pro-poor. During the period 1999-2010, Sudan witnessed "the oil decade" which was characterized by the strongest growth trend in the country's history. The period 2003-2010 witnessed a drastic change in the composition of government expenditure, with the federal share in total expenditure dropping from 92% in 2000 to 64% in 2006 due to the implementation of the Comprehensive Peace Agreement (CPA) which emphasized the role of sub-national governments in the country's public finance. The relatively huge amounts of oil reserves accumulated were not converted into equivalent public investments in education, health and infrastructure.

The year 2011 witnessed the session of South Sudan, which was accompanied by the fall of oil production by three quarters and the decline in revenues by more than 50% bringing the economy to the verge of recession. The deficit in the trade balance reached a record US$ 9 billion in 2011. The market exchange rate dropped first from 3 SDG/USD to around SDG 5 and then later to around 7.1 SDG/USD, after its slight appreciation following the official rate devaluation in June 2012. Inflation soared to over 40% triggered by rising transport and import costs of necessary goods. Fiscal deficit reached about 5% of GDP.

Confronted by this serious economic crisis, the government launched the Second Five-Year Strategic Plan (2012-16), which aims to diversify the economy away from oil to agriculture and other sectors and the Three-Year Programme for Sustainability of Economic Stabilization 2012-2014. Fiscal policy was the first resort to cater for the immediate negative impact of the secession of the south. A supplementary budget was introduced in the second half of 2011 to accommodate the 35.6% loss in total revenue without jeopardizing growth. The amended 2011 budget focused on cutting spending, increasing taxes and removing subsidies (AfDB, 2012). In order to contain the fiscal deficit, the government removed subsides from major fuel products and sugar, with an estimated saving of 1% of GDP in 2011. In an effort to boost tax yield, VAT exemptions were reviewed and the structure of import tariffs was reformed The tax on telecommunications was raised to 30% in the second half of 2011 up from 20% and a 5-10%

development tax was imposed on selected consumer imports. Nevertheless, the high level of unrecorded transactions in the shadow economy, estimated at 65% of GDP, decidedly diminished the impact of the fiscal adjustment policies. Despite the fiscal reforms, expenditure reduction remained below the level needed to compensate for lost oil revenue, generating a fiscal deficit of 5% of GDP in 2011. The wage bill (Chapter One) amounted to 44% of government spending in 2011 and is expected to decline to 40% in 2012. The share of Federal transfers to state governments was 27% of total government revenue during the period 2011-2012. Pro-poor spending on social services, including health and education, averaged only 1% during said period. Capital expenditure was a mere 8.2% of the 2011 budget, 50% less than originally budgeted. The share of capital expenditure in GDP fell from 2.6% in 2010 to 1.3% and 1.4% in 2011 and 2013, respectively.

Table (3.1)
Public Finances (Percentage of GDP)

	2003	2006	2007	2008	2009	2010	2011	2012	2013
Total revenue and grants	16	21.0	20.6	22.7	16.3	16.4	12.1	10.7	10.6
Tax revenue	5.8	7.4	6.9	6.6	7.1	6.5	7.5	5.2	5.1
Oil revenue	9.1	11.2	11.6	14.9	7.9	8.5	5.3	2.6	2.5
Grants	-	-	-	-	-	-	-	-	-
Total expenditure and net lending	15.3	25.6	26	24.2	21.2	19.5	16.4	14.1	14.9
Current expenditure	12.7	21.1	21.1	20.9	18.2	16.8	14.8	11.5	11.8
Capital expenditure				3.4	2.9	2.6	1.8	1.3	1.4
Excluding interest	11.1	20.0	20.2	20	17.2	15.9	13.3	9.6	9.7
Wages and salaries	4.1	5.8	6.8	5.1	5.6	4.9	5.1	4.9	5
Interest	1.6	1.2	1	0.9	1	0.9	1.5	1.9	2.1
Primary balance	2.3	-3.4	-4.4	-0.6	-3.8	-2.2	-2.8	-1.5	-2.2
Overall balance	0.7	-4.6	-5.4	-1.5	-4.8	-3.1	-4.3	-3.4	-4.3

Source: AfDB, (2012) and IMF 2012

As table (3.1) shows, total government revenue fell from 22.7% of GDP in 2008 to 12.1% in 2011 and to 10.7% in 2012, before it fell further to 10.6% in 2013. Oil revenue fell from 14.9% of GDP in 2007 to 5.3%, 2.6% and 2.5% during the same years. Current expenditure also witnessed drastic decline in the years following the session of the South and the subsequent loss in oil revenue. In 2010, current expenditure was 18.2% of GDP but it fell to 14.8% in 2011 and to 11.5% in 2012, while projected to slightly increase to 11.8% in 2013. Similar pattern was recorded for capital expenditure, which fell from 2.6% to 1.8%, and to 1.3%, before rising slightly to 1.4% during the same years. On the other hand, despite the fall in revenue after the secession of the south, wages and salaries witnessed steady performance during the period covered ranging between 4.9% and 5.0% of GDP during the same years. The consequent effect of the fiscal developments was the deterioration in the fiscal deficit from 3.1% of GDP 1n 2010 to about 4.3% in 2012 and 2013.

Table (3.2)
Current Federal Transfers to States
(2011-2012)
(SDG)

Item	2011	2012
Current Transfers	2,806,348,680	2,793,600,000
Compensation for Agric. Taxes	330,000,000	330,000,000
Broadcasting	19,869,998	19,869,998
Children Free Medical Care	28,000,000	27,996,667
President's Grant	503,934,000	755,901,000
Total	3,688,152,678	3,927,367,665
GDP	186,689,900,000	243,412,800,000
% of GDP	1.96	1.61

Source: Ministry of Finance and National Economy

As for transfers to states after the session of the South, Table (3.2) shows that total federal current transfers to states dropped to 1.61% of GDP in 2012 from 1.96 of GDP in 2011. This decline is consistent with the overall drop in Total government expenditure due to the loss of 75% of the oil revenue due to the session of the South. According to the Annual Report of the Bank of Sudan 2012, total current transfers to states dropped by 48.5% in 2012, (Table 3.3).

Table (3.3)
Federal Transfers to States and Total Current Expenditure
(2010-2012)
(SDG million)

Item	2010	% from Total Exp.	Rate of Change %	2011	% from Total Exp.	Rate of Change %	2012	% from Total Exp.	Rate of Change %
Transfers to States	5,755.8	23.8	20.5	11,012.1	38.5	91.3	5,666.1	21.6	(48.5)
Total Current Expenditure	24,162.1	100	10.1	28,578.3	100	18.3	26,272.1	100	(8.1)

Source: Bank of Sudan Annual Reports.

In an attempt to neutralize the huge economic shocks inflicted by the secession of the South, the government took a number of measures to preserve the continuation of fiscal decentralization. These measures included increasing the VAT from 15 to 17%, increasing the development tax from 10 to13%, increasing the business profit tax on the banking sector from 15 to 30%, increasing stamp duties on financial transactions and enhance revenue collection and lift discretional tax exemptions. At the revenue side, the remedial measures included phasing out fuel subsidies and strengthening social safety nets, liberalizing the price of sugar and consolidation of ministries at all levels of government, raising the salary of civil servants and pensioners by 100 SDG per month (about 40 percent of minimum wage), more than doubling spending on social benefits, lowering custom duties on main staples and exempt medicine.

Although the reforms adopted by the government are meant to have a positive impact on fiscal decentralization efforts, there are still many challenges ahead. These include reforming state finances in order to reduce the states' prime dependence on central transfers. There is also urgent need for improving revenue collection capacity and rationalizing expenditure control at the state level while rebalancing federal transfers toward capital spending and the delivery of basic social services.

3.2 Sudan Poverty Profile:

The Central Bureau of Statistics (2009) examined the status of MDGs in Sudan and found that the incidence of poverty stood at 46.5% in 2009. The poverty gap ratio and the poverty severity index stood at 16.2% and 7.8% %, respectively. The incidence of poverty ranges from a little over a quarter of the population in the capital (Khartoum) to more than two thirds of the population in Northern Darfur. About 44.8% of the population of Sudan are consuming below food poverty line of 69 SDG per month. Food poverty index is higher in rural (55%) than urban areas (28%). The overall inequality measured by Gini coefficient is estimated at 0.353 which is quite moderate compared to countries with similar level of development in Sub Saharan Africa (SSA) and the Middle East. Though there is disparity in income between rural and urban areas, there is no significant difference in the magnitude of the Gini Coefficient for rural (0.331) and urban (0.329) areas. While Gini coefficient is 0.31 in Northern Region, it is 0.38 in Darfur and 0.36 in Kordofan indicating poverty reduction will be difficult in regions with high income inequality such as Darfur and Kordofan. As for the nutrition situation, Sudan is characterized by high levels of underweight and chronic malnutrition, as well as persistently elevated levels of acute malnutrition. Nationally, one third (32.2%) of children under the age of five years in Sudan is moderately or severely underweight.

