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Revenue mobilization at sub-national levels in Sudan

Odd-Helge Fjeldstad

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Abstract

Sudan has undertaken decentralization reforms since the early 1990s, in a federal government system with three tiers: federal, state, and local government levels. Fiscal decentralization was fueled by a decade-long oil boom. With the secession of the South in July 2011, Sudan suffers from large oil revenue losses and significant economic instability. Own revenue mobilization at sub-national levels is low. Inadequate and unevenly distributed own-revenues at both state and local government levels and unpredictable levels of transfers from the federal government pose serious obstacles to implement the policy of decentralization. The purpose of this study is to assess how the current sub-national revenue system can be better designed and managed to thereby strengthen the states' and localities' own resource mobilization. The analysis focuses on the composition of sub-national revenues, administrative practices, and possible impacts of the current system on economic activities. Experiences from other African countries that have suffered similar challenges in the past are also examined. On this basis the study provides recommendations on how to improve sub-national revenue collection without jeopardizing economic activities and private sector development.

Keywords: Intergovernmental fiscal relations, state and local revenues, taxes, business licenses, property tax, user fees, Sudan, Africa

JEL Classification: H71, H77, O23, O55, R51

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Note on the author

Odd-Helge Fjeldstad holds a PhD in economics from the Norwegian School of Economics and Business Administration. He has more than 25 years of experience from research and policy analysis in many African countries and the Middle East. Fjeldstad has published widely, both scholarly and policy-oriented. He has authored several dozen articles and book chapters on tax reform, revenue administration, tax compliance and evasion, fiscal corruption, capital flight, local government taxation and intergovernmental fiscal relations. He has been advisor for African Governments on public financial management, and has worked as consultant for bilateral and multilateral development organisations. Fjeldstad is Extraordinary Professor at the [African Tax Institute](#), University of Pretoria, South Africa; Research Director of the [International Centre for Tax and Development](#), Institute of Development Studies, United Kingdom; and Senior Researcher at [Chr. Michelsen Institute](#), Bergen, Norway. Corresponding address: CMI, P.O. Box 6033 BD, 5892 Bergen, Norway; e-mail: odd.fjeldstad@cmi.no

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1 Introduction

A sound revenue system for sub-national governments is an essential pre-condition for the success of fiscal decentralization (Bird 2010; Martinez-Vázquez and Smoke 2010a; Olowu and Wunsch 2003). In addition to raising revenues, local revenue mobilization has the potential to foster political and administrative accountability by empowering communities (Shah 1998; Oates 1998). Being closer to the people, it is argued, sub-national authorities can more easily identify people's needs, and thus supply the appropriate form and level of public services (Rondinelli *et al.* 1989; Oates 1972). Communities are likely to be willing to pay local taxes where the amounts they contribute can be related more directly to services received (Livingstone and Charlton 1998). As a result, it is expected that the level of tax revenue may be increased without excessive public dissatisfaction.

Yet, both the approach and the results of decentralization have varied widely between countries. According to Smoke and Lewis (1996: 1281), the main challenges are linked to two factors. First, the decentralization process has been resisted or undermined by central government institutions fearful of losing power and rationale. Second, many initiatives have been externally driven, over-ambitious, and not taking into consideration the complex institutional realities that govern the extent to which, and the pace at which, decentralization can occur in a particular country. Oates (1998) argues that the case for decentralization has often been made in a very general and uncritical way with little systematic empirical support.

Sudan has undertaken fiscal decentralization reforms since 1995, when the revenue-sharing agreements of the federal and state governments were declared (IMF 2012: 54). Since then Sudan has had a federal government system with three tiers: federal, state and locality with elected legislatures at each level and elected state governors. The Interim National Constitution (INC) and the Comprehensive Peace Agreement (CPA) of 2005 commit to fiscal decentralization and to empower sub-national governments to align the use of resources with the need to address wide regional disparities and trace the root causes of conflict more effectively. As a result, both states and localities have taken over additional responsibilities from the federal government, particularly vis-à-vis publicly funded pro-poor activities such as in the health, education, and water sectors.

To fulfill service delivery responsibilities and conduct expenditure assignments and address local needs, sub-national levels need adequate revenue. However, according to IMF (2012: 56), “spending decentralization has outpaced revenue decentralization, resulting in the emergence of vertical fiscal imbalance (VFI)”. This implies that the devolution of spending responsibilities has not been matched by the devolution of revenue responsibilities. In 2010, for instance, the central Government collected about 97% of total tax revenues and 86% of total tax and non-tax revenues combined (*ibid.*). Thus, the central level has maintained control over the revenue collection while assigning more expenditure responsibilities to state governments.

Overall, own revenue mobilization at state levels is low. The states have become increasingly dependent on transfers from the central government to meet their responsibilities for basic service delivery (see Section 2) and the vertical fiscal imbalance is

increasing. While transfers on average represented 25% of the states' total revenues in 2000, this share increased to 70% in 2010 (IMF 2012). This implies that, on average, less than one-third of the states' expenditures are funded by the states' own revenue sources. However, there are large differences between states with respect to their dependency on federal transfers, varying from 38% in Khartoum, to 86% in Blue Nile in 2010 (ibid.).

More than 60% of the transfers are allocated to wage and salaries. In 2012, transfers to states broke the constitutional ceiling of 30% of the federal government's total revenues and grants (IMF 2012). While the large increases in transfers to states have contributed to rapid growth in state spending, the situation is not sustainable. The fiscal tightening at the federal level will need to be transmitted to states and will require stronger emphasis on measures to enhance states' and localities' own revenue mobilization.

Fiscal decentralization in Sudan poses a number of challenges to own revenue mobilization and management. Some of these are pointed at in the Public Expenditure Review (PER) from 2006/07, prepared jointly by the World Bank and the Government of Sudan (World Bank 2007).¹ The PER argued that inadequate and unevenly distributed own-revenues at lower levels of government and unpredictable levels of transfers from the central government pose serious obstacles to the fulfillment of the vision of decentralization. These are still major constraints for the evolution of fiscal decentralization in Sudan. In addition, the weak own revenue mobilization efforts can be attributed to factors such as poor infrastructure, lack of trained staff, and poor quality of data on economic activities and the revenue bases. Moreover, revenue sources are undermined by depressed economic activity caused by low productivity and security problems, insufficient diversification of markets for agricultural exports, a weak private sector and underdeveloped financial sectors at the state level (IMF 2012). It is also possible that the transfer policy has weakened the states' incentives to raise own revenues. Thus, there is a need (a) to substantially enhance the financial capacity of sub-national governments in order to raise own revenues and meet their expenditure responsibilities, and (b) to address the federal and state policies related to the transfer system and revenue sharing.

The purpose of this study is to assess how the current sub-national revenue system can be better designed and managed to strengthen the states' and localities' own resource mobilization, and at the same time not discourage economic activities. The analysis focuses on the composition of sub-national revenues, administrative practices, and possible impacts of the current system on economic activities. Experiences from other African countries that have suffered similar challenges in the past are also assessed. On this basis the study provides recommendations on how to improve sub-national revenue collection without jeopardizing economic activities and private sector development.

This report draws on data and information collected during World Bank missions in 2012 and 2013. The field studies were conducted in River Nile, Kassala and Khartoum states in November 2012 and in North Kordofan in February 2013. In each state the World Bank Team visited several localities. These missions aimed at collecting primary data and analyses

¹ A central focus of the PER 2006/07 was on the role of intergovernmental transfers and fiscal decentralization in the wealth and power sharing arrangements following the 2005 decisions.

of the capacities and constraints of the sub-national revenue policy and administration, especially in relation to tax design, revenue collection, incentive problems and service delivery. They covered both state and localities levels. Information was collected from a variety of sources using different methods and interviews covered staff members of the finance and revenue administrations and local politicians as well as business people. In addition, data on state and federal revenues were collected from the Sudan Chamber of Tax (SCT), where we interviewed officials on the relationship between local and central government revenue mobilization. The research team also acquired information and data on sub-national revenues from the IMF, and information on the transfer system at the Fiscal and Finance Allocation and Monitoring Committee (FFAMC).

The report is organized as follows: Section 2 reviews the general characteristics of the sub-national own revenue system. The importance of various revenue sources is discussed and the administrative set-up for revenue collection briefly examined. Section 3 explores how the present revenue system emerged. It examines legislation and discusses criteria used for tax design. Section 4 explains the gap between the statutory and effective revenue system. Both administrative and political factors are examined. In Section 5, reform possibilities based on lessons from other countries and the situation in Sudan are discussed. Finally, options for reforms of the sub-national revenue system in Sudan are presented in Section 6. Two sections are annexed to the report: Annex 1 presents data from the *Doing business* and *Paying taxes* surveys and compares Sudan's ranking with other African countries, as well as with Sub-Saharan and OECD averages. Annex 2 gives an overview of the largest sources of own revenues in selected localities in Sudan.

2 The current sub-national own revenue system

At the sub-national level, Sudan is divided into 18 states (wilayat) each with several localities.² The Interim Constitution of 2005 sets out the various types of income, revenue, taxes and other sources of wealth to which the respective levels of government are entitled (Article 185, sub-article 9). According to the Constitution (Article 185, sub-article 10) “[A]ll taxes and duties set out in this Constitution shall be regulated by law to ensure coordination, fairness, equity, transparency and to avoid excessive tax burden on the citizens, private sector and investors”. The Constitution further emphasizes (Article 178, sub-article 2) that “[T]he state shall promote and empower local government”.³ These are all sound principles and good reference points for the development of effective revenue systems for effective sub-national governments. The challenge, however, is how these principles are practiced.

Generally, there is no ideal assignment of revenue sources between central and lower levels of government (see Box 1). However, tax assignment almost always favours central over sub-national taxation. Although the literature generally emphasizes that each level of government should be assigned taxes that are as closely related as possible to the benefits derived from spending them, it often also notes that “if fiscal decentralization is to be a reality, sub-national governments must control their own sources of revenue” (Martinez-Vazquez *et al.* 2006: 21). But, as argued by Bird (2010: 5), it is not easy to satisfy both of these conditions:

² http://www.presidency.gov.sd/en/index.php?option=com_content&view=article&id=123:2009-02-25-13-15-07&catid=62:2009-02-25-12-57-49&Itemid=165 [Accessed on 20 March 2013].

³ RoS (2005) *The Interim National Constitution of the Republic of Sudan 2005*.

“the standard model of tax assignment in a multi-tier governmental structure essentially assigns no productive taxes to subnational governments”. Local governments are commonly left with little but property tax, business licenses, user charges and market fees, although, a wide range of low productive revenue instruments often are in place.

Box 1: Who levies what taxes?

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

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

While the general principles and theoretical discussions of revenue assignments summarized above are useful reference points, in practice, country-specific factors play a crucial role when considering optimal ways to dividing revenue responsibility between central and lower tiers of government (Bird 2010; Tanzi 2000). The case for centralization is usually built around macroeconomic considerations and equalization, and the case for local government taxing powers on efficiency considerations and increased accountability. The ‘optimal’ way to do things, however, depends on how the government weighs these considerations (Martinez-Vázquez and Smoke 2010b; Boex 2009). Furthermore, the capacity to administer revenue instruments is always an important constraint to the assignment of ‘taxing powers’ to lower levels of government in developing countries. Finally, but not least important, revenue sources must be politically acceptable (Bahl *et al.* 2003: 75). As a rule of thumb, less visible revenue instruments tend to be more acceptable to taxpayers.

The remaining part of this section examines the own revenue system at state and locality levels in Sudan in general, but exemplifies specific issues with experiences from River Nile, Kassala, Khartoum and North Kordofan, and respective localities within these states.

2.1 Composition of own revenues at state level

In addition to federal transfers, states have two distinct sources of revenues: shared revenues and own revenues. Each state is entitled to a share of the Value Added Tax (VAT) collection (43%), public enterprise profits (10%) and petroleum revenue (2%) determined on a derivation basis (IMF 2012: 54). In addition, Article 195 of the Interim National Constitution (RoS 2005) empowers states to collect own revenue from 10 specific sources, and opens up to impose “any other tax as may be determined by law” (Box 2).⁴ With respect to own revenues, the states have the highest degree of autonomy, including authority to determine rates.

Box 2: Own revenue sources assigned to states

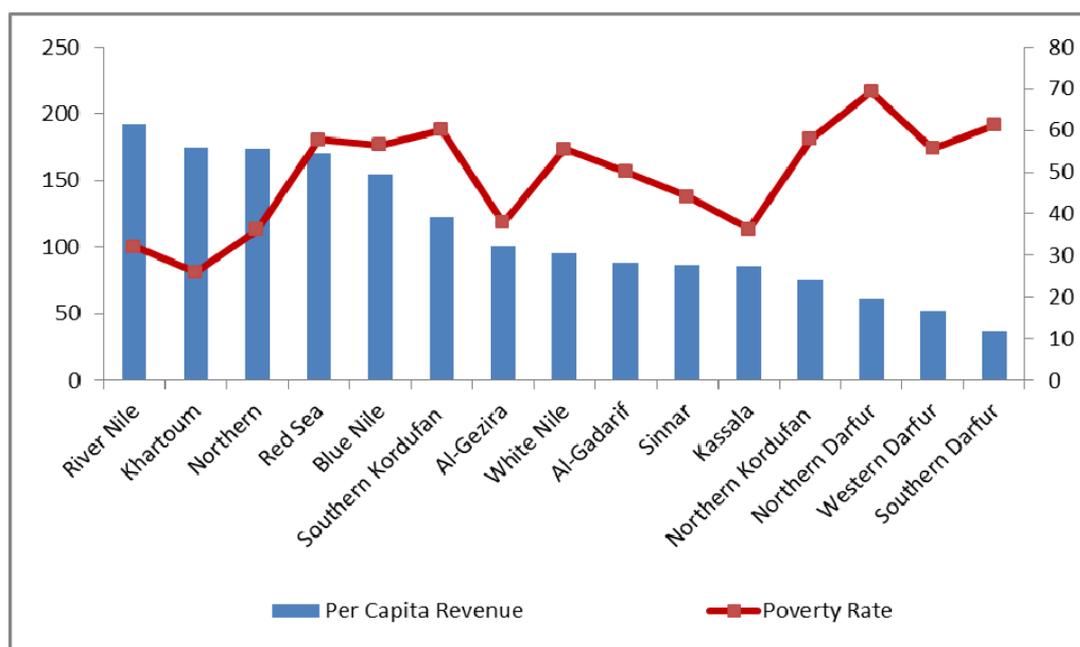
- State land and property tax and royalties
- Service charges for state services
- Licenses
- State personal income tax
- Levies on tourism
- State government projects and national parks
- Stamp duties
- Agricultural taxes
- Excise duties
- Border trade charges or levies in accordance with national legislation
- Any other tax as may be determined by law

Source: The Interim National Constitution (RoS 2005).

Although the states’ own revenue mobilization has increased in recent years, they are heavily dependent on federal transfers. According to the states’ final account reports, the ratio of state own revenues to total revenues fell from about 76% in 2000 to 39% in 2010 (IMF 2012: 57). However, the dependency of transfers varies substantially between the states (Table 1). In 2010, own revenues contributed 62% of total revenues in Khartoum, 36% in North Kordofan, and only 14% in Blue Nile. Further, own revenues per capita differ substantially between states and localities. On average, the per capita revenue of Khartoum and River Nile states is over two times higher than that of Kassala and North Kordofan states (Figure 1). This reflects that more urbanized states generally are able to generate more revenues from, for instance, property taxes and levies on businesses than less urbanized states.

⁴ Article 195 of the Interim Constitution also includes ‘grants-in-aid and foreign aid’, but since these are not ‘own’ revenues, they are not included in Box 2.

Figure 1: State's poverty rate and state's average per capita revenue (2000-2010)



Sources: States' final accounts reports, MoFNE

The picture that emerges from Table 1, with huge differences between the states' dependency on transfers from the central level, reflects differences in the states' economic resource base, poverty levels, degree of urbanization, administrative capacity, and political unrest. The last decade has also seen substantial changes of the states' degree of dependency on federal transfers. Furthermore, the composition of sub-national revenue sources varies greatly across states.

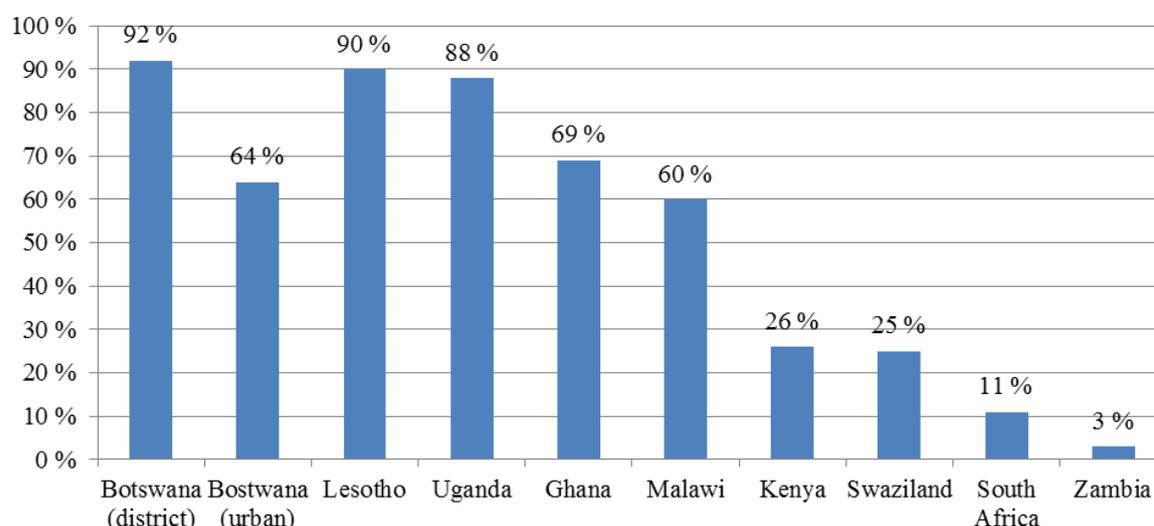
Table 1: States' own revenues as share of total state revenues (2010)

State	Own revenue in % of total state revenues
Blue Nile	14
North Darfur	18
South Kordofan	18
Sinar	22
Kassala	25
Northern	25
White Nile	25
Gezira	27
West Darfur	27
South Darfur	29
Gadarif	33
North Kordofan	36
River Nile	37
Red Sea	52
Khartoum	62

Sources: States' final account reports (2000-2010)

Similar patterns can be observed in other African countries. Generally, the level of intergovernmental transfers varies widely between countries and also between rural and urban councils within individual countries (Chitembo 2009). Figure 2 illustrates the share of total local government revenues that stems from central government transfers in selected African countries in 2007. Generally, there are substantial rural-urban differences. In Botswana, for instance, rural local government authorities receive 92% of their total revenues from the central level, compared to 62% for urban areas. Also in Uganda, local governments are heavily dependent on transfers from the central government (on average, 88% of total revenues in 2007), while local governments in South Africa, on average generate the bulk of the revenues from 'own' sources (89%) of which the most important are user charges on services (electricity, water and sanitation) and property rates in urban areas (Fjeldstad and Heggstad 2012).

Figure 2: Intergovernmental transfers in percent of total local revenues in selected African countries (2007)



Source: Fjeldstad and Heggstad (2012), adapted from Chitembo (2009: 11) citing Commonwealth Handbook 2007.

Transfers and grants also constitute the largest share of total receipts to the local government councils in Anglophone West-Africa. According to Jibao (2009: 43), local councils in Nigeria received on average almost 78% of their revenue from transfers. In Sierra Leone local councils received 74% of their revenue from transfers, in Ghana 69%, and in The Gambia 65%. In Liberia revenue collection is centralised and local government councils rely 100% on transfers from the central government. Thus, the situation with a high dependency on central government transfers in Sudan is not unique.⁵

⁵ The dependence of sub-national governments on grants from the central level is also high in other regions. A study of intergovernmental transfers within OECD-countries shows that the gap between sub-national tax and expenditure shares widened in the period 1995-2003 (OECD 2006). Fiscal decentralization has led to increased sub-national responsibilities in the area of spending, while at the same time sub-national governments have become more dependent on central governments for their resources (ibid. 5).

There are substantial differences between the states' dependency on federal transfers and the composition of state revenue sources in Sudan. Below, the composition of total state revenues and changes over time from year 2000 to 2010 are illustrated for the four states River Nile, Kassala, Khartoum and North Kordofan. Total revenues consist of three components, i.e. federal transfers and "own source revenues" which can be disaggregated into "tax revenues" and "non-tax revenues". The figures also graph the development of total state revenues measured in Sudanese Pounds (SDG).

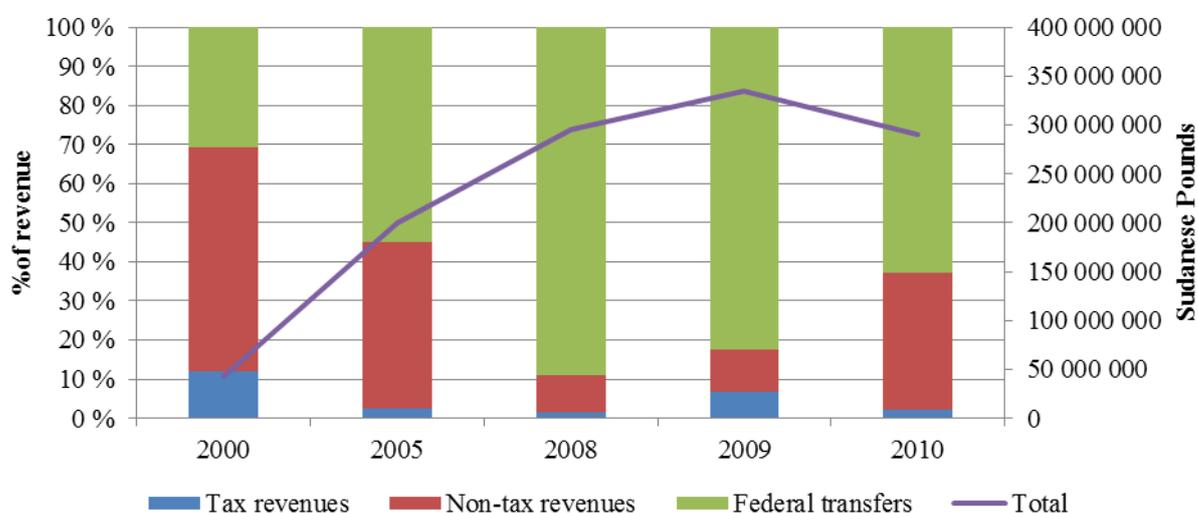
River Nile State

Over the past decade, River Nile State has depended extensively on federal transfers to fund its expenditure. Figure 3 shows the composition of total revenues from 2000 to 2010 split by federal transfers and own source revenues (disaggregated into tax and non-tax revenues) measured along the primary vertical axis. It also shows the development of total revenue, depicted by the line which measures Sudanese Pounds along the secondary vertical axis.

The figure shows that the state's dependence on federal transfers has varied over time. While the state's own revenue sources contributed as much as 70% of total revenues in year 2000, it decreased manifold, to 11%, by 2008. The relative importance of own revenue increased in 2009 and 2010, but the dependency on federal transfers was significantly larger in 2010 compared to a decade earlier. The share of total revenue attributed to tax has generally been low in the state. Between 2005 and 2010 it averaged about 2%, with the exception of 2009 when it reached 7%. For non-tax's share of total revenues we observe a different pattern, where its significance decreased dramatically from 2000 to 2009 and then increased again in 2010.

With respect to the composition of own revenue sources, the distribution between tax and non-tax own source revenues varied extensively over the decade. In 2005, only 5% of the state's own source revenues were attributed to taxes compared to almost 40% in 2009. Total revenues increased from SDG 43,000,000 in 2000 to SDG 335,000,000 in 2009, and thereafter decreased to SDG 289,000,000 in 2010.

**Figure 3: River Nile State
Federal transfers and own source revenues (2000-2010)**

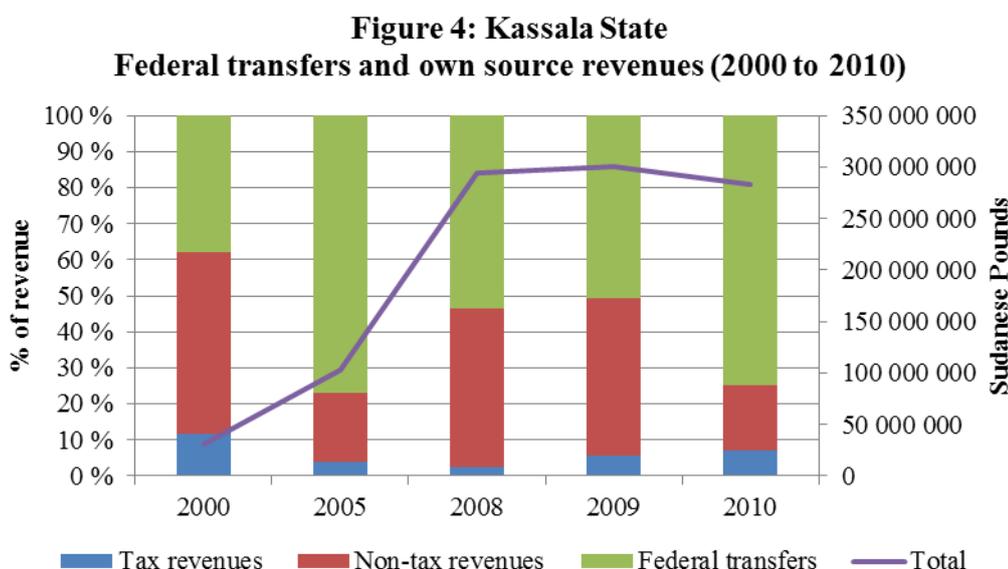


Non-tax revenues such as fees, permits and other user charges are the major own revenue sources in River Nile. Charges on cement are a relatively significant revenue source (54% of own revenues in 2010). According to state officials interviewed, most of this revenue is collected from five recently established cement factories that pay the state a fee of SDG 25 per ton produced. Revenues from cement charges are likely to increase due to expected increases in the production level. The state monitors the production closely by deploying some of its staff to the cement factories on a full time basis.

Revenues from land sales and survey fees is the second highest revenue earner (15% of own source revenues in 2010) in the River Nile state. However, the contribution from the real estate tax is very low (only 1% of total own source revenues in 2010). This tax is levied at a rate of 10% on the annual rent. Of this 35% is deducted for maintenance and operations. There is also a tax free allowance of SDG 3 000.

Kassala State

Also in Kassala, the state is heavily dependent on federal transfers, but as illustrated by Figure 4 the extent of dependency has varied throughout the decade. Between 2000 and 2005, own source revenue decreased with almost two thirds from about 60% to 22%. The share later increased to close to half of total revenues in 2008 and 2009 before declining to a quarter in 2010. Tax revenue's share of total revenues was modest throughout the period and varied from 10%, in 2000 to 3-4% in 2005 and 2008. The variation in non-tax revenues' share was larger. While it accounted for about half of total revenues in 2000, it only made up about 20% in 2005 and 2010. This dependency on federal transfers is a reflection of the high level of poverty in the state, which also suggests that taxable capacity is lower than in states such as Khartoum and River Nile.⁶⁶ Livelihoods in East Sudan have been undermined by war, climate change and environmental degradation (Ali 2012).



⁶⁶ According to a UNDP survey of 2010, one third of the state's population live below the poverty line. www.sd.undp.org/doc/MDG%20Summery%20East%20Sudan.pdf [accessed 28 March 2013].

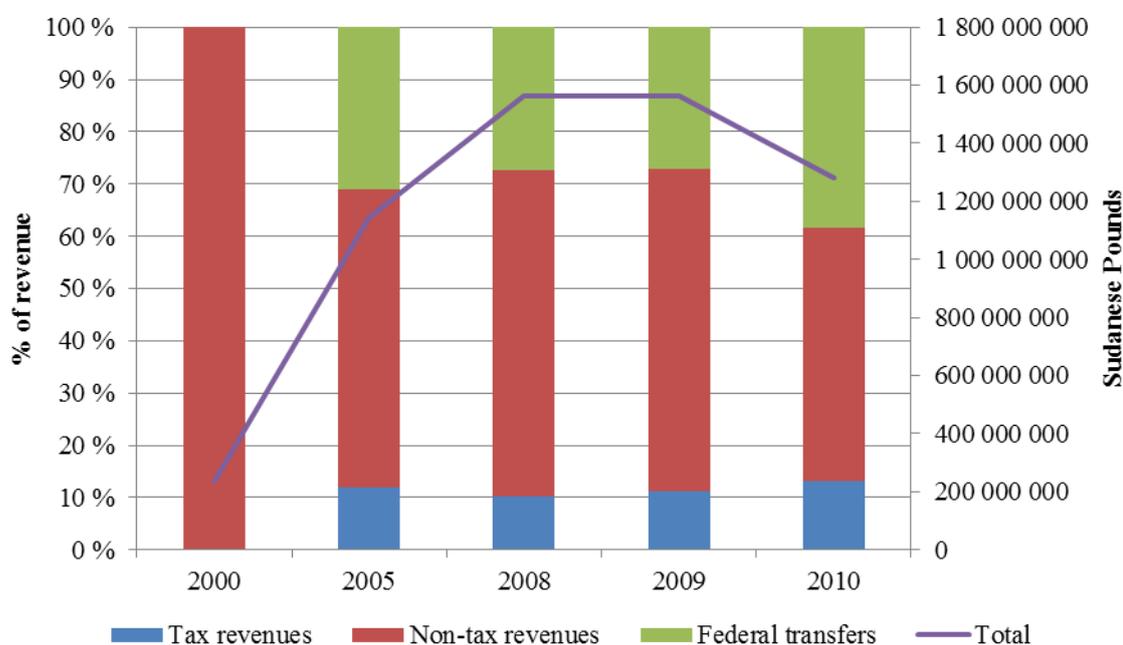
In terms of the composition of own source revenues, the importance of tax has fluctuated substantially over time. In 2000 and 2005, close to a fifth of own source revenue was attributed to tax, but this share decreased to 5% in 2008. In 2010 the picture changed again and tax revenues then accounted for almost 30% of own source revenues. During the decade, total revenues increased sharply from about SDG 31,000,000 to more than SDG 280,000,000.

Property tax is one of the most important tax revenue earners in Kassala State. In addition to real estate tax, it comprises taxes levied on property (including residences, arable land, endowments, inheritances, asset transfers). In 2001, this tax contributed 12% of taxes on goods and services, and 3% of total own revenue.

Khartoum State

Relative to the other states in Sudan, Khartoum is less dependent on federal transfers and more dependent on own revenue sources which contributed a relatively stable share of about 70% of total revenues in the period between 2005 and 2009 (Figure 5). However, this share was much higher (100%) in year 2000 when Khartoum State did not receive any federal transfers. In 2010, the share decreased to 62% of total revenue. The share of total revenues attributed to own source tax revenues remained fairly stable around 10% from 2005 to 2010, while non-tax revenue's share was slightly lower in 2010 than the preceding years. While taxes' share of own source revenue decreased from 17% to 14% between 2005 and 2008, it increased to 21% in 2010.

**Figure 5: Khartoum State,
Federal transfers and own source revenues (2000 to 2010)**

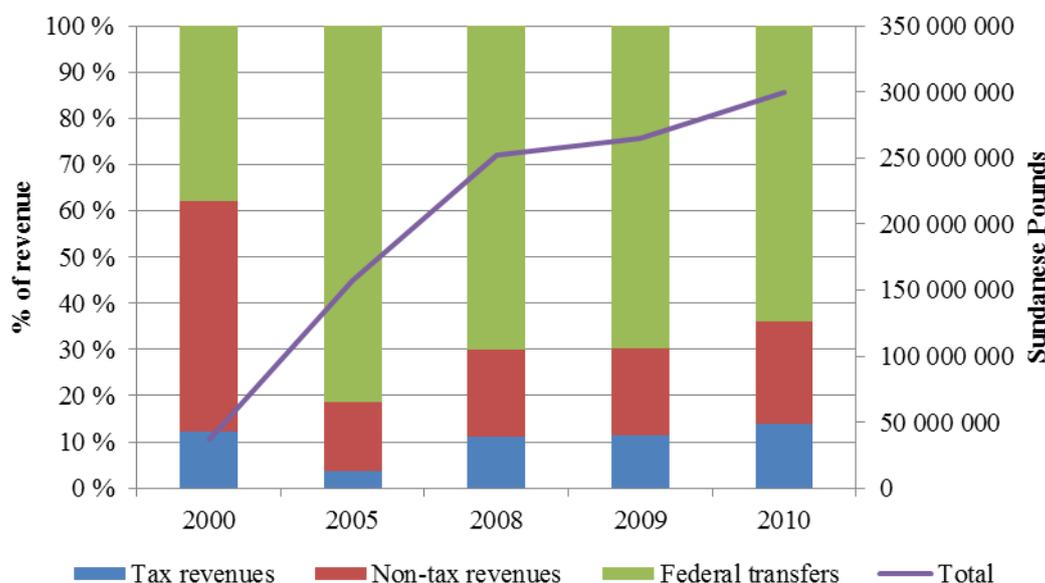


Similar to River Nile and Kassala state, total revenues in Khartoum increased from SDG 235,500,000 in 2000 through 2005, 2008 and reached a top of SDG 1,565,000,000 in 2009. Thereafter total revenues decreased significantly to SDG 1,283,000,000 in 2010.

North Kordofan State

The dependency on federal transfers is large in North Kordofan and the state's own source revenues as share of total revenues dropped to less than 20% in 2005 (Figure 6). Since then it has been relatively small, but steadily increasing towards 35% in 2010. Tax revenues are growing in relative importance and rose from about 3% in 2005 to around 13% in 2010. Non-tax's share of total revenue similarly increased from 14% in 2005 to 22% in 2010.

**Figure 6: North Kordofan State,
Federal transfers and own source revenues (2000 to 2010)**



In terms of the composition of own source revenues, taxes accounted for a significantly larger share in the period 2008-2010 than in 2000 and 2005. There thus seem to be a tendency of tax becoming a more important revenue source in the state. Total revenue grew throughout the decade and was eight times as large in nominal terms in 2010 as in 2000 (SDG 300,000,000 compared to SDG 37,000,000).

The major own revenue sources in North Kordofan are fees collected by state ministerial departments.⁷ In 2012, these non-tax revenues contributed 68% of total own revenues, of which 43% from state ministry departments and 25% from local government departments. The major state tax revenue sources in 2012 were taxes on goods and services (10% of total own revenues); state transferred taxes (8% of total own revenues); taxes on sugar and petroleum products (4% of total own revenues); and state stamp duty fees (3%).

Cross-state comparison

All the four states discussed above have seen a dramatic increase in total revenues during the last decade. However, own revenue's share of total revenues differs substantially between the states. Khartoum generated the largest share of own revenues, i.e. between 60% and 70% of the total revenues, while River Nile generated the smallest share with between 10% and 35% of total revenues. In all the four states, year 2000 stands out with the smallest share of federal transfers. Non-tax revenues is by far the largest component of own source revenues in all the states throughout the period. The importance of non-tax revenues, in particular user

⁷ Source: North Kordofan State Fiscal Performance Reports (2005 - 2010).

fees, is partly a reflection of the states' narrow tax base and the fact that most of the productive and buoyant sources of tax revenue (e.g. income tax, value added tax, customs) have been assigned to the federal government (World Bank 2011: 34). The extensive use of user fees might also be a response to the abolishment in 1999 of the agriculture production tax, which was one of the states' most revenue productive taxes (see Section 4.3.1). However, there seems to be a slight tendency of tax revenues gaining relative importance in Kassala, Khartoum and North Kordofan.