As a part of its poverty assessment in Sudan, the World Bank prepared a poverty profile for the country (IBRD 2011). It estimated that 46.5 percent of the population in Sudan is below the poverty line. Poverty rates are substantially lower in urban areas, where 26.5% are below the poverty line, compared to 57.6% of the rural population. The poverty rate is highest in Northern Darfur and lowest in Khartoum. It has also been found that education levels are very low, and poverty rates correlate highly with education. 45% of household heads have no formal education. Poverty rates are highest for those living in households whose head has no education and are also high for those whose heads have only some primary education. Table (4) shows selected poverty related public service indicators during the period 2000-2012.

Table (3.4)
Selected Public Service Indicators

Item/Years	2000	2005	2006	2007	2008	2009	2010	2011	2012
Access to Safe Water (% of total population):	62	58	58	57	56	56	55	55	….
Rural (%)	56	53	53	53	52	51	51	50	….
Urban (%)	76	71	70	69	68	67	66	66	….
Access to Sanitation (% of population)	25	24	24	23	23	23	22	24	…..
Rural (%)	16	15	14	14	14	14	13	13	….
Urban (%)	48	46	46	45	45	44	44	44	…..
Life Expectancy at Birth – Total (years)	58	60	60	61	61	61	62	62	62
Female (years)	60	62	62	63	63	63	63	64	64
Males (Years)	56	58	57	59	59	60	60	60	60
Adult Illiteracy Rate – Total (%)	39	….	….	….	….	…..	28	…	….
Females (%)	48	….	…..	….	….	…..	39	….	
Males (%)	…..	…..	…..	…..	…..	……	19	…..	…..

Source: AfDB, 2014.

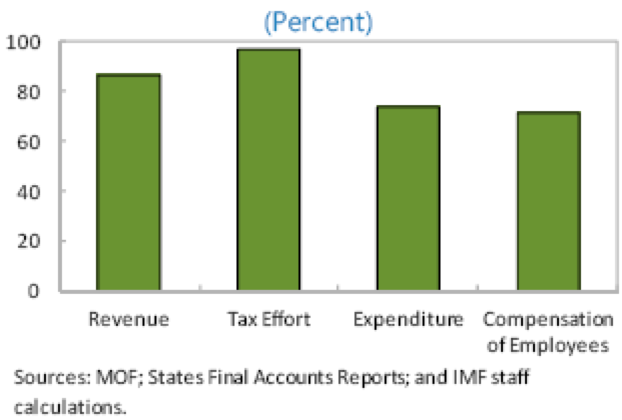
4. Trends in Fiscal Transfers and Poverty Reduction

4.1 The Extent of Fiscal Decentralization in Sudan:

Fiscal decentralization is notoriously difficult to measure, especially in the absence of reliable consistent data, like the case of Sudan. However, most empirical studies consider the extent of fiscal decentralization as the local share of total government expenditures (Oates, 1985; Jin *et al.* 2005). This indicator measures the degree of local expenditure responsibility in the economy. Alternatively, the local share of total government revenue is also considered as an acceptable measure of the extent fiscal decentralization.

For measuring the extent of fiscal decentralization in Sudan, the IMF (2012b) used the execution rate by the state governments of four general government fiscal indicators: (a) total revenues, (b) tax revenue, (c) total expenditures, and (d) compensation of employees. Figure (4.1) shows that in 2010 the decentralization of government finances was still very limited and the central government retained most of the execution power, ranging from 71 to 97%, on each of the four fiscal indicators. The repetition of this pattern during most of the years since the adoption of fiscal decentralization in Sudan in 1995, reveals that the government remains relatively centralized.

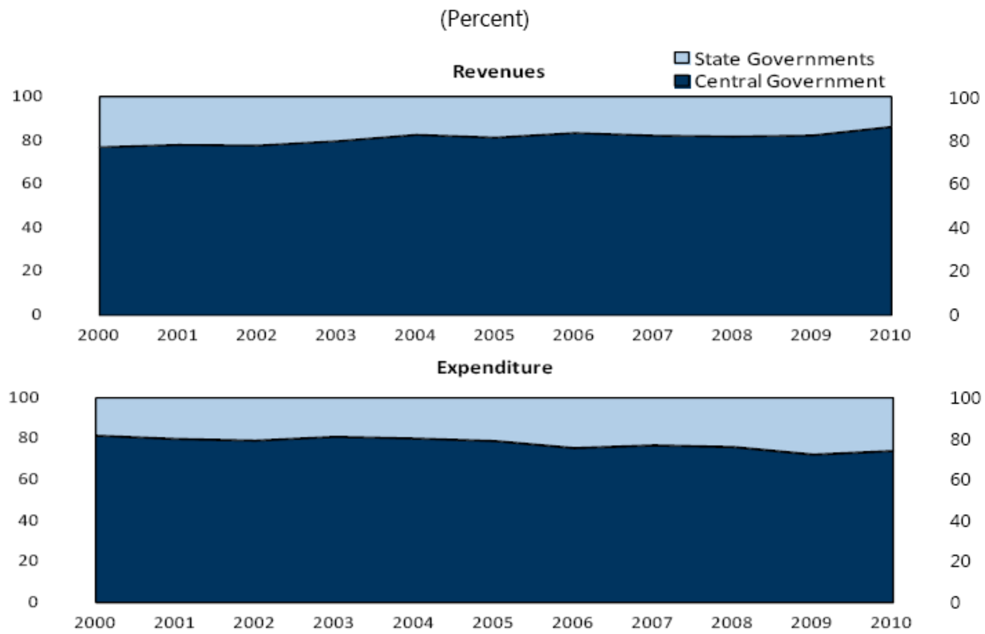
Figure (4.1)
Central Government Execution of Selected Fiscal Indicators, 2010



Source: IMF, 2012

The evolution of the fiscal aggregates during the period 2000-2010 reveals that the ratios are relatively stable reflecting only minor change (Figure 4.3). Tax effort was the fiscal indicator with the lowest dispersion over time while expenditure and compensation of employees showed a visible if minor increase in decentralization. Revenue, on the other end evolved toward a more centralized structure over the period 2000-2010.

Figure (4.2)
Selected Fiscal Indicators by Government Level



Source: IMF, 2012

Another feature of fiscal decentralization in Sudan is the outpacing of expenditure decentralization over revenue decentralization, which indicates the prevalence of vertical fiscal imbalance (VFI). This is an indication that the devolution of revenues responsibilities falls short of the devolution of expenditure responsibilities. The year 2010 typifies this characteristic as the federal government collected about 97% of total taxes and 86% of total revenues (Figure 4.3). On the other hand, the state governments executed a relatively high level of government employment, in the form of wages and salaries, and expenditures. Here, the central government accounted for only 71% and 74% respectively. In other words, the central government has maintained control on the revenue collection while assigning more expenditure responsibilities to state governments (IMF, 2012b).

4.2 Legal and Institutional Background of the system of Federal Grants to the States:

The declaration of the revenue-sharing agreement between the federal and state governments in 1995 marked the start of the process of fiscal decentralization in Sudan. Proclamations were issued increasing the number of states from 9 to 26. A three tires federal system composed of federal, state and local authorities was operated. The principles of wealth sharing between the federal government, the government of South Sudan and lower levels of government was enacted in the Interim National

Constitution (INC) and Comprehensive Peace Agreement (CPA) in 2005 to address regional disparities. The Constitution grants governments of Northern States the right to legislate for raising revenue collection through a variety of local taxes and charges for services provided by the state. The federal government is assigned the power to collect customs revenues, business profit taxes, personal income taxes, and VAT. In addition to tax revenues, the federal government accrues non-tax revenues, mainly from oil. This vision of fiscal decentralization led to substantial increases of transfers from the federal to the state levels with the aim of effectively delivering public service and broader development outcomes.

The INC, in article (185), states guiding principles for equitable sharing of resources and common wealth:

- Resources and common wealth of the Sudan shall be shared equitably to enable each level of government to discharge its legal and constitutional responsibilities and duties to ensure that the quality of life, dignity and living conditions of citizens are promoted without discrimination on grounds of gender, race, religion, political affiliation, ethnicity, language or religion.
- The sharing and allocation of the resources and common wealth of the Sudan shall be based on the premise that all parts of the country are entitled to development.
- Revenue sharing shall reflect a commitment to devolution of powers and decentralization of decision making in regard to development, service delivery and governance.
- No level of government shall withhold any allocation or financial transfers due to any other level of government. In case of dispute, any level of government, after attempting amicable solution, may initiate proceedings in the Constitutional Court.