Land sale for housing and commercial purposes is perceived to be a potentially high revenue yielding source by states and localities. Land is frequently one of the most valuable resources on the asset side of sub-national balance sheets in developing countries. This is also the case for sub-national government finances in Sudan. As described above, revenues from land sale is already a substantial revenue source in some states, for instance in River Nile. Land sale is managed by the State Ministry of Physical Planning and the Ministry retains 20% of the revenues to cover administrative and operational costs. Of the remaining amount, 60% is retained by the State and 40% transferred to the locality. Sale of land, however, is not without challenges. In some states it has led to disputes between the State Ministry and the native Administration. In 2012 for instance, the sale of plots for housing in Bara Locality in North Kordofan was stopped due to such a dispute.⁸

The attractiveness of integrating land financing into the sub-national fiscal management framework can be examined from several perspectives (Peterson and Kaganova 2010: 1). First, the sheer size of land asset transactions points to the importance of regulatory guidelines. Second, publicly owned land is in limited or fixed supply; decisions about land disposition therefore are difficult to undo, either for a specific land parcel or for public landholdings as a class. Third, if land sales are relied on to finance a significant part of local budgets, this source of revenue can suddenly disappear in the face of land market declines or exhaustion of public land supply. Fourth, urban land values are generally highly volatile and commercial land development by public entities can be even more so.

2.2 Composition of own revenues at locality level

Localities (or local governments) have two major revenue sources; own revenues and revenue sharing with the state. With respect to own revenues, each state assigns taxing powers to localities through local government legislation. While the main categories of local revenue sources are prescribed by law, the individual local government council decides on what revenue sources to be used and the tax or fee rates. Generally, own revenues collected by the localities are for their own use. Local government own revenues comprise taxes on property, local transportation, local livestock production (40% of which is transferred to the state government), local trade and business licenses, and a wide range of other fees, charges and duties levied on local economic activities.

Own revenues

Sudanese localities levy a large number of taxes, licenses, fees and charges, some of which are listed in Table 2. The table lists 7 main categories of taxes; 4 main categories of licenses; 29 groups of charges and fees; and 3 items listed as 'other' revenue sources. The distinction

⁸ Interview with senior officials in Bara Locality, 20 February 2013.

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

Table 2: Own revenue sources in localities

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

Source: Local government laws from various states.

The number of different taxes, licenses, charges and fees is high and varies between localities.⁹ For instance, more than 50 types of own revenue sources are listed in the accounts in Aroma, Kassala and Wad-al-Helew localities in Kassala State.¹⁰ However, several of these revenue sources have not generated any revenue in recent years. Localities in North Kordofan also levy more than 50 different categories of own revenue sources. These figures do not take into account the various sub-groups of particular revenue bases. In Bara locality in North Kordofan, for example, more than 300 different categories of businesses are listed for licensing, each facing different license rates depending on type and size of business, location, social impact, etc. However, according to officials interviewed in Bara only around 100 businesses are registered in the locality, most of which are small shops.¹¹

Another illustration of the complex local revenue system is the stamp duty. In 2012, revenues from stamp duties generated on average 2.8% of total own revenues in localities in North Kordofan¹², and 2.7% of total own revenues in 2011.¹³ However, the effects of stamp duties on individuals and businesses are probably much larger than this small percentage indicates. The duty is imposed on about 500 public documents, including invoices, receipts, and title deeds (FIAS 2006: 152). It is charged at various rates, some fixed and some *ad valorem*, at rates as high as 15% for certain kinds of advertising. Like in many other countries, the stamp duty is imposed on property transfers and financial transactions, and banks and insurance companies are therefore the largest contributors to this revenue source. With 500 dutiable transactions, Sudan has one of the most complex and comprehensive stamp duty systems in the world and some of the highest rates (*ibid.*). Applications for an industrial license or to alter an industrial license to increase production or to introduce a new product line are also subject to 1% stamp duty. Most business services, such as printing, insurance brokerage, photocopying, computer and secretarial training, and all media and journalism activities, are subject to 5% stamp duties, while all telecommunications are subject to a 1% stamp duty.

The revenues from stamp duties are low compared to the cost of administering them and can be seen not only as a source of revenue, but also as a means of controlling almost every conceivable kind of financial or commercial transaction. As such, their effect on the business environment may be graver as an administrative barrier or inconvenience than as a business cost.¹⁴ Serious attention should therefore be given to reducing the number of dutiable transactions and the rates imposed, or abolishing stamp duties entirely.

⁹ In 2003, there were only 91 localities in Sudan. However, the number of localities is increasing. Due to attempts to equalize rates on some revenue bases among localities within the same state, some rates have tended to differ by states.

¹⁰ Source: Locality of Wad-al-Helew Final Accounts Reports

¹¹ Interview, Bara Locality, 20 February 2013.

¹² Source: North Kordofan state financial performance (2008 - 2012).

¹³ Source: Kassala State - Ministry of Finance & Economy - Financial Performance Reports (2007 - 2012)

¹⁴ Annex 1 gives an overview of how Sudan is ranked compared to other countries with respect to various constraints facing investors, including constraints related to paying taxes, based on the World Bank/IFC "Doing business" and "Paying taxes" databases.

In spite of the large number of revenue sources, a limited number of these are the main contributors. Information on own revenue generation is not publicly available. For the purpose of this study, data was collected from selected localities in River Nile, Kassala, and North Kordofan.¹⁵ The data shed light on the features and trends in own source revenue generation at the local level.

Shared revenue

The other main revenue source for localities is transfers from the state. This can be categorized into two flows: the first is the direct support on wages and salaries of localities, and the second is the transfer of the localities' share in taxes collected by the Sudan Chamber of Tax (Table 3). The 2003 Local Development Act (Article 27, Chapter 7) identifies which of the taxes accruing to the state should be shared with the localities. These include individual business tax, VAT, and capital profit tax.¹⁶

Table 3: Localities share of the state's taxes, fees and duties

Revenue sources	Percentage to the locality
1. Fees on vehicle licenses and driving licenses	60%
2. Real estate tax	60%
3. State's stamp duty	40%
4. Personal income (State) tax	40%
5. Land and river transportation fees	40%
6. Fees on the registration of clubs, societies, and associations	40%
7. Sale proceeds of investment lands	40%
8. Agricultural and animal production tax	60%
9. Service fees	60%
10. Fees on veterinary examination and fees on slaughtering and slaughterhouses	60%
11. Fees on residential plans, designation and allocation of lands for residential, commercial, agricultural, industrial, and investment purposes	40%
12. Fees on the State's forestry products	60%
13. Value added taxes	60%

Source: Local government laws from various states.

Revenues shared between state government units and local government units are to be divided on the third day of each month based on actual flow of revenues as set forth in the Local Government Law of 2006 as amended in 2010.

The Local Government Laws of the States also refer to the following 'other revenue sources' for the localities:

1. The state subsidies.
2. Grants, loans and credit facilities approved by the Government.
3. Return on investments placed by the localities.

¹⁵ Information on own revenue in localities Khartoum State was not available for the study.

¹⁶ Revenues shared between state government units and local government units are to be divided on the third day of each month based on actual flow of revenues as set forth in the Local Government Law of 2006 as amended in 2010.

4. Self-help and popular participation.
5. Percentage of the oil and mining revenues as a percentage allocated for the state (by law).
6. Percentage of the proceeds of governmental projects and national reserves (by law).
7. Percentage of the revenues/proceeds of tourism (by law).
8. Percentage of foreign grants and aid (by law).
9. Percentage of the taxes and fees on cross-border trade in accordance with the national legislations (by law).
10. Percentage of any other taxes assigned under the Law for the state (by law).

Of these sources, “self-help and popular participation” contribute substantially to own revenues in some localities (Box 3). For instance, in Al-Nohood Locality, North Kordofan, self-support contributed with 24% of total own revenues in the locality in 2012.¹⁷ The corresponding figure for Heikan Locality was 16%; for Sowdari Locality 12%; for Um-Rowaba Locality less than 2%; and for Bara Locality about 1% of total own revenues.

Box 3: Self-help financing of development at locality level

Self-help or Popular Support programs are development spending projects undertaken mainly by the people in the locality in socially essential services, like building of roads or electrification of villages and neighborhoods, or building of schools or health centers. Citizens will raise funding for the projects through direct donations (in cash or in kind). A special development committee is formed to administer the development fund.

The locality will normally respond positively to the initiative by providing technical and/or engineering expertise. In most cases the locality will also provide about 20% of the total cost of the project. The people would directly supervise their development spending and mobilize popular support until it is successfully finished. This pattern of funding development projects is quite widespread in Sudan and has become a critical financing vehicle to development.

Source: Ahmed et al. (2006: 22)

2.3 Revenue administration

The responsibility for the collection of state tax revenues is allocated to field offices of the Sudan Chamber of Tax (SCoT), while non-tax revenues are collected by other state institutions. For instance, the SCoT collects property tax, tax on income and stamp duties. In turn, the Chamber either transfers the collections to the State Ministry of Finance (SMoF) in whole or shares, depending on the nature of taxes (see Section 2.1). Generally, the SMoF itself does not collect taxes. The Chamber of Tax has offices in all states and in many localities. In North Kordofan, for instance, it has 18 offices, including the head office in the capital.¹⁸

¹⁷ Source: North Kordofan state financial performance (2008 - 2012).

¹⁸ Source: Chamber of Tax (undated). ‘General administration.’ Memorandum. North Kordofan.

Interviews with senior staff of the Chamber of Tax in various states indicate that they often experience substantial difficulties in collecting state taxes. Some of the constraints include: widespread resistance and evasion by taxpayers, poor business registers, outdated databases of taxpayers and revenue bases. Not knowing the accurate size and extent of the taxpayer population is a major shortcoming that not only affects systematic taxpayer compliance management, but impacts on revenue forecasts and resource management in the revenue administration such as planning and organizational structuring, staff skills development, planning for logistics, and the resultant funding arrangements (Zake and Al Arabi 2011:7-8). There are also weaknesses in tax policy design and the resultant legislation. Frequent changes in the legal framework, where, for instance, duty and fee rates have changed annually, combined with low service levels, contribute to taxpayer resistance and disputes with tax collectors.¹⁹ Widespread tax exemptions also contribute to erode the revenue base (see Section 3).

The way revenue collection is organized in practice may vary between localities within and between states. At the locality levels, different agencies including service delivery agencies collect fees. Many public entities seem to look for ways and means of collecting their own revenue and there are no transparent guidelines clarifying roles and responsibilities among various government agencies involved in revenue collection at sub-national levels. This leads to a situation where revenue collection and administration often is non-transparent and uncoordinated between various public agencies and levels of government. Moreover, it may create a situation where sources of revenue remain largely 'off budget' and, thus, outside the resource envelope which impacts on the efficiency and effectiveness of budget management and the resource allocation process.

Most taxes are paid in cash. One exception is for civil servants whose income tax is withheld from their salaries. Some taxes, fees and duties are levied on a daily basis, others monthly, biannually or yearly. In addition, stamp duties are imposed on individual 'transactions'. Market fees are in general levied daily on people selling their goods at market places. Licenses are often issued on an annual or biannual basis. Spot-checks of businesses are used to control that licenses are paid.

According to IMF (2012), cash management procedures in Sudan are weak and there is no systematic reporting. The lack of intergovernmental cooperation between levels of government and between government agencies also hinders revenue management by limiting sharing of functional information on taxpayers and revenue bases. Limited human capacity compounded by institutional weaknesses impedes the authorities' ability to assess, collect and audit revenue mobilization.

Administrative costs

One consequence of the current, complex sub-national revenue system is the high costs of tax administration. For example, as discussed above, the revenues from stamp duties are low compared to the costs of administering them. Further, the large number of these duties, charged at different rates, indicates that their effect on the business environment as administrative obstacles and inconvenience are large. We do not have data on the administrative and

¹⁹ Interview with senior staff of Chamber of Tax, North Kordofan, 21 February 2013.

compliance costs of sub-national revenue collection disaggregated on individual revenue sources in Sudan. However, studies from other African countries where the sub-national tax system has similar features as the current Sudanese system, suggest that these costs are high and may, in some cases, be major impediments for the development of small-scale enterprises (Box 4).

The costs of tax enforcement also vary between different revenue sources. Some revenues are relatively less costly to administer because there are clear methods to deal with defaulters. For instance, water services may be disconnected if the user fails to pay the water fees. Similarly, a license may be withdrawn if business people fail to pay a license fee. Many taxes are, however, relatively difficult to collect. The revenue officers from the Chamber of Tax and collectors in localities we interviewed considered business licenses on traders and livestock tax on moving cattle to be among the most problematic to collect due to taxpayer resistance, followed by property taxes and rental income tax. The many sub-bases with different rate structures add to the costs.

High costs of revenue collection are a main challenge in many localities. According to the state ministry of finance in North Kordofan, the high collection costs are “due to long distance between the headquarters of localities and the administrative units and the capital of the State, increasing prices of fuel and spare parts, and rising depreciation of vehicles and means of transportation” (North Kordofan SMoF 2012: 5). These administrative costs seem to be largely unrecognized by localities. There is little appreciation of the opportunity costs of the staff employed by the locality. One might even argue that for certain small taxes and charges the collection costs are the reason for the levy. In other words, the purpose is to create employment or at least an income-earning opportunity for someone who might otherwise be unemployed. Furthermore, the way in which budgets are compiled, whereby tax revenues appear under one heading and the costs of the local revenue office under another, does not encourage cost-effectiveness. In addition, many costs are simply not made explicit, for instance the use of government owned buildings or the use of vehicles to collect certain taxes.

The Ministry of Finance in some states and the Chamber of Tax have initiated various measures to mitigate these challenges. For instance, due to widespread resistance, taxpayer education seminars and information leaflets are used by the Chamber of Tax to enhance taxpayers’ compliance.²⁰ One may, however, question whether such initiatives are effective if the likelihood for non-compliers to be detected and punishment imposed is low, and/or if taxpayers see little in return in the form of public services for taxes paid.

²⁰ Interview with senior officers at the Chamber of Tax, North Kordofan, 21 February 2013.

Box 4: Features of local government tax systems in African countries

Many local tax systems in Africa are characterized by high levels of arbitrariness, coercion and corruption. A widely found feature is the huge number of revenue instruments used by local authorities. Local governments seem to raise whatever taxes, fees, and charges they are capable of raising, often without worrying about the economic distortions and distribution effects that these instruments may create.

A complicated and non-transparent local government revenue system is costly to administer and it facilitates corruption and mismanagement. Moreover, many local taxes have a distorting effect on resource allocation decisions, and thus an inhibiting effect on the start-up of new enterprises and the achievement of economic growth. These effects occur when effective rates vary greatly between different goods that are traded, or when license fees are set too high for start-up small-scale enterprises to survive. In a study of small and medium sized enterprises in Zambia, Misch *et al* (2011) found that the effective tax burden varies substantially between firms. Enterprises face a range of different taxes, fees and licenses, and the types of taxes that firms are subject to differ - not only between sectors, but also between firms within the same sector. Even among marketers in the same municipality the type of fees and levies may differ substantially.

In addition, the levels and types of local revenue instruments by themselves can result in the tax burden falling more on the poor than on the relatively better off in local communities. A recent study from Uganda shows that small informal non-farm enterprises pay local taxes in a regressive way (Pimhidzai and Fox 2011). While the majority of the micro enterprises in the Ugandan sample were poor enough to be exempted from the national business taxes (i.e. the small business tax and VAT) they ended up paying a large share of their profits to local authorities - with the poorest paying the highest share of profits. This is mainly due to the basic design of the local revenue system and the way revenues are collected. Thus, a top-down drive toward more tax revenue from this sector through formalisation could be counterproductive, and would increase the vulnerability of this segment of informal enterprises.

Sources: Fjeldstad and Heggstad (2012); Misch *et al.* (2011); and Pimhidzai and Fox (2011).

3 Legislation and criteria for tax design

The sub-national revenue structure in Sudan is complicated and non-transparent, especially at the locality level. Moreover, large variations exist among states and localities with respect to the number of revenue sources and rates. Revenues per capita vary significantly between states and localities indicating both differences in revenue potential and in the effectiveness of the sub-national revenue administrations. No clear pattern can be discerned as each state and locality has its own revenue structure. How did this revenue system emerge? There are five main reasons for this:

- (1) abolishment of the most revenue productive sub-national own revenues sources, especially agricultural production tax;
- (2) extensive tax exemptions granted to individual companies and specific sectors;
- (3) legislation that allows localities to introduce new taxes, duties and fees, and change rates frequently, without proper consideration of the revenue potential, economic efficiency, administrative and compliance costs;
- (4) lack of clear criteria for tax design; and
- (5) poor co-ordination between the various levels of government has allowed sub-national revenue systems to develop without much interference from the federal level.

The following sections examine each of these reasons in turn.

3.1 Abolishment of revenue productive sources

User fees, duties and charges are important sub-national revenue sources. For instance, a large share of the resource inputs at health facilities (hospitals and health centers) is funded from user fees rather than federal transfers and regular tax revenue (World Bank 2011: 74). On average, user fees account for more than 32% of health facility level inputs in the states. The extensive use of user fees might be a response to the abolishment in 1999 of one of the states' most revenue productive taxes, the agricultural products tax. This was a sales tax imposed on farmers selling their crops in local markets.²¹ The purpose of removing this tax was to encourage agricultural production, trade of agricultural products, and to increase farmers' income by reducing their tax burden. The agricultural production tax used to be collected at a 15% rate of the crop value and was levied by locality governments.

Agricultural compensation transfers from the federal level were introduced to neutralize foregone revenue from the abolished agricultural tax. The historical levels of the agriculture tax determine the allocation. Normally, there is an annual increase in the allocation, which was around 8% in 2012. However, the current allocation system of agricultural compensation transfers does not reflect the economic changes that take place across the state governments, since it is based on the assumption that the size of the state's agricultural sector remains unchanged over time (Badawi *et al.* 2006: 30).

According to officials at state and locality levels interviewed as part of this study, the abolition of the agricultural production tax had unfavorable fiscal and real effects for localities, which have resulted in (a) considerable revenue losses with negative effects on basic service delivery and investment planning; and (b) undermined localities' fiscal autonomy. Further, they argued, the abolishment of the tax failed to benefit farmers since it did not contribute to improve incentives for farmers to increase agricultural production. Consequently, in search for reliable and productive sources of revenue to compensate for lost revenues from the agricultural production tax and to balance uncertainties around federal transfers, states have an incentive to look at non-tax revenues in the form of user fees, charges and licenses as alternatives.

3.2 Tax incentives

Like many other countries, Sudan offers a number of fiscal investment incentives to investors. For instance, the *Company Act* and, more recently, the *Investment Promotion Act* for Kassala State provide 'tax holiday' incentives to new investors. Tax exemptions also impact on the distribution of the tax burden by favoring new investors on account of existing and small scale enterprises. It is, however, questioned whether tax incentives are required to attract new investments (Box 5). Members of business associations in Kassala, interviewed as part of this study, argued that a transparent legal framework, a predictable tax regime and access to finance are more important than tax incentives to encourage investments. These views are in line with findings of many business surveys in other countries (see Annex 1).

²¹ While crop producers had their sales taxes eliminated they still pay local government taxes in primary markets near production areas, and traders pay taxes at points of final sale which get passed back to the producers (World Bank 2009: 81).

While there is limited evidence that tax incentives are required to attract new investments in Sudan, tax exemptions have adverse impacts on revenue mobilization. The Chamber of Tax in North Kordofan estimated in 2010 that the revenue loss due to tax exemptions that should not have been granted if the legislation had been followed was 6-7% of total revenue collection in the state that year.²² This percentage would have been substantially higher if statutory exemptions also were included. These findings are consistent with findings from other African countries. According to the OECD, tax incentives tend to reduce government revenues by 1-2 per cent of GDP (TJN-A and AAI 2012: 14). However, this figure is probably at the lower end. A recent study on Tanzania, for instance, suggests that exemptions and tax incentives could account for up to 6 per cent of GDP (AfDB 2011: 242). Thus, a major challenge for building an effective, transparent and accountable tax system is the current tax policies on exemptions and tax incentives. Generous investment incentives to specific companies, institutions and sectors lead to large revenue losses and distorted competition (Keen and Mansour 2010). In addition to undermine the tax revenue base, a high occurrence of tax exemptions creates room for bribery and corruption, and increases the appearance of loopholes for tax evasion (Zee et al. 2002).

Box 5: Messages from research on the effectiveness of tax incentives

Proponents of tax incentives often argue that it is imperative to provide tax incentives to attract investors, given the generally poor investment climate in poorer countries. This position is disputed:

Using data from a cross section of 80 countries, van Parys and James (2009) find that for countries that have a poor investment climate it is ineffective to lower the tax rate to compensate for the bad investment climate. Instead, they argue, countries should focus on improving the basic investment climate. A joint report by the IMF, OECD, UN and the World Bank (2011: 19) find that where governance is weak, corporate income tax exemptions may do little to attract investment, and when they do, this may well be at the expense of domestic investment.

Challenges with tax incentives can be summarized as follows (Klemm 2009):

1. The benefits of investment tax incentives are widely exaggerated, while the costs are often underestimated or overlooked altogether.
2. Tax incentives can stimulate investment, but non-tax elements of the investment climate are generally far more important than tax incentives in determining the level and quality of investment flows.
3. Fiscal incentives do not effectively counterbalance unattractive investment climate conditions such as poor infrastructure, macroeconomic instability, and weak governance.
4. There is evidence of harmful tax competition between countries reflected in (a) very low tax rates and (b) generous tax holidays.
5. Some investors play one country against the other as part of their strategy to gain tax incentives and other benefits from governments.
6. In many cases the final investment choice is already made without consideration of the tax incentives granted.

²² Interview with senior officials Chamber of Tax, North Kordofan, 21 February 2013.

3.3 Legislation

At present sub-national governments in Sudan have a high degree of autonomy in proposing tax legislation and changing current laws. The *Local Government Laws* of the various states²³, the *Financial and Accounting Procedures Law of 2007* and fiscal resolutions issued by the Council of Ministers of the State specify sources of revenue and procedures for imposing and collecting taxes. In principle, every activity located within the jurisdiction of a locality is taxable.²⁴

With respect to own revenues, each state assigns taxing powers to localities through local government legislation. While the main categories of local revenue sources are prescribed by law, the individual local government council decides on what revenue sources to be used and the tax or fee rates. The current legislation allows localities to introduce new taxes, duties and fees, and change rates frequently, without proper consideration of the revenue potential, economic efficiency, administrative and compliance costs. According to revenue officers in the Chamber of Tax in North Kordofan, such changes in the legal framework contribute to taxpayer resistance and disputes between taxpayers and collectors.

In Khartoum, the State Ministry of Finance aims to standardize the legislation on what sources of revenues localities can impose without compromising the legal and constitutional rights of the existing administration entities (Khartoum State 2012). The ministry has started to issue uniform revenue laws for similar activities, particularly those that apply revenues for ministries and localities (licenses, charges, and various user fees). Such measures may contribute to a more transparent and predictable sub-national revenue systems within the state.

3.4 Criteria for tax design

The appropriate tax structure represents a tradeoff among conflicting goals - for example, efficiency, equity, transparency, growth, stability, and simplicity - that are chosen subject to various constraints - for example, achieving a revenue target, minimizing revenue volatility, meeting distributional requirements, and satisfying citizens (Alm 2013). In this broader context, the current sub-national revenue system in Sudan has substantial weaknesses.

The Local Government Laws of the various states, the Financial and Accounting Procedures Law of 2007, and fiscal resolutions issued by the Council of Ministers of the State are not explicit about the criteria to be followed when proposing and approving new taxes, fees and charges, and/or rate changes. However, the criterion of revenue generation can be taken for granted as central to local government taxation. Only implicit suggestions can be read in between the lines with respect to other criteria, including considerations of equity and ability to pay. Provision of graduated rates allows for considerations of ability to pay, and implicitly emphasizes the issue of vertical equity. Revenue transparency is addressed in the legislation in some states. For instance, the *North Kordofan Financial Authorization Law* of 2013 states that the rates of duties and charges should be advertised at the collection points in pursuance

²³ In North Kordofan this refers to the *Local Government Law of North Kordofan State of 2006 as amended in 2012*.

²⁴ Specific exemptions do, however, apply to publicly owned lands and buildings, cemeteries and burial grounds, charitable and educational institutions.

of transparency (North Kordofan State Ministry of Finance 2013). No clause in the legislation seems to encourage sub-national governments to take economic efficiency into consideration. Neither is there any reference to the administrative costs of the revenue system. However, the Khartoum State's pursuance of standardization of the legislation on what sources of revenue localities can impose may implicitly be aimed at lowering the administrative costs (see Section 3.3).

We would expect that the various decision-makers involved in revenue design pursue different criteria more rigorously than the others. Therefore, there are inherent reasons in the sub-national institutional arrangement to design a revenue system that points in many directions. Differences between the various stakeholders with respect to revenue design might be exacerbated by internal and external pressures that contribute to strengthening or altering their priorities and choices. First, federal and state governments' pressure on localities to raise revenue to finance (part of the) salaries of the staff will alter the relative importance of the revenue criterion at the expense of other criteria. Second, taxpayers' pressure on politicians to lower taxes and/or grant exemptions will alter the relative weight between the ability-to-pay criterion and other criteria. Politicians are interested in securing their political base at all levels. Thus, they most likely are influenced by their constituents when proposing changes in revenue bases and rates. In some localities this influence is reflected in the fine-tuning of the revenue structure, based on equity considerations. The large number of sub-bases and rates observed in some localities, for instance in Bara locality, North Kordofan, with respect to business licenses (see Section 2.2), may reflect the influence of local politicians in tax design. This implies that we may observe large variations in revenue design between localities.

3.5 Co-ordination between levels of government

Presently the relevant decision-making levels have limited tax expertise and resources for designing an appropriate tax system.²⁵ At the locality level, the serious shortage of qualified staff at the treasury and planning departments has been noted across most localities. Due to limited capacity and poor co-ordination between the state and localities hardly any questions are raised at the state level on states' and localities' tax proposals. Therefore, the revenue systems in localities seem to have developed without much interference from the state. Furthermore, poor co-ordination between the central and state levels has led to duplication of taxes and inconsistencies between taxes imposed by sub-national authorities (e.g., relatively high taxes, fees and licenses on smaller enterprises) and the national government's policy to encourage economic growth and employment creation. Granting tax incentives to specific sectors and companies is part of the problem by creating economic distortions and undermining the revenue base.

To address some of these challenges, the Khartoum State Ministry of Finance has initiated work to standardize the source of revenues legislations without undermining the legal and constitutional rights of existing administration entities (Khartoum State 2012). The State

²⁵ The necessary skills are knowledge to read, understand and interpret the tax statutes and central government guidelines, regulations and policy directions, and availability of the relevant information and data for estimating accurately the budgetary requirements (both revenues and expenditures). This requires substantial human resources such as statisticians, tax experts, including accountants, auditors, lawyers, etc.

Ministry has started to issue uniform revenue laws for similar activities within the state, particularly those that generate revenues for ministries and localities (licenses, proceeds, and various user fees).

4 Revenue generating capacity and constraints

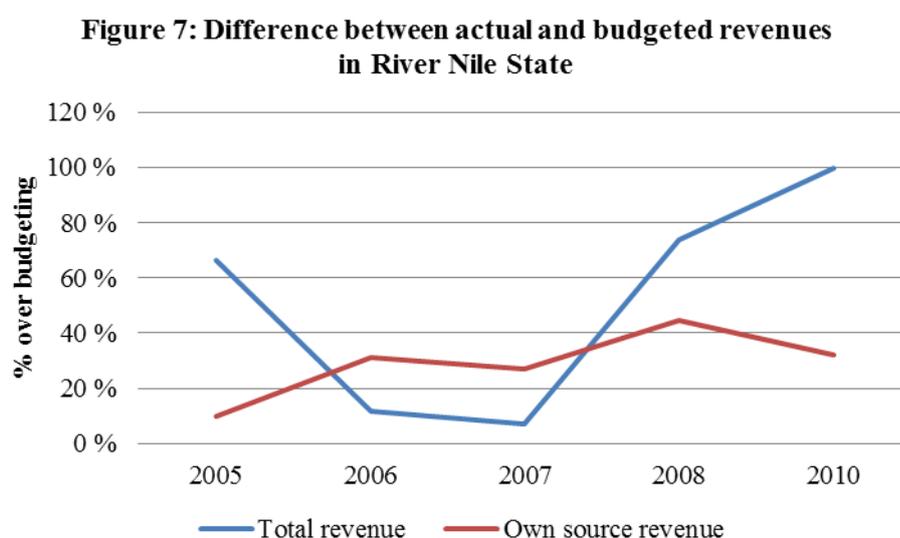
This section examines constraints facing the revenue generating capacity at the sub-national levels. One major administrative problem for many states and localities is their inability to fully recognize the revenue due to them. The ratio between projected (budgeted) and reported revenues differs significantly both between states and localities. Sub-section 4.1 addresses these disparities in three selected states. Other constraints, administrative capacity, taxpayer resistance, corruption and negligence by the government are further investigated in turn.

4.1 Revenue budgets and actual collections

Examining the differences between actual and budgeted revenues in the state budgets gives the impression of a systematic over budgeting of revenues. The following Figures 7 – 10 illustrate this for River Nile, Kassala, Khartoum, and North Kordofan states.

River Nile State

In River Nile state, both own revenue sources and total revenues were over budgeted in all years between 2005 and 2010, meaning that the state budgeted for more revenues than it was actually able to generate. While the over budgeting of total revenue decreased from more than 60% in 2005 to less than 10% in 2007, it increased to as much as 100% in 2010. The extent of over budgeting of own sources of revenue has been less volatile and displays an increasing trend throughout the five-year period. According to Figure 7, it seems to be more difficult to predict federal transfers than own source revenues in River Nile State.

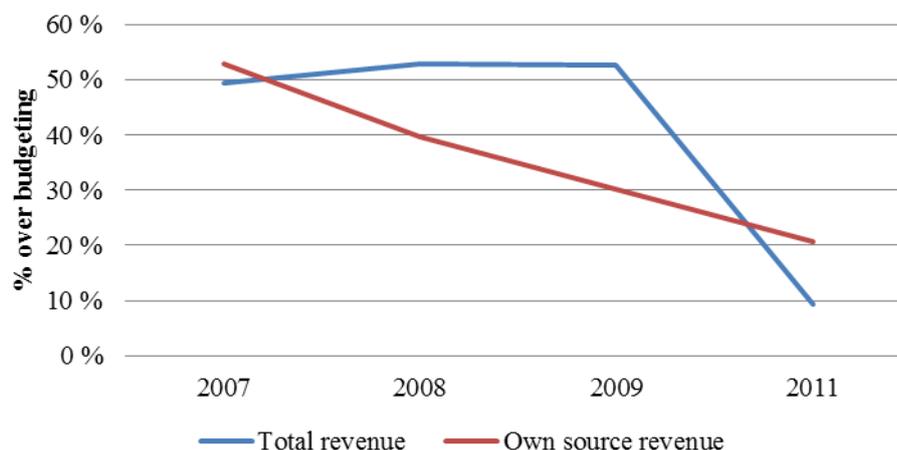


Kassala State

In Kassala, both total and own source revenues were systematically overestimated in all the years 2007, 2008, 2009 and 2011. However, Figure 8 shows that the overestimation has

decreased in size over time.²⁶ While the budgeted amount of revenue was about 50% higher than actual total revenues in 2007-2009, the size of over budgeting was 9% in 2011. The budget for own source revenues was slightly more overestimated in 2007 and 2011, but less in 2008 and 2009. Similar to River Nile state, federal transfers over all seems to be harder to predict than own source revenues.

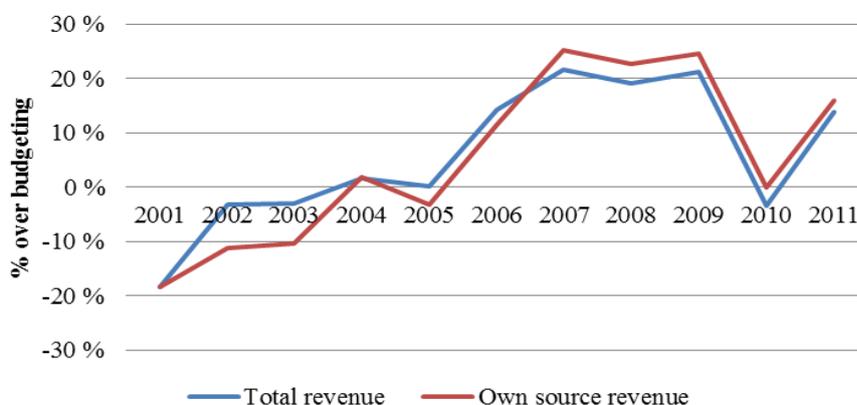
Figure 8: Difference between actual and budgeted revenues in Kassala State



Khartoum State

From 2001 to 2003, both own source and total revenues were under budgeted in Khartoum, meaning that the state managed to raise more revenue than it budgeted for. This changed in 2006 and from this year through 2009, budgeted total revenues were 14% to 21% higher than actual. In 2003 there was a slight under budgeting, but in 2011 the amount budgeted for was again much higher than actual revenues. Own source revenues shows a similar development. Overall, over and under budgeting seems to be a much smaller problem in Khartoum than in the River Nile and Kassala states.

Figure 9: Difference between actual and budgeted revenues in Khartoum State

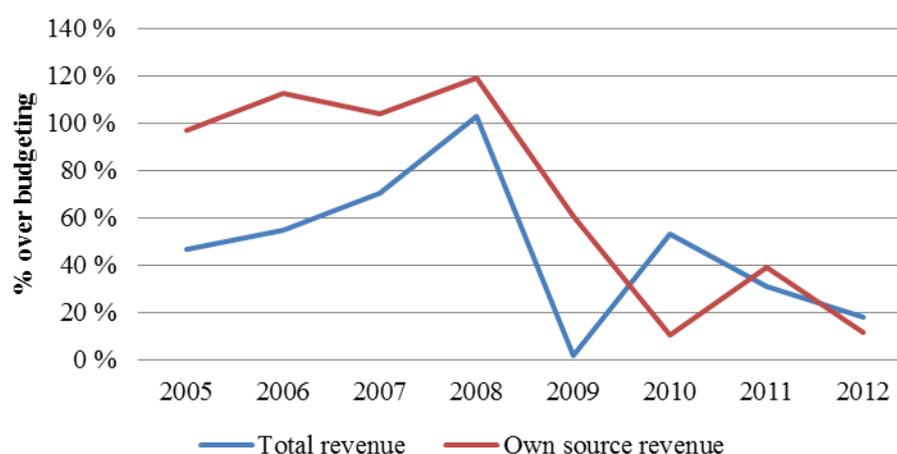


²⁶ Budget for 2010 was not available.

North Kordufan State

As in River Nile and Kassala, revenue mobilization was systematically over budgeted in North Kordufan in all the years for which we have data. The size of the over budgeting varies over time, and for total revenues it increased from 47% in 2005 to 103% in 2008. In 2009, however, the over budgeting was only 2%. In contrast to River Nile and Kassala over budgeting was higher for own revenue sources than for total revenues all years except for 2010 and 2012.