The institutional body of the fiscal system in Sudan is specified in Chapter V of the INC to include:

The National Revenue Fund (NRF):

- All revenues collected nationally for or by the national government shall be pooled in the NRF administered by the national treasury. The NRF shall embrace all accounts and sub-funds, into which monies due to the government are collected, reported or deposited.
- All the revenues and expenditure of the government shall be on budget operations and made public.

Fiscal and Financial Allocation and Monitoring Commission (FFAMC):

FFAMC shall be established, to ensure transparency and fairness in regard to the allocation of nationally collected funds to the government and the states. It undertakes the following duties and responsibilities:

- Monitor and ensure that equalization payments (grants) from NRF are promptly transferred to respective levels of government.
- Guarantee appropriate utilization and sharing of financial resources.
- Ensure that resources allocated to conflict affected areas are transferred in accordance with agreed upon formulae.

The structure, functions, duties and operations of FFAMC are specified in the Republican Decree No. 31 in July 2007.

The purpose of the equalization grants is to provide revenues to enable all states, especially the less prosperous ones, to provide reasonable levels of services and local development. In addition, the federal government undertakes national development in accordance with national development plans. More funds than those provided from NRF are transferred to the states. These include grants from foreign sources and resources secured from borrowing from internal and external sources.

It has been observed that the share of the states from the NRF has been growing over time in harmony with the growth of national revenues and GDP. At present it stands at 24% whereas the federal government has a share of 76%. It should be noted that states have their own funds from source prescribed by the INC (Hassan, 2013).

The fiscal decentralization system assigned the states three sources of revenue namely (a) own revenues (taxes, fees, and user charges); (b) shared revenues (mainly consist of 43 percent of VAT collection, 10 percent of public enterprise profits and 2 percent of petroleum revenue); and (c) federal transfers (from the budget through the National State Support Fund (NSSF) are determined by agreed formula).

Local government revenues comprise taxes on property, local transportation, local livestock production (40 percent of which is transferred to the state governments), and other local taxes or duties, as well as transfers from the state governments of some profits from public enterprises (IMF, 2012b).

States' budgets are prepared by the council of state ministers and approved by the State Assembly. The states enjoy the freedom to allocate their financial resources, except federal transfers through the NSSF, which are earmarked for specific capital or social development projects. States' expenditures are broadly set in the constitution; with the main outlays going for primary health care, basic education, and safe drinking water. The allocation, through the NSSF, of funds among the different states is based on a set of criteria, which are: financial performance; population density; availability of natural resources; human resources expertise; adequacy of available infrastructure; education level; availability of health services; security situation; and average per capita income. The High Council on Resources (HCR) allocates to the states their share of the VAT and public enterprise profits. The HCR designates the public enterprises or joint ventures whose profit is to be allocated to the states and determines each state's share (Brixiova *et al.*, 2003).

The federal transfers to the states in Sudan include the following: (i) current earmark transfers; (ii) block transfers; and (iii) development transfers. The current earmarked transfers are allocated to wages, operations, and social subsidy and are determined by existing establishment costs (Table 4.1). Block transfers are determined according to a formula based on weighting criteria including population size, minimum requirement for government responsibility, social development (health and education), and the states' ability to collect own revenues. The allocation of development transfers is based on alternative indicators such as the states' development neediness and absorptive capacity. However, difficulty in identifying and quantifying the underlying indicators implied significant variation in the implementation of development projects across states (IMF, 2012b).

Table (4.1)
Sources of State Revenue

Revenue Type	Revenue Items	Collection/Allocation Criteria
Own Resources	State land and propertiy tax and loyalities; charges for state services; licenses; state personal income tax; levies on tourism; stamp duties; state projects and national parks; grants aid and foreign aid; excise duties; border trade charges or levies in acciordance with national legislation; other state taxes	Tax base and fiscal effort by individual state
Shared revenue	VAT Sharing 2 percent of petroleum revenues	Derivation
Central transfers	(i) Current earmarked transfers: Wages Operations Social Subsidy (ii)Block transfers (iii)Development transfers Local component Foreign component	Agreed formulas; existing establishment costs; or ad-hoc criteria

Sources: World Bank (2007).

It is to be noted that using poverty as a factor in the distribution of federal transfers could discourage states from undertaking serious poverty alleviation effort in order to maximize their transfers. It follows that there is a strong case for adopting specific purpose transfers specially designed to alleviate poverty. The general argument is that redistribution is predominantly a central function and therefore, the funding for this should come from the centre. However, it is the local government have the information on who the poor are, what are the causes of poverty and how the poverty should be alleviated. Therefore, while the funding for poverty alleviation should come from centre, the design and implementation of the anti-poverty interventions should be left to the state governments. That is the way in which co-operative federalism is supposed to work (Rao and Da-Gupta, 1995).

4.3 The Allocative Formula:

Since the adoption of the federal system in Sudan in 1995 and until the Interim National Constitution (INC) in 2005, no clear indicators were identified in the sharing of the financial resources between the federal and states governments. Article (16) of the Presidential Decree No (12) of 1995, stipulates the setting up of the National States Support Fund (NSSF) for states with the objectives of transferring resources from the centre to the states on a fair and equitable basis. In allocating transfers to the states, the Fund identified 9 indicators which were adopted with the aim of achieving fair and equitable system of transfers. Table (4.2) depicts these indicators and the weights attached to each of them.

Table (4.2)
Subsidies Indicators and Weights (1997-2005)

Indicator	**Weight (%)**
Financial Performance	20
Population Size	10
Human Resources	10
Natural Resources	10
Infrastructure	10
Education	10
Health	10
Security	10
Per Capita Income	10
Total	**100**

Source: States Subsidies Fund report, June 2006.

In 2005, a specialized committee was formed by the Financial Allocation and Monitoring Commission (FFAMC) to revise the above indicators. The committee confirmed the said indicators and recommended slight modifications in the weights attached to some as shown in Table (4.3).

Table (4.3)
Subsidies Indicators and Weights (2006-2013)

Indicator	**Weight (%)**
Financial Performance	10
Population Size	10
Human Resources	10
Natural Resources	15
Infrastructure	10
Education	10
Health	10
Security	15
Per Capita Income	10
Total	**100**

Source: States Subsidies Fund report, June 2006.

The application of the amended formula for the allocation of federal transfers to states resulted in distributing the funds as shown in Table (4.4).

Table (4.4)
The States Share from Federal Government Support

State	**Share (%)**
Khartoum	4.7
Red Sea	6.6
Kassala	6.8
Gadarif	6.3
Gazira	5.8
White Nile	6.1
Sinnar	6.3
Blue Nile	7.6
North Kordofan	7.7
South Kordofan	7.1
North Darfur	7.3
South Darfur	7.2
West Darfur	7.9
Nile	6.0
Northern	6.6
Total	**100**

Source: National States Support Fund

From a pro-poor perspective, one would expect NSSF current transfers to states to be strongly linked to poverty at the state level. However, available evidence reveals that there was no systematic relationship between the actual NSSF current transfers to states and poverty reduction. Rather, those transfers correlated more strongly with state population size than with the percentage of rural population where most of the poor are situated (UNDP, 2006).

Significantly, the above indicators are only applicable in determining the horizontal distribution of the federal subsidies. Different indicators are operational when considering allocations for development. These indicators include needs of the various states, their development constraints and absorptive capacities. Table (4.5) shows the indicators used for federal allocations directed to the states for development purposes (Suliman, 2008).

Table (4.5)
Development Allocations Indicators and Weights (2006-2013)

Indicator	Weight (%)
Strategic importance of the development project	15
Extent of the project's positive impact on man and animal	15
Effect of non-implementation on outward migration and security	15
Whether project is part of the overall development plan of the state	15
Impact of the project on local community and Poverty reduction	15
Project implementation costs and the technical and financial execution abilities of the state	15
Priority given to the less developed states	10
Total	**100**

Source: National States Support Fund

A closer look at the federal development transfers to the states reveal that they do not seem to target reducing disparities between states. There are indications that these development transfers have been allocated on *ad hoc* basis. As for the VAT grant which is a portion of the VAT collected that is returned to the state of origin, evidence shows that the three relatively wealthier states (Khartoum, Gezira and Red Sea) received approximately 78% of VAT transfers in 2002 and 2003. Gezira, Gadaref and Sinnar received about 38% of Agricultural Compensation grants in both 2002 and 2003. As such, there is little evidence that such grants have an impact on reducing fiscal disparities between states. For most of the funds allocated to the states by the NSSF (current transfers, VAT allocations, and agricultural compensation grants) data paucity hindered the determination of their impact on poverty alleviation. Based on simple correlation coefficients, it appears that most of these transfers were not redistributive and did not reduce fiscal disparities between states (UNDP, 2006).

4.4 The Incidence of Vertical and Horizontal Imbalances:

4.4.1 Vertical Fiscal Imbalance (VFI):

In allocating resources vertically Sudan follows a pragmatic approach. Past level of revenues and expenditures of the federal government and states are considered as proxies for the required expenditure. It has been commonly accepted that expenditures are sticky on their path downwards, unlike revenues which can be increased with relative ease to meet the increasing demands for revenues especially from the states. Vertical allocation of revenue is approved by the council of FFAMC, which is composed of representative of the federal government and finance ministers from all the states. Past experience reveals that more resources are transferred by the federal government to the states than the approved allocations to meet acute difficulties e.g. unforeseen state budget deficits and accumulated budgetary arrears (Hassan, 2013).

The calculation of (VFI) is done using the following formula:

$$VFI = 1 - [\,(Rs / R) / (Es / E)]$$

Where:
VFI = Vertical Fiscal Imbalance
Rs = State Revenue
R = Aggregate Domestic Revenue
Es = State Expenditure
E = Total Expenditure (Federal Plus States)

A value of zero for VFI indicates that states are autonomous in their decision-making as their expenditure and revenue share in the aggregate are the same. On the other hand, a coefficient close to 1 indicates absolute federal control over the states, as states’ revenue share is extremely small in aggregate relative to the expenditure share (Adem 2001).

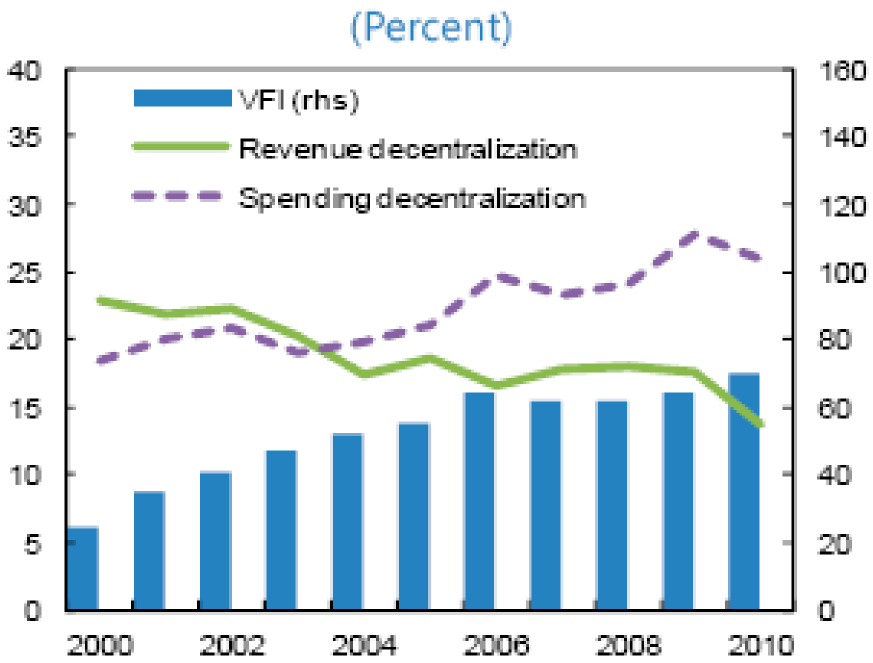
The vertical fiscal imbalance, measured as the gap between own spending and own revenues at the state level, is very high in Sudan. Only about one-third of states’ expenditures are mobilized from states’ own revenue sources in 2010 (IMF, 2012b). This contradicts with the international evidence which reveals that sub-national governments in developing countries finance up to 70% of their spending from own sources.

The vertical fiscal imbalance has increased overtime due to a progressive devolution of spending responsibility coupled with increasingly centralized revenue functions. Between 2000 and 2010 the vertical fiscal imbalance (VFI) increased from 25% to 70% indicating that the mismatch of spending and revenue decentralization has increased (Figure 4.4). This trend reflects increased expenditure decentralization on the back of declining revenue decentralization. (Figure 4.4) indicates that states' own-source revenues fell sharply as a share of total revenues, especially between 2000 and 2007. This steady fall was primarily attributed to continuous decline in states' own revenue mobilization capacity due to the lack of infrastructure, absence of trained staff, security problems especially in conflict areas such as Darfur, Blue Nile, South Kordofan, depressed economic activity, and underdeveloped financial sectors at the state level. Moreover, local tax collection is undermined by the poor quality of data on state economic activity and tax base on which to found state taxes.

The share of state expenditure in general government expenditure has risen from 19 to 26%, the revenue share has fallen from 23 to 14% (Figure 4.5) due to the limited capacity of states to collect own revenues leading to an increased states' dependency on federal transfers. This unsatisfactory performance of states to mobilize own revenue is largely attributed to the lack of infrastructure and human capacity, and depressed economic activity due to security problems in some states.

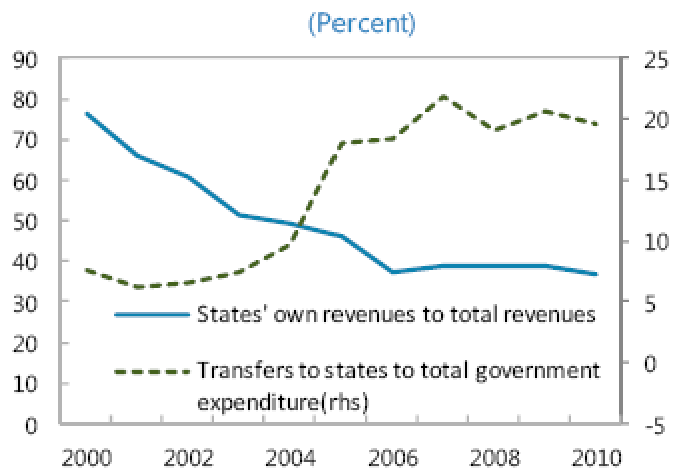
According to the states' final account reports, the ratio of state own revenues to total revenues fell from 76.4 percent in 2000 to 38.9 percent in 2010. On the other hand, transfers to states (capital and current), which accounted for 7.7 percent of total central government expenditure in 2000, rose to 19.5 percent of total government disbursement in 2010 (Figure 4.5). About 57 percent of such increase occurred in 2005 with the signature of the CPA and the introduction of the Interim National Constitution. This underscores the fact that since the deepening of fiscal decentralization in Sudan in 2005, federal transfers have been the predominant financial resource available for the states.

Figure (4.3)
Fiscal Decentralization and Vertical Fiscal Imbalance



Source: IMF, 2012b

Figure (4.4)
Federal Transfers to States



Sources: MOF; States' final account reports, and IMF staff calculations

Another notable feature of the states composition of revenues is the great variation across sub-national governments, resulting in significant differences in vertical imbalances. While the average vertical fiscal imbalance during the period 2000-2010 was approximately 70%, a large dispersion among states was observed. Whereas vertical fiscal imbalance registered 34%, in Khartoum and the Red Sea; this ratio reached 89% in Blue Nile. This heterogeneity is largely attributed to the dispersion of expenditure across states, the standard deviation of expenditure being 43% higher than the standard deviation of own revenues. This indicates that, while there are significant differences in the capacity of states to raise own revenue, the latter varying from 9 SDG per capita in North Darfur to 142 in Khartoum, the variation of expenditure across states is mostly determined by the amount of central transfers (IMF, 2012a).

4.4.2 Horizontal Fiscal Imbalance:

The allocation of federal revenues among the 18 states in Sudan is done through an index constructed to reflect the proposed share of every state in the increase in the allocated revenues. This approach intends to avail a level of revenue that meets states commitments in an equitable, transparent and credible fashion. A weighted average scheme is used to construct the index where suitable weights and criteria are selected bearing in mind data limitation. The diversity of data necessitates normalization and standardization prior to computation. All variables are converted to ratios to overcome the diversity of units of the selected absolute variables.