Figure 10: Difference between actual and budgeted revenues in North Kordufan State



How to explain the observed wedge between revenue budgets and actual collections in the states? The following factors matter:

- (1) poor administrative capacity to enforce the taxes;
- (2) explicit and intentional tax evasion and resistance from taxpayers;
- (3) corruption, including embezzlement of revenues; and
- (4) negligence of government agencies to pay taxes.

4.2 Administrative capacity

In many localities there is a scarcity of collectors to cover major market centers. In such cases, revenue collectors must travel between market sites, which makes collection more occasional and difficult to enforce. Taxing moveable objects like livestock and traders is even more challenging. Lack of reliable transport may further exacerbate the situation. Given the complicated revenue system, already discussed above, it is justified to suggest that localities do not have adequate collection personnel, and that a substantial strengthening of staff is needed to administer the present revenue system. However, there are 18 states and many localities in each state in Sudan. To establish adequate capacity for designing and administering the existing revenue system in all these sub-national entities will require more resources than can be available in the short to medium term in Sudan.

There is undoubtedly room for improved tax administration. However, before considering the issue of capacity a more fundamental issue has to be addressed. This has to do with the rationale to squeeze additional revenues from poorly designed taxes. In other words,

improved administrative capacity may increase the negative effects on the economy and society in general, and lead to more inferior outcomes than the present system. Thus, the most urgent challenge may not be lack of capacity, but the revenue structure itself. This reasoning has implications for the sequencing of the reform activities to be discussed below.

4.3 Resistance from taxpayers

Interviews with officials at state and locality levels in Kassala, North Kordofan and River Nile suggest that many taxes, fees and charges are difficult to collect, partly due to taxpayer resistance. Interviews with private sector associations in North Kordofan confirm the unpopularity of the revenue system.²⁷ Poor infrastructure (roads and electricity) were listed as a major constraint facing enterprises.²⁸ One of the people interviewed argued that “taxes and fees are used to finance public administration, not services and infrastructure”, indicating that taxpayers see few tangible benefits in return for the taxes they pay. The deterioration of public services may increase taxpayers’ perceptions of exploitation from an unequal contract with government. This promotes tax resistance. Increasingly, user fees are introduced to finance public services.

Although most taxpayers are unable to assess the exact value of what they receive from the government in return for taxes paid, it can be argued that they have general impressions concerning their terms of trade with the government.²⁹ In this context, it can be assumed that taxpayers’ behavior is influenced by their satisfaction or lack of satisfaction with the terms of trade with government (Levi 1988). Thus, if the system of taxes is perceived to be unjust, tax resistance may be considered as an attempt by the taxpayers to adjust their terms of trade with the government.³⁰

4.4 Corruption

Fiscal corruption is a challenge in Sudan.³¹ Revenue collection is characterized by a general lack of transparency in enforcement of regulations, which provides many opportunities for corruption and bribery. *Transparency International Global Corruption Barometer* (TI 2011) found that of those respondents who have had contact with nine public institutions (tax revenue, customs, police, education, judiciary, medical services, land services, registry and

²⁷Interviews with several business associations in El-Obeid, 18 February 2013.

²⁸There are huge differences between states with respect to infrastructure development and availability.

Khartoum State has the most developed infrastructure, followed by River Nile State which has witnessed massive infrastructure development in the recent years. Kassala and North Kordofan are among the least developed states in terms of infrastructure availability, poor transports, limited access to electricity and water.

²⁹Survey research from Western countries also suggests that taxpayers make judgments about the fairness of particular taxes. See, for instance Smith (1992). Fjeldstad *et al.* (2012) provide an extensive review of research on taxpayer compliance in Africa.

³⁰Non-compliance is sometimes an important political weapon. Scott (1985), for instance, argues that one of the most important ‘weapons of the weak’ is the ability to withdraw compliance. This can take a passive form, such as shirking, or an active form, such as rebellion. Historically, unwillingness of the population to comply with a tax that is deemed unjust has been a catalyst for political action. The Boston tea party and the Thatcher poll tax are illustrative examples. Bates (1983) provides some examples from Africa.

³¹ Fiscal corruption is here defined as any action in which revenue collectors use their position to extort money from taxpayers or collude with taxpayers to defraud the treasury or find some other means to embezzle money from the revenue authority.

permits), 21% reported paying bribes. Citizens' experience with corruption was found to be significant in dealing with the police (where 29% of those in contact with the police reported paying bribes), customs (24%), tax revenue authorities (14%), and land services (12%). The majority of the Sudanese respondents reported having paid bribes in order 'to speed things up' (40%) or to avoid a problem with the authorities (42%).

In the current study we have not examined features and challenges of fiscal corruption at sub-national levels in Sudan. However, studies from other countries in the region suggest that fiscal corruption may take many forms and varies by types of taxes, fees and charges, methods of revenue collection and location (Iversen *et al.* 2006; Kolstad and Fjeldstad 2006). For instance, research from Tanzania and Uganda find that although many cases of collusion between taxpayers and collectors are reported at the local government level, the most common type of fiscal corruption is embezzlement of revenues by revenue collectors and administrators. Three factors are found to lead to widespread embezzlement of revenues within local authorities (Fjeldstad and Semboja 2000):

- the low level of wages paid to staff;
- the complex nature of the revenue structure; and
- inadequate controls.

The combination of low wages, a non-transparent tax system, and lack of controls promotes corruption. This is illustrated by a survey on corruption in Tanzania, where 78% of the respondents mentioned low salaries of public service workers as a major incentive for seeking and accepting bribes (CIET International, 1996: 24). One of the Tanzanian respondents stated: "You may find someone having not received salary for at least three or four months. What do you think he will eat? He will eat us!" The characteristics of the local revenue system may also promote corruption. The combination of a complicated and non-transparent revenue system and poor administrative capacity may breed corruption and facilitate tax evasion. Furthermore, weak effective monitoring and audits facilitate unethical behavior. Box 6 provides some examples of the mechanisms and scope of fiscal corruption in local government authorities in Tanzania.

Box 6: Fiscal corruption in local government authorities in Tanzania

Most taxes in rural local governments in Tanzania are collected in the form of cash. The collector is supposed to deliver a receipt to the taxpayer, a copy (counterfoil) of which is retained for auditing. In principle, the tax collector is required to surrender the receipt books showing used counterfoils and unutilized receipts to the office before receiving new ones. In practice this procedure is often not followed. Fjeldstad and Semboja (2000) found evidence that large numbers of tax receipt counterfoils were not surrendered to the council headquarters as required by the financial regulations. In one local government authority they found that in total, 771 receipt books were not surrendered in the period 6 January 1995 to 26 February 1997. It is reasonable to assume that at least parts of the counterfoils not returned are used to embezzle tax revenues.

For one revenue source (the head tax) it was estimated that the unaccounted counterfoils corresponded to more than 35% of the local council's actual revenues from this source. For other revenue sources such as crop taxes, livestock tax and market fees, it was difficult to estimate the amount embezzled in this way, since the receipts issued varied from one transaction to the other, depending on the specific tax item, rates and units. However, for 1995 more than 30% of the receipt books issued for such taxes were not surrendered.

Even those receipt books that were surrendered could easily be modified. One well-known method for stealing money paid by taxpayers is through the use of *the carbon shipping system*: The taxpayer is given a receipt showing the amount paid. Since no carbon paper is put under the original receipt in the process of writing, the collector later enters a lesser figure on the copy and pockets the difference. Another method is to write receipts noting a lower amount than the amount paid by the taxpayer. This method is more common when dealing with illiterate taxpayers. In other cases, the carbon paper is placed in such a way that the counterfeit only registers a part of the figure written on the taxpayer's receipt, for instance, omitting some zeros.

Embezzlement also takes place through collusion between staff of the council's treasury department and bank officials, leading to the non-banking of tax revenues. Bank officials issue a receipt on the correct amount to the treasury official. The receipt is brought back to the council's revenue office for control, and is consistent with the money remitted. However, only a part of the tax revenues is actually deposited into the council's account. The rest is shared between the involved bank officials and collectors. This method can be sustained over time since what actually is deposited in the council's bank account is rarely controlled. One such case was brought to court in the late 1990s in Dar es Salaam. It involved several staff members of the municipal's revenue department. The amount embezzled in this specific case during the first 6 months of 1997 corresponded to 10% of the total own revenues of that council in 1996. In early 1998, the Controller and Auditor General uncovered cases from 31 councils where cashbook-receipts were not reflected in the bank statements. The total unaccounted amount in these cases was TSh 1.1 billion, corresponding to 3.5% of the total recorded local government tax revenues in 1997.

Source: Fjeldstad and Semboja (2000)

4.5 Negligence by government institutions to pay taxes

A final major administrative problem faced by states and localities is the negligence of some government institutions in submitting the taxes and charges they owe to the state and localities. Local government officials cannot easily turn off the water supplies to schools and hospitals, and they cannot force central government ministries or other sub-national authorities to pay for such services. Although there is little data available to quantify this problem, the practice appears to be widespread.

5 Options for reform: lessons from other African countries

It is clear from the above analysis that the sub-national revenue system in Sudan is in need of reform. The current sub-national revenue system is partly a result of tax design and weak administrative capacity for revenue collection, and partly of poor co-ordination between the sub-national levels of government and between the federal and sub-national levels. Redesigning the sub-national revenue structure and building administrative capacity for collection are required to reduce revenue losses caused by inefficiency, tax evasion and corruption. However, tax resistance is likely to continue (and increase) if service provision does not improve. Improvement in service delivery - a key objective of public sector reforms in Sudan - is therefore a necessary condition to improve taxpayers' compliance.

While sub-national revenue reforms have yet to evolve in Sudan, several other countries in Africa have conducted comprehensive reforms of their sub-national revenue systems. Looking at their experiences provide some important insights in the re-design of the Sudanese system. The main elements of these reforms have been (i) abolition of unsatisfactory local revenue instruments that were costly to collect from administrative and political perspectives, (ii) improvements to remaining revenue bases by simplifying rate structures and collection procedures, (iii) building administrative capacity, and (iv) establishing better links between tax payment and service delivery. For instance, Uganda abolished the graduated personal tax (a head tax) in 2005 in response to its growing unpopularity and politicization (Fjeldstad and Therkildsen 2008). Tanzania has also demonstrated that substantial reforms of the local revenue system are possible (Box 7).

Generally, a fundamental requirement when redesigning sub-national revenue systems is greater emphasis on the cost-effectiveness of revenue collection, taking into account not only the direct costs of revenue administration, but also the overall costs to the economy, including the compliance costs to taxpayers. In addition, losses through evasion need to be reduced.

Nevertheless, surveys in various countries indicate that citizens have a general appreciation of the necessity of taxation to support local service provision, but chose non-compliance due to lack of confidence in local government (Fjeldstad *et al.* 2012). Studies from Tanzania also suggest that peoples' views on local taxation may change over time with implications for policy design. Based on survey data from 2003 and 2006, Fjeldstad *et al.* (2009) found that people were much more positive towards the tax system in 2006 compared to three years earlier. According to the authors, this was partly due to improvements in service delivery, particularly education, health, and law and order, and partly due to reforms which led to less oppressive revenue collection. There was also an increasing demand from citizens for more information on revenues collected and how the revenues are spent.

Box 7: Reforming the local government revenue system in Tanzania

Until mid-2003, it was common that local authorities in Tanzania had more than 70 different taxes, fees, and charges. In addition, there were many sub-groups of specific revenue instruments. There were also large variations of the rates imposed by councils on similar revenue bases, which led to smuggling of tradable goods across council borders within the country.

In June 2003, a comprehensive reform of the local government revenue system was carried out. A large number of so-called nuisance taxes, which were costly to administrate and generated limited revenues, were eliminated. Thereafter, in June 2004, local business licenses were abolished based on the argument that they provided disincentives for the development of local enterprises. The Tanzanian reform demonstrates that radical changes of the local revenue system are possible. The longer-term impact of this reform on local government revenues, however, has been reduced fiscal autonomy and increased dependency on central government transfers.

Work initiated by the ministry responsible for local authorities focuses on reform of the current local revenue system and to identify new revenue options. Among the proposals discussed are reforms of the property tax system and introduction of a unified business tax. As part of this work, business licences were reintroduced in July 2011. Moreover, many local government authorities have started to explore methods to reduce the financial gap caused by the rationalisation by:

1. outsourcing revenue collection to private collectors to increase revenues from existing sources;
2. reducing costs (for example, by limiting the number of meetings and workshops and by retrenching surplus staff); and
3. imposing more cost-effective spending (for example, on electricity and stationery).

Current attempts for economic diversification may also help to expand the local revenue base in the longer term. Co-production of services by councils and local communities is also on the rise. For instance, an increasing number of primary schools are maintained and expanded via self-help schemes combined with technical support from the local government authorities.

Source: Fjeldstad and Heggstad (2012).

Fiscal decentralization reforms are generally framed around three pillars (see Box 8):

- the need for clarity of roles and responsibilities between different levels of government;
- a minimum degree of autonomy for sub-national governments on the expenditure and revenue side; and
- institution building; a prerequisite for successful decentralization is that sub-national governments possess the administrative and technical capacity required to effectively carry out their assignment responsibilities.

In the Sudanese setting, the fundamental issues to be addressed in the context of reforming the sub-national revenue system are:

- (1) to redesign the current revenue structure;
- (2) to build institutional capacity; and
- (3) to enhance tax compliance through improved service delivery.

Box 8: Pillars of fiscal decentralization reform

Fiscal decentralization reform should rest of the following three pillars:

- **The need for clarity of roles and responsibilities** between different levels of government. Clarity, transparency, stability and well-defined rules of the game are paramount for achieving accountability, which efficient and sound decentralization requires. Given the interdependence among the various components of the system of intergovernmental relation, this requires a clear and effective delegation of functions by central government, with revenue assignments that are transparent, unambiguous, and commensurate with sub-national governments' expenditure responsibilities. It also requires transfers that are based on stable principles and specified by legal formulas that support hard budget constraints.
- **A degree of autonomy** for sub-national governments on the expenditure and revenue sides is crucial for realizing the efficiency gains of decentralized government and supporting macroeconomic stability.
 - ✓ On the expenditure side, this requires sub-national budget flexibility to decide – within limits – expenditure priorities and the choice of both the output mix and techniques of production.
 - ✓ On the revenue side, this requires that sub-national governments have the authority to own-finance locally provided services at the margin. More complete revenue autonomy requires a minimum of authority to set tax rates and assignment of at least one significant tax source.
 - ✓ Sustainable autonomy and economic efficiency also requires a reduction of vertical imbalances and some equalization of opportunity to allow sub-national governments to perform their assignment functions. This points to the importance of inter-governmental transfers in fiscal decentralization design.
 - ✓ While autonomy should be explicit and well-defined, it must be circumscribed with respect to the access to borrowing by sub-national governments in order to support hard budget constraints and reduce moral hazard.
- **Institution building** is a prerequisite for successful decentralization. Sub-national governments require administrative and technical capacity to effectively carry out their assignment responsibilities. Supporting institutions, including democratic representation, sound budget processes, sub-national revenue collection capacity, and mechanisms to ensure coordination and cooperation between different levels of government – both at the political and the technical level – are crucial for the functioning of a multi-tier system of government.

Source: Dabla-Norris and Wade (2002)

5.1 Reforming the current sub-national revenue structure

There is undoubtedly room for improved fiscal and financial management both at the state and locality levels in Sudan, as well as improved co-ordination between the different levels of government. However, attempts to squeeze additional revenues from poorly designed taxes may exacerbate the negative effects of the tax system on the economy and the society in general. Thus, reforming the tax structure should precede the reform of tax administration since there is not much merit in making a bad tax system work somewhat better.

More attention is required to how taxes, fees, licenses and duties affect key policy objectives. In particular, it is important to ensure that they do not adversely affect income distribution and undermine economic growth. Raising productivity of and income for small scale farmers and enterprises are potentially the most important strategies to alleviate poverty. To determine the impacts of tax, fees, and licenses on poverty and private sector

development and growth, more analytical work is required to suggest adjustment towards a more effective revenue regime.

In reforming the revenue structure, the following options should be considered:

- abolition of unsatisfactory local taxes;
- improvements to remaining revenue bases;
- cost recovery through user charges; and
- revising the tax incentive and exemption regime.

Abolition of unsatisfactory local taxes

Given the poor performance of many sub-national revenue sources, a reform program should include the abolition of several of these sources. Many taxes, licenses and fees generate very little revenue, e.g. cinema and entertainment fees, taxes on youth and sport. Some fees do not generate revenues at all, e.g. taxes on fruit producing trees, rain-fed agriculture services fees, fees on pasture services, and wandering sheep/camel shed fee. These taxes simply have a high 'nuisance value' and cost more to enforce than what they yield in terms of revenues. Hence, they should be considered to be abolished.

Improvements to remaining taxes

Sudan probably has one of the most complex and comprehensive stamp duty system in the world with 500 dutiable transactions, and also has some of the highest rates (see section 2.2). The revenues from stamp duties are low compared to the cost of administering them. Further, their effect on the business environment may be graver as an administrative barrier or inconvenience than as a business cost. Serious attention should therefore be given to reducing the number of dutiable transactions, reducing the rates imposed, and/or abolishing some stamp duties entirely.

There is also a need to simplify the license and fee structures by reducing the number of rates and coverage. In Sudan, like in many other African countries, the standard mechanisms for mobilizing sub-national revenues from businesses have been through licensing. Although the original intent was regulatory, local business licensing has increasingly become simply a revenue source in most places. However, the business licensing system often has been quite unsatisfactory, inequitable, and has imposed huge costs on business, while generating relatively little revenue. Yet, experiences from other countries show that it is possible to reform the business license system in ways that both contribute to mobilize more revenues and reduce the administrative and compliance costs. This also applies to property and land taxes that are attractive as local revenue bases since they are imposed on immobile resources and, therefore, are difficult to avoid - at least in principle.