The horizontal allocation of revenues includes:

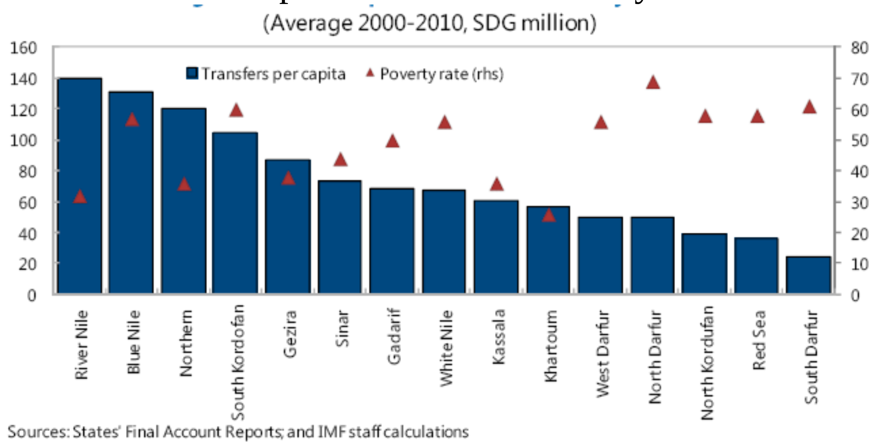
- Revenues to meet current expenditure.
- Compensation in lieu of abolition of states agriculture taxes by the federal government.
- Revenues for state development (Capital expenditure) in addition to the federal development expenditure that may benefit states directly or indirectly.

The index of the current revenue allocation is determined on the basis of the following variables: population, agriculture, security, education, health, fiscal performance, average distance from desirable locations, non-budgeted sources.

It is to be noted that the present indices for the allocation of revenues to the states are about three years old. There seems to be a scope for new indices to be constructed in view of the creation of new states and the recent developments in the economy of the states. The allocations to the local governments should be given special care in the quota assigned to the states in view of their role in the provision of education, infrastructure and addressing the causes of local conflicts.

However, the modalities adopted in Sudan for the horizontal allocation of resources among the states reveal significant variation. Transfers per capita accrued to the top recipient state were on average six times higher than the bottom recipient during the period 2000-2010 (Figure 4.6). The Blue Nile, the River Nile and the Northern States are the highest recipients of federal transfers on a per capita basis. On the other hand, North Kordofan, Red Sea and South Darfur figure at the lower end of the ranking (IMF, 2012a). It is to be recalled that Article (16) of the Presidential Decree No (12) of 1995, stipulates the setting up of the National States Support Fund (NSSF) for states with the objectives of transferring resources from the centre to the states on a fair and equitable basis. Nevertheless, there is also evidence that the current mechanism for the allocation of national resources is not entirely transparent and leaves space for discretionary (political) allocations. It is not clear whether the current allocations for VAT and agriculture compensation is made on an annual derivation basis, or based on historic collection and agriculture production level estimates. In practice, the current transfers are largely allocated to assist in covering the rising public-sector and security costs, or defined by a formula. While the former may distort incentives, hamper investments and limit the flexibility of state balances, the latter is based on criteria difficult to reproduce under the constraint of data paucity. This led to discouraging the identification and applicability of a fair and equitable system. Consequently, some states expressed dissatisfaction about being under-resourced on the grounds of their large population size and the spread of poverty.

Figure (4.5)
Per Capita Federal Transfers by State



4.5 Fiscal Decentralization and Poverty Reduction:

As explained in Section Three, a variety of factors have led to the prevalence of poverty and poor social indicators. The combination of prolonged civil war, natural disasters, a heavy debt burden, have contributed to both rising poverty and erosion in the level and quality of social service delivery in recent years in Sudan. There is also an evidence of clear regional dimension to poverty in Sudan. Most surveys underscored the observation that the poorest states are those that are periodically hit by draughts, namely the Darfur and Kordofan states and the Red Sea.

The thorough examination of the impact of fiscal federalism on poverty in Sudan requires the availability of consistent data involving the decomposition of federal and states expenditure by functional classification is needed. However, such classification is not consistently available for the entire period 1990-2012, as the commencement of the 1990s witnessed the government's discontinuation of providing the functional classification of expenditure in the federal budget. Instead, it provided aggregate allocations of spending grouped in four chapters that obscure the conventional functional classification as follows (UNDP, 2006)

UNDP, 2006 found that during the period 1998-2001, federal government in Sudan has been systematically following a pattern of spending that is not beneficial to the poor. Spending wages and salaries claimed an average of 25% of government expenditure, whereas social services that directly benefit the poor received a very modest share (3.8%) of total spending during 1998-2001. As for the period 2001-2003, the federal government allocated an average of 6.3% of total expenditure for social services (education 4.4%, health 1.6%, and water 0.3%). Transfers to states accounted for an average of 8.8% of government spending during this period, and state administration accounted for an average of 5.4%. On the other hand, defence and security activities accounted for an average of 23.8% of government spending during this period, while external and internal debt service accounted for 9% and infrastructure expenditure averaged 9.9%. Consequently, UNDP, 2006 concluded that there is an imperative for restructuring federal expenditure to make it both growth enhancing and poverty reducing.

On the other hand, IBRD (2007) observed weak performance of human development relative to income per capita. While per capita GDP in Sudan was approximately $1,000 (25 percent higher than the Sub-Saharan African countries) average, Sudan’s health outcomes leave it on par with countries near $400 per capita GDP. Rapid economic growth is relatively recent, and programs and policies will affect outcomes with a lag. At the same time, a concerted effort is needed to ensure this opportunity is used to put the country on a path for significantly improved pro-poor outcomes. As such, there is a great need for improved fiscal decentralization with federal, state and local governments fulfilling their pro-poor social service delivery responsibilities

Nevertheless, pro-poor spending in Sudan has relatively increased during the period 2000- 2006. During the period 2000-2004, pro-poor spending averaged approximately $16 per capita (19.3% of total federal expenditures and 2.8% of GDP). This was followed by a remarkable rise in federal poverty-reducing expenditure which increased to $68 per capita in 2006 (24.8%f total central expenditure and 5.5%f GDP). Although this represented an encouraging increase, but was still below budget plans (6.6% of GDP). It is worth noting that the average for HIPC countries (7% of GDP), and, for neighboring Ethiopia (19% of GDP) and Uganda (11% of GDP).

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Chapter I: This aggregate expenditure category consists of wages and salaries for all federal employees and the central government contributions to the Pension Fund and central government contributions to the Social Security Fund. Allocations to this category indicate the extent of involvement of the federal government in the provision of jobs in the economy.

Chapter II: This expenditure category consists of goods and services purchased for governmental units. In addition, it includes social subsidies that directly benefit the poor, which are mainly directed to subsidizing electricity, free medication in emergencies, free medicines for kidney dialysis and heart disease, and support to poor students in higher education. Also included here are centralized obligations, which include internal debt, external debt, travel abroad, subscription in international organization, custom duties for government units, pipeline fees, training, replacement of equipment and emergency reserves.

Chapter III: This expenditure category consists of current and development transfers to states, as well as agriculture tax compensation for states through the Federal Rule Chamber (FRC). These transfers are called Central Grant-in-Aid to the States. At the time the states prepare their budgets (including revenue and expenditure estimates), the federal government finances their deficits through these transfers. They are strictly unconditional transfers, and the states are not required by law to report details of their spending to the federal Ministry of Finance and National Economy.

Chapter IV: This expenditure category consists of national development expenditure, transfers of development funds to states, capital contributions in government projects financed by foreign loans and financing of agriculture. Allocations in this chapter for development are directed to maintain and sustain the functioning of existing projects. Contributions in capital in late 1990s became significant as the government started to undertake some serious investments in oil sector projects.

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Table (4.6)
State Allocation of Current Expenditures by Chapters
(2011-2012)
(SDG)

Item	2011		2012	
	Planned	**Actual**	**Planned**	**Actual**
Chapter I	844,828,085	12,857,269,351	560,549,985	437,714,361
Chapter II	321,182,238	254,876,024	247,171,888	132,046,632
Chapter III	1,402,593,492	23,628,976,342	1,140,803,575	256,665,458
Total Expenditure	2,568,603,815	36,741,121,717	1,948,525,448	826,426,451

Source: Ministry of Finance

Table (4.6) shows that expenditure of the states on Chapter I, which is primarily wages and salaries, increased from 35% of total expenditure in

2011 (SDG 12,857,269,351) to 53% of total expenditure in 2012 (SDG 437,714,361). This indicates that the period following the session of the South witnessed direction of states expenditure towards more spending on wages and salaries at the expense of pro-poor development expenditure.

Notwithstanding this reported trend in federal and states pro-poor spending, there are a number of important remarks to be made.

First, there is no reliable consistent information from the sub-national governments about the quality of efficiency of utilizing these pro-poor federal funds for their intended purposes.

Second, the growth in pro-poor spending has occurred in the context of rapidly expanding total expenditures that characterized the oil decade. There are no indications that this rise in federal pro-poor expenditure involved reallocation in level terms from other spending categories as all categories experienced real growth.

Third, there are indications that the increase in pro-poor federal transfers reinforces the overall trend in pro-poor spending which is skewed toward the federal level, suggesting under-funding of poverty-reducing expenditure at the state, and local levels, where basic pro-poor services are financed and delivered.

Fourth, the available evidence reveals that most of the federal share of pro-poor spending was development oriented, while state pro-poor spending has increasingly been allocated to recurrent expenditure (approximately 66% in 2006 and 53% in 2012). The dominance of recurrent pro-poor spending (mainly wages and salaries) over development spending at the state level raises concerns, since improving service delivery to the poor in the longer term requires investment in schools, clinics, roads and water. The relative emphasis on recurrent spending leaves little room for items that have a direct impact on the quality of services such as investments in facilities, equipment and capacity development (IBRD, 2007).

Fifth, the functional data base compiled by the World Bank reveals that agriculture and livestock was the largest item on average, despite notable annual fluctuations. Total expenditure on infrastructure (roads and bridges, energy and electricity, and water) averaged approximately 25% of federal pro-poor spending. A similar average was also observed for social subsidies.

Sixth, as health, education and water are constitutionally the responsibility of sub-national governments; their shares remained modest and stable at 8%, 4% and 0.3% of total federal pro-poor expenditure.

Seventh, case studies targeting the functional classification of states' expenditure revealed that due to the eroded infrastructure, state spending on pro-poor facilities remained far below what is needed to meet the MDGs. State-level allocations to pro-poor activities were mostly for general public services, reflecting support for wages and salaries.

Eighth, the extremely low level of states' investment spending in the health and education sectors, with over 95% allocated to current expenditure, is an issue of great concern. The desired pro-poor service delivery requires much higher investment in health and education infrastructure.

Ninth, limited progress toward the improvement of social indicators was observed, rendering a strong case for refocusing expenditure to those states with higher poverty rates. Trends in education, health and access to safe water reveal that nearly two decades of decentralization have not led to a visible improvement in pro-poor social service delivery in Sudan.

Tenth, the experience of decentralization in Sudan might affect poverty directly through regional targeting of transfers, and indirectly through higher efficiency in local public service delivery and the related growth effect.

5. Challenges and Constraints to Pro-Poor Fiscal Decentralization In Sudan

Fiscal decentralization has been on the policy agenda of Sudan since its independence in 1956. It was mainly driven by political pressures motivated by multiple ethnicities, and wide regional disparities in incomes and resource endowments. Decentralization pressures reflected a desire for more participatory government and greater voice of local constituents in the allocation of budgetary resources. As such, efforts have since 1995 been exerted in Sudan to design intergovernmental fiscal arrangements that can assist in realizing the desired political objectives. This, however, proved to be a formidable task as fiscal decentralization is one of the more complex areas of public finance, since it spans a number of policy and institution-building issues, requiring careful coordination and sequencing. Further complications are exercised by the strong influence of historical, political, and social, as well as economic, forces that characterized the various regions of Sudan. Under such circumstances, the Sudanese experience with fiscal decentralization, which spanned for nearly two decades, faced a number of challenges and constraints. The complexity inherent in the fiscal decentralization process in Sudan was further aggravated by its cross-cutting impact, which arises from its far reaching impact on a wide range of issues including service delivery, poverty reduction and macroeconomic stability For policymakers, who often have little control over the political genesis or pace of fiscal decentralization, the challenge is to implement it in a way that ensures the stability, efficiency, and equity of the economic system.

In identifying the lessons learned and the challenges that face fiscal decentralization in Sudan, the following observations may be made:

5.1 Inappropriate Sequencing of Federal Resource Availability and States' Spending Responsibilities:

The experience of Sudan with fiscal decentralization reveals a lack of appropriate sequencing between availing the resources to the states and assigning them the spending responsibilities. It has been observed that spending mandates were pushed down to the states, without adequate provision of resources, leading to a significant deterioration of the quality of the decentralized pro-poor public services.

5.2 Inadequate Adherence to the Federal and States' Roles in the Provision of Pro-Poor Social Services:

The experiences of Sudan in this area, as outlined in Chapter IV reveals the lack of adherence to the responsibilities of each level of government as specified in the constitution. States have continuously failed to comply with their obligation to provide the primary education and health services assigned to them.

5.3 Lack of Complementary Policy Reforms in the Civil Service and Regulatory Frameworks:

The practice of fiscal decentralization in Sudan, which lasted for nearly two decades, has been characterized by deteriorating level of pro-poor social services in health, education, infrastructure and water. An important factor behind this unsatisfactory performance has been the inadequate scope for geographic or functional mobility of qualified civil servants. Similarly, the devolution of subsidized public services (e.g., utilities) to local governments has not led to a reduction of subsidies. On the contrary, the lack of regulatory framework (like price adjustment by local authorities) has resulted in the deterioration of such services.

5.4 Inadequate Capacity Building to Enhance Transparency in Budget Processes:

A close examination of the states' budgets portrays a rising bias in favour of recurrent expenditure to the detriment of development expenditure. There is also evident lack of transparency in the allocation of federal transfers which render these revenues unpredictable and hence limit their capacity for forward planning. This causes mismatch between expenditure responsibilities and revenue allocations, resulting in widening the gap between states' revenues and expenditures. The ultimate result is hampering budget execution, especially with regards to development expenditure targeting service delivery to the poor. The realization of the potential efficiency gains of fiscal decentralization in the provision of pro-poor public goods and services in Sudan requires significant investments in capacity-building and improvement of performance fiscal management systems at the states level, in particular aiming at improving transparency of the budget process in all its phases.

5.5 Lack of Sufficient Own and Transferred Federal Resources Hampered the Implementation of an Effective "Hard Budget Constraint" on the States:

The entire period of decentralization in Sudan witnessed a persistent significant mismatch of spending needs and resources of states. This led over time to inadequate provision of satisfactory public services, and to fiscal indiscipline (typically resulting in inappropriate resort to borrowing, or accumulation of arrears). It should be conceded, however, that a great difficulty was encountered in assessing the spending needs of the states in the absence of reliable information on cost-effectiveness of spending programmes at all levels of government.

5.6 Failure of Federal Control of States' VAT Resources in Adhering to Equity Requirements:

It has been observed that the VAT grant, which is a portion of the VAT collected by the federal government that is returned to the state of origin, is not distributed fairly. The three relatively wealthier states (Khartoum, Gezira and Red Sea) received approximately 78% of VAT transfers. Under such circumstances, the federal control over a portion of states resources failed to promote accountability of the states to their constituents, which has negatively affected fiscal responsibility and tax compliance.

5.7 Failure of Intergovernmental Transfers to Offset Fiscal Vertical Imbalance:

The vertical fiscal imbalance has increased overtime in Sudan due to a progressive devolution of spending responsibility coupled with increasingly centralized revenue functions. Between 2000 and 2010 the vertical fiscal imbalance increased from 25 to 70% indicating that the mismatch of spending and revenue decentralization has increased. This contradicts with the international evidence which reveals that sub-national governments in developing countries finance up to 70% of their spending from own sources. The share of state expenditure in general government expenditure has risen from 19 to 26%, the revenue share has fallen from 23 to 14% due to the limited capacity of states to collect own revenues leading to an increased states' dependency on federal transfers. The vertical fiscal imbalance phenomenon is likely to worsen in view of termination of the "oil decade" after the separation of the oil rich southern part of Sudan.

5.8 Failure of Intergovernmental Transfers to Moderate Fiscal Horizontal Imbalance:

The modalities adopted in Sudan for the horizontal allocation of resources among the states reveal significant variation. Transfers per capita accrued to the top recipient state were on average six times higher than the bottom recipient during the period 2000-2010. The Blue Nile, the River Nile and the Northern States are the highest recipients of federal transfers on a per capita basis. On the other hand, North Kordofan, Red Sea and South Darfur figure at the lower end of the ranking. There is also evidence that the current mechanism for the allocation of national resources is not entirely transparent and leaves space for discretionary (political) allocations.

5.9 Rising Risk of States Incurring Debt Obligations Leading to Massive Federal Support in the Form of Extraordinary "Bailouts":

Article 11C of the Interim National Constitution allows states to resort to borrowing to bridge the gap between their limited revenue sources and their escalating expenditures. There raises concern that fiscal decentralization may weaken fiscal discipline to the extent that states may undertake commitments or incur debt obligations that subsequently result in massive federal support, in the form of extraordinary transfers, or "bailouts." Such bailouts could in turn cause national fiscal imbalances, excessive borrowing, and macroeconomic instability.