The following paragraphs briefly examine experiences from various African countries with respect to improving the business license and property tax regimes.

Business licenses

Local business taxes are generally levied in one of two ways: (a) either as a fixed amount, which usually varies by type, size, or location of the business, or (b) as a percentage of turnover or profits. Assessing turnover or profitability, however, is difficult both in relation to small businesses, which often do not maintain proper records, and to large businesses with

multiple premises across various jurisdictions. Thus, local business taxes often use proxies for turnover or profitability, such as the size of premises, type of business, number of employees, installed electricity power, etc.

Obtaining a business license typically involves multiple visits to various offices, sometimes over several days, with associated travel costs. Failure to provide the correct license receipts may result in closure of the premises. Poor administration and lack of proper business registers often mean that many businesses are not included in the license system. As discussed in Section 2.2, some localities in North Kordofan, for example, operate with more than 300 different categories of businesses listed for licensing, each facing different license rates depending on type and size of business, location, social impact etc. Weak financial management, however, will often imply that collection and enforcement provisions are rarely enforced. This erodes the tax base and introduces inequities into the system. Thus, the current business license systems in Sudan have serious defects. These include:

- high (potential) compliance costs to businesses, due to multiple licensing and complex procedures;
- tariff structures that are complicated and do not reflect ability to pay;
- a process loaded with ineffective regulatory requirements, which provide opportunities for rent seeking;
- poor administration and evasion, which reduce the tax base and generate inequities; and
- a revenue source that generates relatively little income for local governments.

Several African countries, including Kenya and Uganda, have reformed their local business licence systems to make them simpler, more transparent, and effective (Sander 2003; USAID 2005). The main objectives of these reforms are to (a) enable local authorities to collect significantly more revenues, and (b) to reduce the compliance burden on the businesses. In the late 1990s, Kenya pioneered a Single Business Permit (SBP) system, which has since become a model for other countries in the region (Box 9).

Despite problems with communication between the local government authorities and local business communities initially - leading to misunderstandings and initial resistance against the reform - the revenue of most local governments increased. In some local councils' revenue from this source more than doubled in one year. In some cases, this was due to improvements in coverage of the revenue base, but in most cases choosing higher tariff sets was the main reason for the increase.

Box 9: The Single Business Permit (SBP) in Kenya

The Kenyan business license reform has the following components:

1. Local business licensing is decoupled from regulatory requirements, since these are usually ineffective and create opportunities for rent seeking.
2. All economic activities within the local jurisdiction are, in principle, included in the base. The law was amended to broaden the base to comprise all businesses and trades, including professionals such as lawyers, doctors, and private consultants. It aimed to widen the revenue base and to improve equity, while at the same time minimizing the economic distortions of the license system. To avoid double taxation, the central government abolished its registration fees on professionals.
3. Businesses are only required to have one business permit per premise regardless of the range of activities carried out there, hence the name Single Business Permit (SBP).
4. Local authorities are required to establish 'one-stop-shops', at which permits will be issued on the spot in exchange for the appropriate fee. The philosophy is a more customer-oriented approach to business licensing.
5. A standardized rate structure is established. Businesses are classified into eight sectors, which are subdivided into broad categories reflecting the scale of profitability of the business. These size categories are based on easily identifiable and objective criteria. The system is based on self-declaration, but with the opportunity for official checking.
6. The tariff structure is designed to be progressive, with smaller businesses paying less than larger ones. The system provides a standard tariff structure for all local authorities, but still allows local government discretion over the actual tariff rates.
7. Measures are taken to improve the local administration of the system. This includes the design of simplified SBP registration forms. Training is provided to encourage local authorities to work with the local business community in choosing the SBP tariff schedule.

Source: Devas and Kelly (2001).

In both Kenya and Uganda, the time required to obtain business permits has been substantially reduced due to the introduction of one-stop-kiosks (Box 9 and 10). This has cut the compliance costs of the enterprises, though not necessarily the total costs since the tariffs have been raised. Although there is a need for improved financial management, the evidence point towards a positive effect (Gamser 2003). The new system seems to enable local authorities to enhance revenues. At the same time, compliance costs on businesses are lowered and the opportunities for rent seeking and corruption are reduced.

Box 10: Streamlining business registration in Entebbe municipality, Uganda

Before the reform, the business registration and licensing system in Uganda was very complicated and time-consuming. On average, it took 36 days to register a business. Hence, many small and micro-enterprises avoided the registration process and remained informal.

A one-stop simplified business registration and licensing system was piloted in Entebbe in 2002–2003. The results of the pilot included:

- The licensing process became cheaper and shorter. Overall, the compliance costs for enterprises were reduced by 75% (for example, registration time was reduced to 30 minutes).
- Compliance levels for registration improved by 43%.
- Total revenue collection increased by 40%.
- Administrative costs for the council were reduced. Administrative savings were 25% in staff time and 10% in financial resources.
- There were reduced opportunities for bribery.
- Relations between local authority staff and businesses were improved.

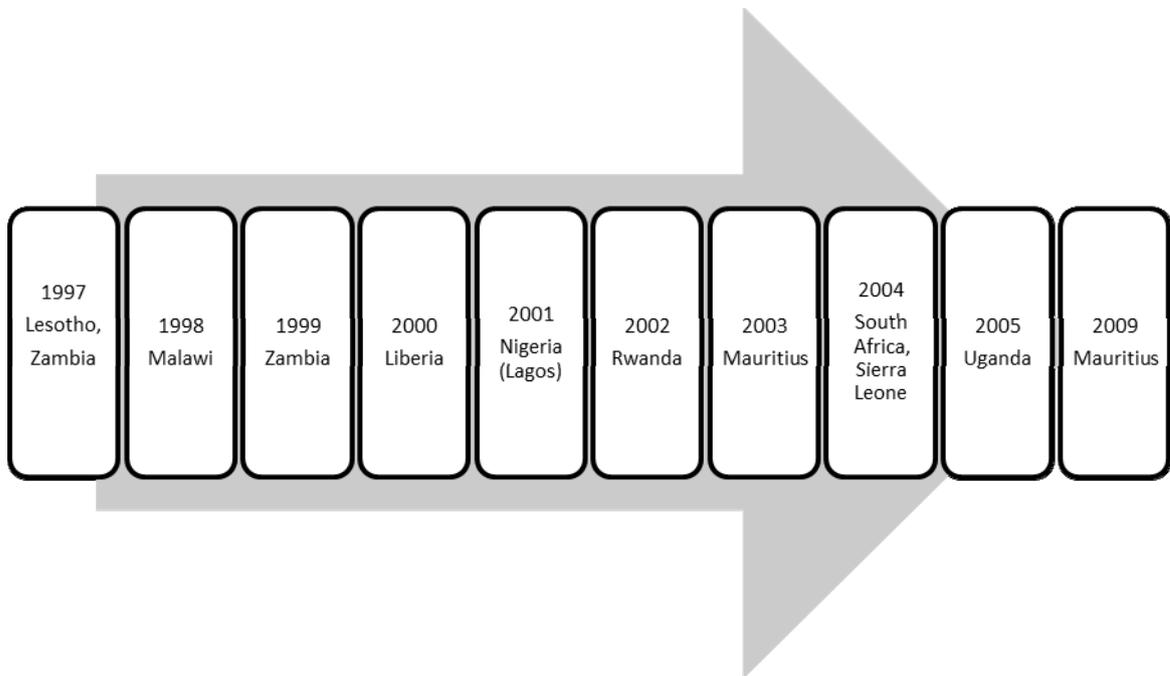
Source: Sander (2003).

Property taxes

Textbooks on revenue assignments between various levels of government generally argue that property tax is one of the most appropriate local government revenue sources. This is due to the fact that real property is visible, immobile, and a clear indicator of one form of wealth. Hence, in principle, property tax is difficult to avoid and, if well administered, it can represent a non-distortional and highly efficient fiscal tool (Alm 2013).

Property tax as an annual tax on real property is levied in many countries in Africa (McCluskey and Franzsen 2005). Commonly it is a local government tax, levied mainly in urban areas. Property tax reforms have taken place in many African countries for more than a decade. Still, property tax revenue accounts for less than 0.5% of GDP in many African countries. In Tanzania, property tax accounted for 10–30% of ‘own’ revenues in urban councils (Fjeldstad *et al.* 2004), and around 20% in metropolitan councils in South Africa (Bahl and Smoke 2003). In Ghana, property tax accounts for about 14% of the total revenues of local assemblies. Figure 11 gives an overview of when property tax reforms were initiated in selected countries.

Figure 11: Property tax reform in a selection of African countries



Source: Franzsen and Youngman (2009:10).

Why is property tax not more heavily exploited as a sub-national revenue source in Sudan? There are a number of constraints that can explain why: (a) Property markets are not well developed; (b) property registers and valuation rolls are often outdated or not in place; (c) administrative capacity and equipment are often limited; (d) the tax base is generally narrowed by extensive legal exemptions; and (e) lack of political support to enforce the property tax and political interference in revenue collection. The property tax has powerful political enemies. The tax strikes people with wealth accumulations quite directly, the real properties to be taxed are obvious to all, and the levy itself is visible. People with substantial property wealth usually have considerable political power and can use that power to thwart taxes that aim directly at their holdings. As Burgess and Stern (1993: 802) suggest, low utilization of property and land taxation “reflects the success of the resistance of the rich and powerful to measures which harm their interests.” The result is that taxes are paid on a base that often bears little resemblance to the true level of property values (Franzsen 2007: 8-9).

Lack of qualified valuers to prepare or maintain property valuation rolls is a challenge in Sudan as well as in many other African countries. This implies that valuation rolls are normally out of date. Some countries, for instance South Africa and Uganda, have introduced ‘mass valuation’ as an alternative to discrete valuations of individual properties or are considering this (e.g. Kenya). External quality control with regard to valuation rolls is generally not in place.

Most African countries, including Sudan, apply different tax rates to different types of property. Rates are generally determined annually, but in some instances are fixed by central government or municipal by-laws for a determined or undetermined period so rates may remain static for years. Where differential rates apply, the tax rates for residential properties

tend to be significantly lower than the rates for commercial, industrial, and government properties, where these are taxable.

There is generally a distinction between imposing tax on land or buildings. Since land in many African countries is owned by the state, it is often only buildings that are included in the property tax base. This applies in Tanzania, Ghana, Mozambique and Sierra Leone. Kenya is the only African country with a land value tax, while South Africa has a uniform, capital value tax. Nigeria is unique in having formally delegated the authority for property tax legislation to the 36 state governments, leaving the various areas in Nigeria with different approaches to estimating property tax (Franzsen and Youngman 2009:12).

In theory, assessment of property value and revenue collection are straightforward: conduct a cadastral survey that assesses the market or site value of each plot of land or property, and send a tax bill to each owner. In practice, however, cadastral surveys are expensive and time-consuming (Bahl *et al.* 2003: 79) and the task is often beyond the financial and technical capability of many sub-national governments. Tax offices in Sudan, as well as in most other African countries are short on assessors, if they have any at all.

Property registers and valuation rolls (cadastral systems) may work in areas with regular street patterns, named streets, and numbered houses. In the absence of this, tax bills are not deliverable, and penalties are unenforceable. Although revenue collection may also prove to be problematic in areas where the property matrix is in place, the absence or scarcity of clear ownership titles is a serious challenge facing this form of taxation. Collection is often poor and many bills go unpaid because taxpayers are not identified or they resist payment because their housing conditions are too poor or urban basic services are not provided to their areas.

Expert opinion diverges on how to improve property taxation in developing countries.³² Some blame the excessive centralization of property tax policy, which may bar local government authorities from increasing the tax rates. Others blame what they consider the almost total anarchy deriving from local government freedom in this field. There is also dispute over tax administration. Certainly, property taxes have many attractions as local bases, but they also have obvious weaknesses that need to be taken into consideration before heavy reliance is placed on them. Often the capability and capacity of the municipality are inadequate to administrate the property tax at a low cost (McCluskey *et al.* 2003: 23). As noted above, these administrative weaknesses are manifested in problems of valuation and arbitrariness in tax assessment and enforcement.

Foreign donors have funded many projects aiming to reform the property tax system and build local administrative capacity, but with mixed results. However, if property tax is to play a greater role in municipal finances in Sudan administrative and technical features of the system need to be improved. Hence, technical assistance should prioritize appropriate training of property valuers and to upgrade relevant skills of municipal staff. The *Municipal Property Rates Act of 2004* in South Africa shows that it is feasible to address

³² Dillinger (1991) provides an insightful summary of these challenges, which still is valid.

some of these problems by stipulating nationally uniform mechanisms of assessment and a monitoring process to ensure assessment quality.

Clearly, property tax has to be simplified to adapt it to the reality on the ground in Sudan. The use of very simple parametric methods for the evaluation of property values is therefore recommended. Parameters could include the number of rooms, the quality of the building materials, and the area of the city where the building is located. Such parameters are transparent and, in general, easy to apply. Similar methods have been used in a number of countries (also in Western Europe) with satisfactory results. Administration could be left local, but the legal framework should be centrally provided. Research undertaken by the African Tax Institute³³, however, argues that many African countries face major challenges if the property tax is to provide a reliable and adequate source of revenue for municipalities.

Thus, experiences advocate cautiousness when (1) extending the present property tax to rural localities, and (2) when imposing a commercial land tax in localities. At this stage of the fiscal decentralization reform process in Sudan it is important to identify the fundamental causes of the problems experienced, in depth and with open minds, to avoid counterproductive biases. In particular, it is important to consider the administrative capacity to maintain assessments of property value seriously. Furthermore, the enforcement mechanisms must be carefully designed to avoid a mushrooming number of court cases and widespread resistance from property owners.

User fees

Taxes are not the best mechanism for matching demand and supply of public services. Better links can be achieved through cost-recovery charging systems, which tie the amount paid directly to the amount consumed. By providing a more direct link between citizens' contributions and service delivery, such mechanisms may become effective means to recover the costs of service provision, and to promote efficiency in the consumption of the service. Hence, most observers argue that user fees should play a prominent role in local government finance (Bahl *et al.* 2003: 76; Bird 2001).

The main economic rationale for user charges is not to produce revenue, but to encourage the efficient use of resources within the public sector. When properly designed, user charges provide information to public sector suppliers on how much clients are willing to pay for particular services. Despite these advantages, experiences from several countries, including Namibia and South Africa, show that user charges can impose a heavy burden on lower-income service users and exclude the poorer segments of the urban population for the services (Fjeldstad *et al.* 2005; McDonald and Pape 2002). Free or subsidized services may also result in over-consumption, and it may prove difficult to target the beneficiaries of free services (see Boxes 11 and 12). Adjustments can, however, be made to offset such effects. For instance, user charges can reflect differences in ability to pay by incorporating sliding scales for the type of user or the amount of usage (Rondinelli *et al.* 1989: 71), although this will require adequate administrative capacity.

³³ African Tax Institute web page: www.ATLup.ac.za [last accessed 17.04.2013]

Box 11: Free services to the poor in South Africa

Improved service delivery to the poor is a priority for most African governments. In South Africa, for instance, the two pillars of this policy are to enable local governments to:

- make basic municipal services accessible to all citizens, and
- provide free basic services for poor citizens who cannot pay.

The challenge with respect to service delivery is foremost to ensure that poor households are the primary beneficiaries of the free services policy and associated resources. Since July 2001, every municipality in South Africa is supposed to provide at least the minimum free 'lifeline' supply to households of 6000 litres of water and 50kW of electricity per month.

Some observers have raised concerns with the manner in which this 'lifeline' policy has been designed and implemented. Firstly, it is argued that the quantity of the free services provided is too small. Secondly, since households are not properly tested to see if they qualify for the free services, some middle- and upper-income households are benefiting more from the provision than poor households. Finally, there is the problem of delivering free services across the country, particularly in rural areas. Therefore, many municipalities have developed indigent registers to ensure that free basic services are provided to the poor.

Source: Fjeldstad (2004).

User charges for 'trading services', including water, electricity, sewage, and solid waste removal, are major sources of revenue in urban municipalities in Southern Africa, especially in Namibia and South Africa. In particular, service charges on water and electricity supply are important. This revenue is generated by a surcharge added to the cost of the utilities that the local authorities typically buy from the utility companies, or, if the authority itself produces the utility, added to the cost of producing it. A large share of these revenues is used to cover the cost of providing the service. However, in some municipalities a substantial surplus is left for general local government purposes. Hence, the tax component of the user fee is hidden for ratepayers, and the 'true level' of local government taxation is not transparent for citizens. This undermines the accountability of the local revenue system. Because the consumer price of the service (for example, electricity) is overstated by the amount of the implicit tax, this may have negative impacts on economic efficiency.

Experiences from South Africa and Namibia show that there are a number of obvious constraints on user charges and other means of cost recovery. These are equity considerations (i.e. ability to pay), collection and billing methods (Box 12), the quality of the services provided, and persistent resistance to pay. These lessons point to the fact that dealing with the policy problem of revenue enhancement requires some understanding of the factors underlying the individual's decision whether to pay or evade service charges (and taxes).

Box 12: Improving compliance through shared private water taps in Ondangwa, Namibia

Residents in the poor informal settlements in Ondangwa Town Council, Northern Namibia, generally prefer a pre-paid water system, since it offers the opportunity to economize water consumption and to control expenses, thus avoiding situations where bills cannot be paid and supplies are cut. However, communal taps frequently break down, often on account of misuse. Repair work is slow, often requiring spare parts that are not available in the country. In January 2004, for instance, Ondangwa Town Council ran twenty-five communal taps with pre-paid cards, of which ten did not work due to damages caused by vandalism. Residents relying on communal taps complained that vandals are usually non-residents.