5.10 Weak Fiscal Institutions and Inadequate Social Service Delivery Failed to Reduce Inequality and Poverty:

Despite the efforts to regulate the institutional relationship between MOFNE, NSSF, FFAMC, states and local governments, the role of each is yet to be fully comprehended by all stakeholders. The frequent lack of transparency and accountability has often constraint the realization of the desired objectives. The observed weakness in fiscal institutions and inadequate social service delivery has so far been ineffective in reducing inequality and widespread poverty.

5.11 Paucity of Data Impeded Designing Effective Intergovernmental Equalization Transfers Formula:

The determination of the extent and efficacy of fiscal federalism in Sudan is facing a daunting challenge in the form of data paucity. The absence of the necessary data on relevant local fiscal, demographic, and socio-economic variables hindered the quantification of local expenditure needs and fiscal capacity. This acted as a major predicament to the efforts aiming at designing a formula-based equalization grants in an efficient, equitable and transparent manner. Furthermore, the design of an equitable mechanism leading to address spillover effects in the allocative formula requires data on a list of variables, such as the number of out-of-state beneficiary population, unit cost accounting and type of pro-poor services rendered. As such data is also an additional hurdle in the implementation of a sound system of fiscal decentralization in Sudan is created.

It is to be emphasized that the thorough examination of the impact of fiscal federalism on poverty in Sudan requires the availability of consistent data involving the decomposition of federal and states expenditure by functional classification. However, such classification is not consistently available for the entire period 1990-2012, as the commencement of the 1990s witnessed the government's discontinuation of providing the functional classification of expenditure in the federal budget. Instead, it provided aggregate allocations of spending grouped in four chapters that obscure the conventional functional classification. Consequently, some states expressed dissatisfaction about being under-resourced on the grounds of their large population size and the spread of poverty.

5.12 Inadequate Transparency in the Federal Allocation of Resources Hampered Legitimacy, Violated Equitability and Weakened Budgetary Processes:

An effective allocative formula should satisfy the following criteria: revenue adequacy, local tax effort and expenditure control, equity, stability and transparency. Since the adoption of the federal system in Sudan in 1995 and until the Interim National Constitution (INC) in 2005, no clear indicators were identified in the sharing of the financial resources between the federal and states governments. Article (16) of the Presidential Decree No (12) of 1995, stipulates the setting up of the National States Support Fund (NSSF) for states with the objectives of transferring resources from the centre to the states on a fair and equitable basis. In allocating transfers to the states, the Fund identified 9 indicators which were adopted with the aim of achieving fair and equitable system of transfers. From a pro-poor perspective, one would expect NSSF current transfers to states to be strongly linked to poverty at the state level. However, available evidence reveals that there was no systematic relationship between the actual NSSF current transfers to states and poverty reduction. Rather, those transfers correlated more strongly with state population size than with the percentage of rural population where most of the poor are situated.

5.13 Meagre Effort Focus Federal Transfers to the Poorest States to Enable More Targeted Development Spending and Reduce Inequality Across States:

There are observed indications that federal development transfers to the states have not targeted reducing disparities between states. Evidence shows that development transfers have been allocated on *ad hoc* basis. As for the VAT grant, which is a portion of the VAT collected that is returned to the state of origin, the three relatively wealthier states (Khartoum, Gezira and Red Sea) received approximately 78% of VAT transfers in 2002 and 2003. Gezira, Gadaref and Sinnar received about 38% of Agricultural Compensation grants in both 2002 and 2003. As such, there is little evidence that such grants have an impact on reducing fiscal disparities between states. For most of the funds allocated to the states by the NSSF (current transfers, VAT allocations, and agricultural compensation grants) data paucity hindered the determination of their impact on poverty alleviation. Based on simple correlation coefficients, it appears that most of these transfers were not redistributive and did not reduce fiscal disparities between states (UNDP, 2006).

6. Toward a Reformed Pro-Poor Intergovernmental Transfers System in Sudan

6.1 Background and Rationale:

The above analysis indicates that fiscal institutions in Sudan are weak, social service delivery is inadequate and fiscal decentralization has so far been ineffective in reducing inequality and widespread poverty. There are different types of intergovernmental transfers available to policy makers, but the proper choice is necessarily linked to the specific objectives that are being pursued (Martinez-Vazquez and Sepulveda, 2011). There are several policy objectives behind intergovernmental transfers in Sudan, including the following:

- reduction of vertical imbalances;

- reduction of horizontal imbalances;
- reduction of horizontal imbalances;
- poverty alleviation through the provision of pro-poor services;
- development financing;
- adjustment for positive and negative spill-overs;
- enhancement of fiscal autonomy.

In order to ensure the realization of each policy objective of the intergovernmental transfers, it is recommended to use a separate transfer programme to pursue each single objective. This also facilitates the monitoring and evaluation of each transfer programme. The formula-based approach, which is used in Sudan, is one of the common approaches used in developing countries to the allocation of intergovernmental transfers among sub-national governments. The justification for using the formulae-based distribution is minimizing the discretionary power of politicians; and ensuring transparency, fairness and certainty in the distribution of central grants.

Hence, important reforms are needed to realize the desired improvements in the factors governing federal transfers and the basic social service delivery and budget management at the state level, with the objective of establishing the basis for a successful fiscal decentralization. To address these issues, reforms in the following areas are of paramount importance to render the existing system more pro-poor, equitable, transparent and efficient.

6.2 Constitutional, Legal and Regulatory Implications:

(i) In view of the complexities embodied in the adoption of fiscal federalism in Sudan, the relationship between various stakeholders must be codified in the constitution, laws, and regulations. More flexibility is needed to change the specificity of implementation instruments, while enshrining the political and philosophical principles in the constitution and the operating structures in the laws.

(ii) Given that macroeconomic stability ranks high in the policy agenda, intergovernmental fiscal relations should be a matter of regulation under the Minister of Finance and National Economy, to give the ministry maximum flexibility in public expenditure management.

(iii) The allowance of sub-national governments to borrow when they have the capacity to repay should be a regulatory and not a constitutional matter. It should be clearly codified that local government loans are internal obligations of local governments and not of higher levels of government.

(iv) Participatory approach requires that the legal and regulatory system should provide full, timely, and easily accessible public disclosure of resource allocation decisions—in budgets, procurement, and expenditure programmes. Citizens must have reliable, secure access to the means to enforce appropriate penalties for violations of rules.

6.3 Institutional Reform:

(i) The institutional reform of fiscal decentralization should be designed with adequate incentives for appropriate institutional behavior; and implemented gradually to avoid antagonizing the powerful federal bureaucracies or stretch the limited capacities of sub-national governments.

(ii) The federal government should assist local governments in adhering to the legal and constitutional provisions that prevent abuse and corruption.

(iii) Reform programmes should be designed to help local governments meet a progression of well-defined and objectively verifiable performance standards in revenue generation and pro-poor service provision.

(iv) Attract donor technical assistance programmes to devise individually tailored reforms to provided flexibility to adapt to the differences across various local authorities. It is also important to accord the local governments the power to manage their own resources and be held accountable for performance by their citizens.

6.4 Addressing the Paucity of Data to Facilitate the Design of intergovernmental Equalization Transfers Formula:

(i) The thorough examination of the impact of fiscal federalism on poverty in Sudan requires the availability of consistent data involving the decomposition of federal and states expenditure by functional classification.

(ii) There is a great need to strengthen comparable GFS (Government Finance Statistics) -consistent reporting on the revenue side at both federal and states levels. On the expenditure side, reporting by functional classification (across health, education, roads, etc.) and economic lines (wages, salaries, subsidies, etc.) are an essential prerequisite for any systematic analysis of the fiscal position of the states.

(iii) A comprehensive and consistent database of government finance for documentation purposes could also improve fiscal reporting by making budget plans and execution publicly available. Transparent guidelines clarifying revenues and expenditure assignments between states and localities would enhance revenue collection, streamline expenditure assignments and set the basis for sound wage and salary policies.

6.5 Suggested Revised Pro-Poor Allocative Formula:

In view of the limited success achieved in directing the intergovernmental transfers towards the poor segment of the population, it is recommended to adopt modified transfer scheme that focuses on the sectors that directly enhance the on-going poverty alleviation efforts. These sectors, which are within the national priorities, include: education, health, water, roads, and agriculture.
It is also to be emphasized that the suggested revised transfer scheme should be phased out over a period of three years. This is intended to minimize the disruptive consequences of implementing a large sudden change in resource allocations to sub-national jurisdictions, which could potentially result in inefficient allocation or even misappropriation of public resources by local governments.
(i) Using the revised formula for the allocation of 10% of the transferred resources in the first year,
(ii) Using the revised formula for the allocation of 40% of the transferred resources in the second year,
(iii) Using the revised formula for the allocation of 70% of the transferred resources in the third year,
(iv) Using the revised formula for the allocation of 100% of the transferred resources from the fourth year onwards.