In order to avoid heavy reliance on unreliable communal taps, residents of the informal settlements have been calling for private taps with the pre-paid system, which by then was only available in the formal settlements. Lacking this option, many residents of the informal settlements instead chose to pool resources and shared a private tap connection, even though it was not pre-paid. In this system, three or more households shared one private tap connection, located in and ascribed to one of the participating household. Sharing the bill, that is paying equal shares of the connection fees and the expenses related to water usage, reduced the average costs for each household. More importantly, it decreased the risk of disconnection due to non-payment, since all parties had an interest in keeping the supply running. Members in the arrangement who repeatedly failed to contribute to the water bills were eventually excluded. The concomitant loss of an assured water-source represented an effective regulatory and enforcing mechanism.

Source: Fjeldstad et al. (2005).

An increasing amount of evidence suggests that the rate of contribution to a public good is affected by factors such as citizens' trust in others and the trustworthiness of the government (Slemrod 2003). Without trust there is little basis for social co-operation and voluntary compliance with laws and regulations that could potentially benefit everyone. In particular, three dimensions of trust seem to affect citizens' compliance: (1) trust in the government to use revenues to provide expected services, (2) trust in government to establish fair procedures for revenue collection, and (3) trust in other citizens to pay their share. Moreover, the attitude of local political leaders with respect to payment seems to be important, for example, they can legitimize non-payment through their own behaviour. This suggests that there are reasons and scope for innovation.

Problems of non-payment of service charges should be attacked on several fronts, including service delivery, better administration and payment schemes, and community involvement. Customer care must show that complaining will bring results. Citizens should be encouraged to report defaults such as leaking taps or non-functioning streetlights. The prompt redress of such complaints may help convince people that the municipality means business. Citizens' involvement in identifying problems and setting priorities may also motivate a greater sense of community involvement. Initially, it may be advisable to link payment directly to visible improvements in services. Finally, the co-operation between government officials, councillors, and community leaders in setting common goals might be a crucial trust-enhancing device.

Recent experiences from North Kordofan suggest that compliance and revenues can be enhanced by using revenues from market fees to improve services at crop and cattle markets through provision of weighting, calibration and sieving equipment and machines (North

Kordofan State Ministry of Finance 2012). This may also contribute to establish a virtuous circle where improved market facilities and services attract more traders and thereby expands the revenue base. Improvement in water supplies (pits and dams) and veterinary services (stationary and mobile veterinary clinics) for livestock owners may also contribute to enhance willingness to pay for services provided by the state and localities.

Reforming the tax incentive regime

Sudan, both at federal and state levels, offers a number of fiscal investment incentives to investors (see Section 3.2). Experience shows that a high occurrence of tax exemptions reduces the tax base, creates room for bribery and corruption, and increases the appearance of loopholes for tax evasion. While there is limited evidence to suggest that tax holiday is a required incentive for attracting new investments, it does have adverse impact on revenue mobilization. The extent of this impact remains, however, unknown. Members of business associations in Sudan, interviewed as part of this study, argue that a transparent legal framework, a predictable tax regime and access to finance are more important than tax incentives to encourage investments. However, a tax incentive regime that favors foreign investors, specific companies and sectors, may contribute to undermine the legitimacy of the tax system. These views are in line with findings of business surveys in other countries as well.

A study from Mozambique, Tanzania and Zambia finds that many taxpayers perceive the current tax system to be unfair since it, according to their views, favors large, multinational companies by granting these exemptions and tax incentives (Fjeldstad and Heggstad 2011). In these circumstances, where the majority of (potential) taxpayers perceive the system to be unfair, it is difficult to build a taxpaying culture characterized by broad-based (quasi-) voluntary compliance. This would require policy makers and revenue administrations to seek more refined means of establishing or maintaining taxpayers' confidence in the tax system and its integrity. Without substantial reforms of the tax incentive and exemption regimes it is unlikely to achieve this in the foreseeable future.

Policy changes with respect to the tax exemption regime will require a combination of measures, including more detailed estimates of revenue losses due to exemptions, and identification of who are granted exemptions, for how long and for what reason. The tax incentive regime should be reviewed regularly. In Tanzania, for instance, such information has been used by the local non-governmental organization Uwazi to foster a broader public debate in the country on exemptions. Available data are collected in order to inform citizens, newspapers and parliamentarians (Uwasi 2010). The stated objective is to enhance transparency and public accountability by making existing data more accessible and informative.

5.2 Improving institutional capacity

Currently, many different agencies, including service delivery facilities, collect fees. One gets the impression that "everyone turns into a tax collector in their hunt for revenue to meet expenditure obligations." It is difficult and costly to monitor this collection regime. There is a need to streamline tax and non-tax revenue collection and administration away from the current non-transparent practices. Revenue should be part of the total resource envelope distributed through a transparent budget allocation process rather than collected and retained

- sometimes “off budget” - by a line ministry. The recommended option is to delegate the responsibility for collecting revenues to the specialized revenue collection agencies, i.e. the Chamber of Tax and/or the revenue department of the State Ministry of Finance and their extended functions at locality level. This will facilitate more effective organization of the revenue collection process.

A major challenge facing sub-national revenue collection in Sudan is related to the assessment and forecasting of the actual revenue potential for various revenue bases. Currently, revenue forecasting is conducted on an *ad hoc* basis, often based on expenditure needs and/or the previous year’s reported collection. Comparing the difference between actual and budgeted revenues in the state budgets gives the impression of a systematic over budgeting of revenues (see Section 4). Our consultations with the revenue departments in several state ministries of finance as well as revenue officers in localities, suggest that they have not yet tried to make revenue forecasts based on an analysis of the revenue potential for individual revenue bases, e.g. by using data on the number of businesses from the State Company Registrar and other sources, and transactions of assets such as property and land. This implies that the revenue potential remains unknown. Introduction of simple, analytical tools to estimate revenues with forecasting for a two-three year period could be required to strengthen public financial management, including the budgeting process.

Revenue enhancement programs at the sub-national levels should ideally include the following components (Garzon and Freire 2013): (a) development of baseline indicators; (b) updating databases (registers) of service subscribers and taxpayers, through field surveys and self-reporting requirements; (c) expanding street nomenclature to update addresses which are needed for billing and collection; (d) updating property tax information; (e) establishment of minimum standards in the provision of municipal services; (f) establishment of good metrics for services provided, including the unit cost; (g) computing and sharing information on actual cost and expected cost.

Introduction of information and communication technology (ICT) should be part of this process, with a view to enhancing efficiency in revenue administration. eFiling for state and locality revenue forecasting, the computerized registers of taxpayers, including enterprises, motor vehicles, livestock owners, the introduction of electronic cash registers for Value Added Tax (VAT) etc., have the potential to become important tax administrative tools. Such initiatives are at different stages of implementation. The Chamber of Tax in North Kordofan has computerized parts of its operations, but still operates with manual taxpayer registers and files as in most other states in Sudan. The effectiveness of ICT-systems will depend on building and maintaining technical and professional capacity to operate and maintain the systems. Moreover, it is important that the ICT-based systems being implemented use an integrated framework, because of the technical and managerial challenges this approach poses. In the absence of integration, the use of the systems will remain sub-optimal. In particular, it is difficult to have a single view of the taxpayer outside an integrated system.

The capacity of sub-national governments in Sudan is weak when it comes to tax design. The resource requirements are relatively high, and can only be done in the medium to longer run. In the short run, there is a need for support to develop clear guidelines for the design and

assessment of sub-national revenue systems. The current system of approving new and amending existing tax legislation should be reviewed, including how to strengthen the coordination between the national and sub-national revenue regimes and policies. As a first step, an expert committee should be established to advise both the Federal and State Ministers of Finance on revenue reforms, including how to secure coherence and avoid duplication and inconsistencies between the revenue systems at various levels of government. This committee should advise the ministers before revenue legislation is approved. The expert committee should not be a substitute for the work of staff at the locality and ministerial levels. However, since it will require more resources than are available in the short term to build relevant capacity at the locality and state levels, the importance of such a committee cannot be overemphasized.

Performance indicators should be balanced. Often the uncompromising revenue target focus of the revenue administrations implies that achieving the collective target becomes not 'everything', but the 'only thing' - sometimes also at 'any cost', to the detriment of other goals of the revenue administration. This may legitimize extortion and harassment of taxpayers, and transparency, accountability and customer friendliness are likely to suffer. Hence, there is a need for striking a balance between revenue and service targets. Performance criteria should be linked to taxpayers' satisfaction with the revenue administration, processing time for declarations, processing time for refund of VAT, the number of taxpayers enrolled in the tax bases, etc. If such a balance between revenue targets and other performance indicators is incorporated in the revenue administration's strategic and/or corporate plans, it is likely that this over time will impact on staff attitudes towards taxpayers.

5.3 Enhancing tax compliance through improved service delivery

Poor revenue enforcement may be due to a combination of various factors: (i) lack of accountability of the government, (ii) lack of political will; (iii) weak institutional and administrative capacity; (iv) lack of incentives for both revenue collection and enforcement; (v) lack of policy to show good use of tax proceeds; and (vi) informal payments and corruption. Surveys in many developing countries show that taxpayers - even the poorer - would be ready to pay more taxes if the services improved and if there was more transparency (Garzon and Freire 2013: 163-4). Sometimes, corruption is so common that taxpayers refuse to pay because they believe that the resources will never be used to improve the living conditions of the population. A study of six African countries found that 30-70% more revenue could be collected at the local level if people paid what they were supposed to (Action Aid 2011). Because of this, less money can be invested in services for the poor and marginalized.

Yet, surveys in various countries in Africa indicate that citizens have a general appreciation of the necessity of taxation to support local service provision, but chose non-compliance due to lack of confidence in local government (Bahiigwa *et al.* 2004). As mentioned before, studies from Tanzania suggest that peoples' views on local taxation may change over time with implications for policy design. Based on survey data from 2003 and 2006, Fjeldstad *et al.* (2009) found that people were much more positive towards the tax system in 2006 compared to three years earlier. This was partly due to improvements in service delivery, particularly education and health services, as well as law and order, and partly due to

reforms which led to less coercive revenue collection. There was also an increasing demand by citizens for more information on revenues collected and how the revenues are spent.

The tax-paying culture in Sudan is generally weak. Some of the reasons for this attitude are the legacy of the oil-economy, the inability of taxpayers to see the relationship between benefits in the form of services being provided by the state from taxes paid and inadequate public education programs by the revenue administration. There seems to have been a general lack of concern for the historical evidence about the connection between taxation and state-building, notably the need to construct tax systems that engage citizens in politics in a positive way, and contribute to the legitimacy of the state (Fjeldstad and Moore 2008: 259).

According to citizen perceptions studies in several African countries, a serious problem hampering collection is that taxes gathered are not spent on public services (Fjeldstad *et al.* 2012). A major challenge is thus to secure better links between taxes paid and public service provision. This involves asking the question: Why should people pay taxes? For taxpayers, paying taxes to the state is a *quid pro quo*, that is, they expect public services to be provided. It is basically 'tax for services'. People are more likely to pay for local service charges if they feel that the government is providing services equitably, collecting revenue fairly and using the revenue to provide services. In Sudan as well as in many other African countries, the provision of public services is generally unreliable and regarded to be of poor quality. The weak link between taxes paid and services provided is likely to erode citizens' trust in government. In this perspective, the use of revenues to build essential infrastructure and finance the provision of basic public services may enhance citizen trust in government and over-time enhance tax compliance.

An important element of administrative accountability is taxpayers' rights vis-à-vis the revenue administration. Though still in their infancy in Sudan, tax appeals boards and tax tribunals are important institutions to secure taxpayers' rights and to establish fairer and more transparent procedures to address tax disputes. However, to make such institutions accessible for a wider segment of taxpayers, there is generally a need for simplification of the procedures for instituting appeals, and for dissemination of more accessible information to the general public on the roles and functions of the appeals board.

A large proportion of the economic active citizens in Sudan belong to the informal sector, both in rural and urban areas. This has affected 'tax literacy' as many people are not able to comprehend the technical issues involved in tax administration and reform. The Chamber of Tax has undertaken taxpayer education interventions, but they have had a limited outreach since most of them have been concentrated in the urban centers.³⁴ Similarly, some elites are probably also tax illiterate because they are not interested in tax issues. A challenge experienced in many countries is that elites regard taxation as a form of coercion and one that will erode their privileges. They therefore turn a deaf ear to the taxpayer education campaigns of revenue administrations. To establish a constructive dialogue with elites on taxation and development remains an unsettled challenge in Sudan.

³⁴ Interview with senior officials, Chamber of Tax, Khartoum, 25 February 2013.

5.4 Intergovernmental fiscal transfers

Whatever is done to improve the local government revenue system, the reality is that most states and localities in Sudan will continue to be dependent on fiscal transfers from the federal government. Transfers should therefore be considered an important component of the decentralization program.

The basic rationale for a system of transfers is the existence of a fiscal gap between own revenue and expenditures (Ahmad 1997). This is exacerbated by federal government requirements for states and localities to maintain established 'minimum' standards of public services. It is beyond the scope of this study to quantify the financial resources needed in the form of transfers from the federal government, but the magnitudes are difficult to estimate due to lack of reliable information on potential revenues and adequate expenditures. However, to achieve adequate service standards, expenditures (on both salary and non-salary) need to be raised to a certain threshold level. Increments below this funding level will most likely only produce limited results.

In the process of fiscal decentralization it is important to be aware of the potential problems for macroeconomic management and fiscal discipline. Substantial devolution of revenues and spending responsibilities to sub-national authorities may affect the federal government's ability to carry out stabilization and macroeconomic adjustment through the budget. The destabilizing potential of sub-national governments is greatest when they face no hard budget constraint (Ter-Minassian 1999). Expectations of bail-out in case of financial trouble may weaken the incentives within sub-national authorities to economize on costs, and generate resource waste and rigidity. These inefficiencies may, in turn, lead to macroeconomic imbalances. Thus, short-run macro-economic management considerations call for effective limits on sub-national governments' deficits, consistent with national objectives for growth, as well as internal and external balances. The creation of institutional fora, such as a 'Financial and Fiscal Committee', to ensure a regular and frequent dialogue between the federal and state governments on budget trends may help in this regard.

6 Policy considerations

The analysis in this report has identified some areas to be prioritized for reforming the current sub-national own revenue system in Sudan. The fundamental issues to be addressed in the context of a sub-national own revenue reform:

- to redesign the current revenue structure;
- to build institutional capacity; and
- to enhance tax compliance through improved service delivery.

When reforming the revenue structure the following options should be considered:

- Abolition of unsatisfactory local taxes, especially those revenue sources that generate little revenues (e.g. cinema and entertainment fees, taxes on youth and sport etc.) or no revenues (including taxes on fruit producing trees, wandering sheep/camel shed fees).
- Improvements to remaining revenue bases. In particular, the stamp duty and business license system ought to be simplified by reducing the number of duties, licenses and fees, and the rates applied. In the medium term, technical assistance should prioritize

appropriate training of property valuers and upgrading relevant skills for property tax collection in municipalities.

- Cost recovery through user charges should aim to establish clear links between payment and public service provision. For instance, recent experiences from North Kordofan suggest that compliance and revenues can be enhanced by using revenues from market fees to improve services at crop and cattle markets through the provision of weighting, calibration and sieving equipment and machines.
- Revising the tax incentive and exemption regime. A high occurrence of tax incentives has negative impacts on revenue mobilization and creates loopholes for tax evasion. The benefits of investment tax incentives are generally exaggerated, while the costs are often underestimated or overlooked altogether. Although tax incentives in some situations may stimulate investment, the non-tax elements of the investment climate are generally far more important than tax incentives in determining the level and quality of investment flows. Fiscal incentives do not effectively counterbalance unattractive investment climate conditions such as poor infrastructure, macroeconomic instability, and weak governance. Further, it is important to ensure that incentives are granted transparently. All tax incentives should be in the relevant tax legislation.

A fundamental requirement when further redesigning the sub-national revenue system is greater emphasis on the cost-effectiveness of revenue collection, taking into account not only the direct costs of tax administration, but also the overall costs to the economy, including the compliance costs to the taxpayers. In addition, losses through tax evasion need to be reduced. To achieve these aims, there is a need to simplify the business license, stamp duties and fee structures by reducing the number of rates and coverage. Moreover, sub-national taxes and licenses should be harmonized with the federal government's revenue bases, to avoid double taxation and conflicts with national development policies, such as job creation and private sector development. The establishment of one-stop-shop Single Business Permit systems has had positive effects in other sub-Saharan countries and could be promising for future reforms also in Sudan.

Officials at state and locality levels interviewed as part of this study argued that the abolition of the agricultural production tax had unfavorable fiscal and real effects on localities. The federal transfers introduced to compensate for revenues lost have proved not to be sufficient. Businesspeople, however, argued against this option. Should the tax be reintroduced? Answering this question requires an in-depth study of the marginal effective tax rate in the agriculture sector and a political-economy analysis of whether reintroducing the tax is feasible in the specific local context.

While the current potential for most rural localities to raising substantial own revenues is limited, the potential for revenue enhancement in urban localities is better. However, one major administrative problem for many states and urban localities today is their inability to fully collect the revenue due to them and huge gaps are observed between reported and forecasted revenues. This is due to: (1) poor administrative capacity to assess the revenue base; (2) poor administrative capacity to enforce the payment of taxes, fees and charges; and (3) explicit and intentional tax evasion and resistance from taxpayers. In this setting, fundamental issues to be addressed in the context of sub-national fiscal reforms are to redesign the current revenue structure and to strengthen financial management. In addition, measures are required

to enhance taxpayers' compliance and to improve the accountability of revenue collectors and elected councilors. This cannot be achieved without substantial and consistent political support from the state and federal governments.

It is vital to strengthen revenue forecasting and economic impact analysis capacity to enhance the quality of policy making at both national and sub-national levels. Simple models of revenue forecasting and analysis at sub-national levels should be developed in the short run. In the medium term the skills and data required for more complex analysis should be developed. Developing this capacity will require joint effort and coordination between the federal Ministry of Finance and National Economy and the State Ministries of Finance.

Improved information supplied to the public on budgets and accounts may improve the opportunities for citizens to exercise their voice and demand accountability from sub-national authorities. This is among the lessons we can draw from the decentralization reform in other countries. It is, however, important to stress that encouraging citizens to engage in fiscal and financial monitoring at the local level does not imply that such measures should replace formal auditing and accounting mechanisms. Nor does it imply that such measures will weaken the formal accountability mechanisms. On the contrary, it can strengthen the legitimacy and standing of sub-national authorities in the communities by contributing with complementary measures to improve the control of revenue collection and expenditures.

More realism is also required when it comes to the implementation of a well-functioning property tax system in Sudan. Property tax has many attractions as a local revenue base since it is imposed on immobile assets and therefore is difficult to avoid – at least in principle. However, it has some obvious weaknesses that need to be taken into consideration before heavy reliance is placed on it. In particular, problems of valuation and tax enforcement often occur due to political interventions and administrative weaknesses. The municipalities' capacity and capability to administer the property tax have in general proved to be inadequate. Hence, it has been difficult for municipalities in Sudan to maintain the current property valuation registers, let alone to continue the property valuation initiatives. It is therefore a need to reassess the basis of the property tax in urban councils and to implement a simpler and more coherent approach to the valuation provision, which takes into consideration administrative capacity and capability constraints facing the urban councils. A pragmatic policy approach is required, which may imply centralization of certain issues, such as management of property titles, valuation assessments, etc.

Sub-national own revenues are a necessary but not a sufficient condition for fiscal decentralization. In most states and localities in Sudan, own sources are not sufficient to develop and supply adequate services for the fast-growing population. The reality is that many sub-national governments will continue to be dependent on fiscal transfers from the federal government. Only a few states and some of the larger urban municipalities are in the shorter run able to finance a substantial share of their total expenditure with their own revenue sources. Transfer systems based upon grants and revenue sharing between the federal and sub-national levels of government should therefore be considered important components of the fiscal decentralization program in Sudan.

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Annex 1 Doing business and paying taxes in Sudan

The *Doing Business* database (<http://www.doingbusiness.org/>) provides measures of business regulations and their enforcement (Doing Business 2011). It indicates the regulatory cost of business, and includes a wide range of countries and topics. The countries are ranked in terms of the ease of doing business, which is an overall ranking of 10 elements relevant to the business environment. The individual elements in 'ease of doing business' are (1) starting a business, (2) obtaining and renewing licenses, (3) employing workers, (4) registering property, (5) getting credit, (6) protecting investors, (7) paying taxes, (8) trading across borders, (9) enforcing contracts, and (10) closing a business. Table A1.1 shows the overall ranking of countries in terms of ease of doing business. The right column describes the ranking on ease of paying taxes which is one of the ten elements of which the ease of doing business entails.

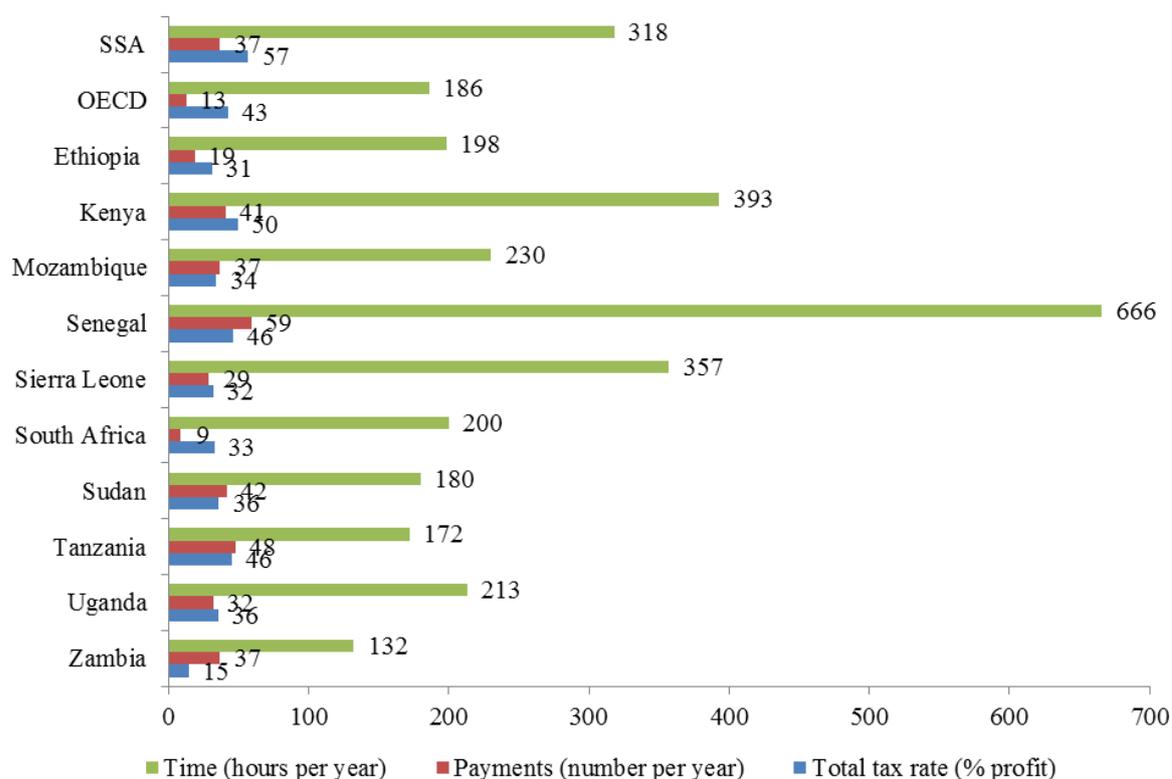
Table A1.1: Worldwide rank of ease of doing business and paying taxes

	Doing Business	Paying taxes
South Africa	35	44
Zambia	84	47
Kenya	109	166
Ethiopia	111	40
Uganda	123	93
Tanzania	127	129
Sudan	135	103
Mozambique	139	107
Sierra Leone	141	76

Sudan ranks among the bottom third among the selected countries in terms of ease of doing business, and in the bottom half in terms of ease of paying taxes. For the overall indicator, ease of doing business, South Africa is rated highest, and Mozambique and Sierra Leone lowest of the selected countries. In terms of ease of paying taxes, on the other hand, Ethiopia is ranked highest, and Tanzania and Kenya lowest. Thus, many of the countries are performing much better on one ranking than the other. The difference was largest for Ethiopia which is ranked as 40th on the ease of paying taxes worldwide, but is rated as low as 111 in terms of ease of doing business. Most of the selected countries rank higher on ease of paying taxes than on the overall ease of doing business, with the exceptions of South Africa, Kenya and Tanzania.

Figure A1.1 gives a graphic presentation of the three components of the ease of paying taxes indicator discussed above, namely the average of the total number of tax payments, the total number of hours spent on preparing taxes and complying with rules and laws, and the total tax rate (measured as share of commercial profits), for medium-sized companies each year (Doing Business 2010: 53). The figure includes selected African countries, as well as the regional and OECD average.

Figure A1.1: Time spent paying taxes, number of payments and total tax rate on profits in selected countries



The Figure shows that the total tax rate on profits is lower than the SSA average rate (57% of profit)³⁵ in all the selected countries. Zambia is by far the country with the lowest tax rate on profits (15%). However, also Sudan (36%), together with Ethiopia (31%), Sierra Leone (32%), South Africa (33%), Mozambique (34%), and Uganda (36%) have a tax rate on profit below the OECD average of 43%. Tanzania (46%) and Kenya (50%) are the only countries in the sample with tax rates on profits between the OECD and SSA average.

The average number of payments made by firms is more than three times the size in SSA than in the OECD region (37 vs. 13 payments). Among the countries in the sample, only Kenya (41), Sudan (42) and Tanzania (48) lie above the regional average. Mozambique and Zambia have numbers equal to the regional average. South Africa is the only country where the number of payments is lower than the OECD average.

The variation in time spent on paying taxes and complying with rules and laws is large. While the number of hours spent on paying taxes annually in Kenya is 393, firms in Zambia only use 132 hours on paying taxes every year. Kenya (393) and Sierra Leone (357) are the only ones of the selected countries that are rated above the SSA average (318 hours) in terms of this indicator.

³⁵ It should be noted that this average is heavily affected by the tax rates in the Comoros, the Democratic Republic of Congo and The Gambia where tax rates are 218%, 340% and 284%, respectively. When these three countries are excluded from the sample, the SSA average tax rate is 41.5%, i.e. lower than the OECD average.

Though Zambia has the lowest tax rate of the countries in the sample (14.5%), figures from the Enterprise Survey shows that tax rates are seen as the top constraint by firms in Zambia (see Figure A1.1). The Doing Business and the Enterprise surveys are inadequate to explain why the perception of firms are so strongly opposed to the level of the tax rates, even though the Doing Business numbers suggest them to be far below the regional and OECD average.

Annex 2 The largest sources of own revenues in selected localities

In spite of the large number of own revenue sources in localities, a limited number of these are the main contributors. Tables A2.1 – A2.7 list the five largest sources of own revenue in recent years in selected localities in River Nile, Kassala and North Kordofan.³⁶

River Nile State localities

Abu-Hamad locality displays a large variation in the largest own revenue source over time. From 2005 to the first half of 2012, it ranged from charges on ferries, diversified revenue items to health licenses and service fees. However, there seems to be a quite consistent pattern that the three most important sources are three of the four categories charges on ferries, diversified revenue items, health licenses and service fees.

Table A2.1: Largest own revenue sources in Abu-Hamad Locality, River Nile State

Rank	2005	2006	2007	2008	2009	2010	2011	Jan-Jun 2012
1	Charges on ferries	Div. revenue items	Charges on ferries	Div. revenue items	Div. revenue items	Div. revenue items	Health licenses	Services fees
2	Div. revenue items	Charges on ferries	Services fees	Charges on ferries	Health licenses	Health licenses	Div. revenue items	Div. revenue items
3	Services fees	Services fees	Div. revenue items	Services fees	Charges on ferries	Charges on ferries	Charges on ferries	Charges on ferries
4	Agric. services fees	Agric. services fees	Agric. services fees	Agric. services fees	Rental of agric. land	Rental of locality's prop.	Rental of locality's prop.	Comm. licenses fees
5	Rental of agric. land	Comm. licenses fees	Comm. licenses fees	Comm. licenses fees	Rental of locality's prop.	Services fees	Services fees	Rental of locality's prop.

Kassala State localities

In Aroma locality, bus station service fees was the largest single source of own revenue during the period 2007 - 2011. Public service fees and animal sales markets were the second most important, and animal sales markets, public services and rental of localities' properties the third most important own source during the period. There is quite a large variation in the ranking of most important own revenue sources over time, but the top three categories are consistent.

³⁶ Information on own revenue in localities Khartoum State was not available for the study.

Table A2.2: Largest own revenue sources in Aroma Locality, Kassala State

Rank	2007	2008	2009	2010	2011
1	Bus station services fees	Bus station services fees			
2	Other div. revenue items	Public service fees	Animal sells markets	Animal sells markets	Animal sells markets
3	Animal sells markets	Animal sells markets	Public service fees	Rental of locality's prop.	Public service fees
4	Commercial	Sloughing fees	Commercial	Comm. licenses fees	Residential
5	Public service fees	Other div. revenue items	Arable land, fees	Public service fees	Forestry

Similar to Aroma, bus station services fees were the most important source of own revenue in Kassala locality (with the exception of year 2011 when residential plan was the most important and bus services fees came second). Tax on commodities was the second most important and commercial license fees, rental income from the locality's properties and residential plan were the third most important revenue sources during the period 2005-2011.

Table A2.3: Largest own revenue sources in Kassala Locality, Kassala State

Rank	2005	2006	2007*	2008	2009	2010**	2011
1	Bus station services fees	Residential plan					
2	Tax on commodities and services						
3	Comm. licenses fees	Rental of locality's prop.	Residential plan	Bus station services fees			
4	Rental of locality's prop.	Tenders	Tenders	Comm. licenses fees	Comm. licenses fees	Rental of locality's prop.	Rental of locality's prop.
5	Commercial	Commercial licenses fees	Comm. licenses fees	Tenders	Commercial	Administrative fees (land doc)	Residential

For the Wad-Al-helew locality, we only have data from 2010 and 2011. There, licensing of small stores was the most important own revenue source in 2010 and the third most important in 2011. The second most important sources were livestock and animal sales fees in 2010 and 2011, respectively. Bus station service fee was the third most important in 2010.

Table A2.4: Largest own revenue sources in Wad-Al-helew Locality, Kassala State

Rank	2010	2011
1	Licensing of small stores	Tax on commodities and services
2	Livestock fees	Animal sells fees
3	Bus station services fees	Licensing of small stores
4	Tax on commodities and Services	Bus station services fees
5	Commercial licenses fees	Animal drinking water facilities

North Kordofan State localities

Self-support was the most important own revenue source in Al-Nohood locality in North Kordofan state in all years between 2008 and 2012, while the second and third most important sources were among the four categories animal sales fees, commercial licenses, crops services fees and market services fees.

Table A2.5: Largest own revenue sources in Al-Nohood Locality, North Kordofan State

Rank	2008	2009	2010	2011	2012
1	Self-support	Self-support	Self-support	Self-support	Self-support
2	Animal sales fees	Animal sales fees	Comm. licenses	Crops services fees	Market services fees
3	Comm. licenses	Comm. licenses	Animal sales fees	Comm. licenses	Animal sales fees
4	Crops services fees	Crops services fees	Crops services fees	Animal sales fees	Villages planning fees
5	Animal tax and its arrears	Market services fees	Villages planning fees	Villages planning fees	Comm. Licenses

In Bara locality, the most important source of own income has varied between four different categories the last five years; animal sales fees, animal tax and its arrears, crops service fees and investment. Animal sales fees and animal tax and its arrears have been important sources and were rated among the five largest income categories in all five years.

Table A2.6: Largest own revenue sources in Bara Locality, North Kordofan State

Rank	2008	2009	2010	2011	2012
1	Animal sales fees	Animal tax and its arrears	Crops services fees	Investment	Investment
2	Animal tax and its arrears	Animal sales fees	Animal tax and its arrears	Animal tax and its arrears	Development and services fees
3	Market services fees	Villages planning fees	Animal sales fees	Animal sales fees	Crops services fees
4	Other	Crops services fees	Goods and services subsidy	Villages planning fees	Animal sales fees
5	Comm. licenses	Goods and services subsidy	Trade banners	Crops services fees	Animal tax and its arrears

Real estate was the most important on revenue source in Sheikan locality (except 2008 when it was out-state departure fees and real estate was second most important). Investment, out-state departure fees, and locality's rentals were ranked second and third sources.

Table A2.7: Largest own revenue sources in Sheikan Locality, North Kordofan State

Rank	2008	2009	2010	2011	2012
1	Out-state departure fees	Real estate	Real estate	Real estate	Real estate
2	Real estate	Out-state departure fees	Investment	Out-state departure fees	Investment
3	Locality's rentals	Locality's rentals	Locality's rentals	Locality's rentals	Out-state departure fees
4	Labor permits fees	Investment	Out-state departure fees	Investment	Locality's rentals
5	Fees on internal bus station	Fees on collection and transport of waste	Fees on internal bus station	Fees on internal bus station	Animal sales fees

Comparison across localities and states

There are some similarities between localities within the same state with respect to the largest own revenue sources. In localities in Kassala State, bus station service fees rank as one of the four most important own sources in all the three localities we examined (Aroma, Kassala and Wad-Al-helew). While animal sales markets are important in the Kassala State localities, Aroma and Wad-Al-helew (only in 2012), it is not among the ten most important sources of own revenue in Kassala locality in the same state.

In North Kordofan, animal sales fee is ranked as one of the four most important own revenue sources in Al-Nohood and Bara localities in all the years covered by this study, but is much less important in Sheikan. Another common feature of Al-Nohood and Bara is the importance of crops services fees, which ranks among the five most important sources between 2008 and 2011. Here also, Sheikan differs from the other two - the crops service fee was not even among the 10 most important sources in this period.

The major three to five own revenue sources in individual localities seem to be stable over time. Animal sales fees are generally important (ranked among the five most important sources all years) in four localities, i.e. Aroma, Wad-Al-Helew, Al-Nohood and Bara located in two different states, i.e. Kassala and North Kordofan. In the localities in Kassala and River Nile, transportation-related fees, bus station services and charges on ferries, respectively, are important sources of revenue for the localities. Rental income from the locality's properties was rated third and fourth most important in all years in Kassala locality (Kassala State), and in Sheikan locality (North Kordofan State).

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Sudan has undertaken decentralization reforms since the early 1990s, in a federal government system with three tiers: federal, state, and local government levels. Fiscal decentralization was fueled by a decade-long oil boom. With the secession of the South in July 2011, Sudan suffers from large oil revenue losses and significant economic instability. Own revenue mobilization at sub-national levels is low. Inadequate and unevenly distributed own-revenues at both state and local government levels and unpredictable levels of transfers from the federal government pose serious obstacles to implement the policy of decentralization. The purpose of this study is to assess how the current sub-national revenue system can be better designed and managed to thereby strengthen the states' and localities' own resource mobilization. The analysis focuses on the composition of sub-national revenues, administrative practices, and possible impacts of the current system on economic activities. Experiences from other African countries that have suffered similar challenges in the past are also examined. On this basis the study provides recommendations on how to improve sub-national revenue collection without jeopardizing economic activities and private sector development.

The programme Assisting Regional Universities in Sudan and South Sudan (ARUSS) aims to build academic bridges between Sudan and South Sudan. The overall objective is to enhance the quality and relevance of teaching and research in regional universities.

As part of the program, research is carried out on a number of topics which are deemed important for lasting peace and development within and between the two countries. Efforts are also made to influence policy debates and improve the basis for decision making in both countries as well as among international actors. ARUSS is supported by the Norwegian Ministry of Foreign Affairs.