The factors to be used in proposed allocation formulae for each of the six sectors are outlined as follows:
(i) Primary and Secondary Education: Number of school-aged children (100%).
(ii) Health Services: Population (70%), Poverty count (based on regional poverty rates (10%), Vehicle route mileage (10%) and Infant mortality count (10%)
(iii) Rural Roads: Kilometers of local earth roads (67%), Kilometers of local gravel or paved roads (33%).
(iv) Water Supply and Sanitation: Population (70%), Land area (15%) and Poverty count based on regional poverty rates, (15%).
(v) Agricultural Extension Services: Number of agricultural producers (70%) and Land area (30%).
(vi) Administration Allocations: Population (70%), Land area (15%) and Poverty count (based on regional poverty rates) (15%).

6.6 Addressing Vertical and Horizontal Imbalances:

6.6.1 Directing Intergovernmental Transfers to Offset Vertical Fiscal Imbalance:

(i) Transfer revenue-raising power to local governments.
(ii) Transfer responsibility for expenditures to the central government.

(iii) Reducing local expenditures/raising local revenues.
(vi) Give the states fair shares of the major national taxes collected in their jurisdictions, including VAT.
(v) States should assist the federal government in revenue mobilization by providing information on local taxpayers, and thereby increasing the pool of tax revenues.
(vi) Unconditional grants should be allocated annually with reference to the reassignment of tasks between the federal and states governments. The total amount of the grant is calculated on the basis of a formula that includes the unconditional grant of the previous year, corrected by the increase in the general price level, plus the net change in the budgeted costs of running newly introduced or discontinued services.
(vii) With regard to conditional grants, the federal government should ensure that states allocate the funds transferred to finance certain pro-poor services, such as primary education, primary health, water supply, agricultural extension and roads. Furthermore, these earmarked grants should target ensuring minimum nation-wide standards for the provision of pro-poor services. In this sense, the transfers are referred to as equalization grants addressing the horizontal imbalances between states with an effect in closing the vertical fiscal gap.
(viii) Enhance the internal audit, improving the reporting systems and the compliance with established financial regulation in all sub-national jurisdictions. This calls for implementing a sound capacity building programme in financial management and monitoring the destiny of the grants transferred.

6.6.2 Directing Intergovernmental Transfers to Offset Fiscal Horizontal Imbalance:

(i) Recognize that geographical areas usually differ with respect to resource capacity and needs and that the tax base per capita often differs substantially between urban municipalities and district councils. The needs for public services may differ because some areas, for example, have a higher percentage of school children and/or elderly people than others.
(ii) Design fiscal institutions to cope with the complex reality of the variation between states and localities, and avoid further aggravation imposed by political imperatives of treating even the most unequal jurisdictions uniformly, and by historically rooted conflicts and rivalries between regions and population groups.
(iii) Allocate equalization grants to channel funds from relatively wealthy jurisdictions to poorer ones with the objective of realizing horizontal equity between states and within-state equity.
(vi) The redistribution among states alone will not bear fruits, unless it is accompanied by appropriate internal redistributive measures. This shifts

the responsibility to states and local jurisdictions to engage in redistribution. It follows that the harmonization between national and sub-national efforts is essential for the success in targeting the poor segments of the population.

6.7 Bridging the Governance Gap:

(i) Focus on fostering cooperation between the different levels of government to enhance service provision, ensure the democratic process is uninhibited, provide dedicated local revenues, and promote a legislative and administrative culture of efficiency and responsiveness.

(ii) The democratic process needs to become a natural and consistent aspect of government at national, states and local levels. Local government posts need to become fully competitive and strong measures taken to ensure freedom and fairness.

(iii) Localities should receive all locally generated and collected revenues that have been sanctioned by the federal government including property tax and a portion of receipts from locally collected national income tax.

(iv) Enactment and implementation of deterrent anti-corruption laws as effective governance cannot be attained in a corrupt environment. Greater accountability and transparency will go a long way to creating a climate of honesty. The perceived climate of dishonesty can only negatively impact regional investment and economic growth.

(iiv)Strengthen the judiciary to be capable of being impartial in resolving the disputes between national and sub-national governments.

(iiiv) Decentralization laws should be further clarified through legislative action to clearly define sub-national authority and the authority that rests with the central government. Local levels of government should be stopped from operating with unchecked autonomy to interpret laws as they see fit.

(ix) Efforts to strengthen local governments should avoid the creation of parallel governance institutions which in the longer term may work to further weaken the efficient traditional administration systems.

6.8 Attraction, Management and Coordination of Donor Support:

(i) Take the necessary measures to enhance Sudan's illegibility for Highly Indebted Poor Countries (HIPC) relief. The relief from donor countries and multinational agencies under the (HIPC) initiative was one of the main sources of donor support, which was a driving force behind the widely acknowledged success of Ugandan experience with fiscal decentralization.

(ii) Establish and invigorate a Poverty Action Unit (PAU) within FFAMC to coordinate the present donor resources earmarked for states suffering from conflict, with the objective of utilizing some of the technical and financial recourses to improve the intergovernmental transfer mechanisms to these states. These funds include: Darfur Reconstruction and

Development Fund; Eastern Sudan Reconstruction and Development Fund; West Kordofan Reconstruction and Development Fund; Darfur Compensation Fund; and Peace Building Project in South Kordofan and the Blue Nile.

(iii) Channel donor support directly to pro-poor sectors like primary and secondary education, health, rural feeder roads, agriculture extension, water and environmental sanitation, micro- finance and adult literacy.

(iv) Design the future donor support modalities in the field of decentralization, away from the typical programme support to a sector budget support/and or general budget support with clear agreements on the milestones and targets to be achieved in the field of poverty.

(v) Attract donor support to assist in invigorating the system of local of revenue raising and mobilization to reverse the reliance on smaller, non-efficient, low yielding taxes, especially on agriculture and smaller enterprises (taxes focusing on production instead of wealth and income). This can be assisted by donor support in the field of tax administration and tax evasion.

(vi) Engage potential donor assistance in programmes containing elements of capacity building, especially in relation to planning, budgeting and raising revenue, with special attention to poverty and gender sensitivity.

(vii) Focus donor assistance on mainstreamed (on-budget) support mechanisms rather than jurisdiction-specific donor support (development grants). This requires new tools for dialogue between the federal government and the donor community in issues like Poverty Reduction Support Credit (PRSC) and the Poverty Reduction Strategy Paper (PRSP) process at central government level, with more on fiscal decentralization issues like strategic and action planning.

(viii) Strike a balance between the need for federal government/donor control to impose poverty oriented expenditure and the need to preserve sub-national governments' autonomy. While sub-national governments need to have enough fiscal control and discretionary powers to plan their activities in an efficient way, there is a strong desire to ensure that funds are utilized within poverty-sensitive areas and that inequality across states and localities are minimized.

(ix) Focus on appropriate incentives in the introduction of donor programmes in local jurisdictions to improve financial management, tax collection and efficient utilization of donor funds.

(x) Prepare a fiscal decentralization strategy in Sudan in coordination with the World Bank and other bilateral donor-support. The objective of the strategy is to strengthen the process of decentralization in Sudan through increasing sub-national governments’ autonomy, widening local participation in decision making and streamlining of fiscal transfer modalities to local governments in order to increase the efficiency and effectiveness of local governments to achieve poverty alleviation objectives within an transparent and accountable framework.

6.9 Capacity Building to Enhance Transparency in Budget Processes:

(i) Encourage significant investments in capacity building and improvement of performance of fiscal management systems at states level, in particular aiming at improving transparency of the budget process in all its phases.

(ii) Improve the potential of state and local governments to manage economic and social development. Capacity building refers to both human capital and technological development and demands support for training activities as well as technological endowments; for both of these, development partners can play a significant role. Selected areas of need include revenue estimation, overall budget process, collection procedures, and development planning and execution.

6.10 Co-operative Fiscal Federalism:

Adopting specific purpose transfers specially designed to alleviate poverty. The redistribution is predominantly a central function and therefore, the funding for this should come from the centre. However, it is the local government have the information on who the poor are, what are the causes of poverty and how the poverty should be alleviated. Hence, while the funding for poverty alleviation should come from centre, the design and implementation of the anti-poverty interventions should be left to the state governments. That is the way in which co-operative federalism is supposed to work (Rao and Da-Gupta, 1995).

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