PROMOTING BILATERAL TRADE BETWEEN SUDAN AND SOUTH SUDAN

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FOREWORD

The inextricable interdependence of Sudan and South Sudan shrouded in common historical and geographical ties make a compelling case for the two countries to engage in open trade, with a view to promoting the commercial interests and welfare of the citizens of the two countries. A booming cross border trade generates economic spin-offs that will improve fiscal sustainability, through generation of trade-related revenue and efficiency gains including economies of scale, economic integration and technological innovation, and thus growth and development. Indeed, maintaining good relationship between Sudan and South Sudan is costless, yet it holds a great promise for the economic advancement of the two countries. This notion was the spirit behind the “soft borders” approach, which was a fundamental principle enshrined in the Border Issues Agreement (BIA) of September 2012 between the two countries.

The two countries share Africa’s longest land border of over 2,000 km, with a significant flow of commerce and merchandize, largely from Sudan to South Sudan, making trade cooperation an economic imperative. With the vast array of land-bordering neighbors to each country (six for Sudan and five for South Sudan), the magnitude of trade-related benefits would be significantly enhanced with mutual trade cooperation as their domestic markets develop. The landlocked status of South Sudan and given the potential of either country to serve as a transit for commerce destined to, or originating from the other, underscores the essence of good trade relations.

For the African Development Bank therefore, the request for a study on promoting bilateral trade between Sudan and South Sudan conforms to the Bank’s strategic objective of assisting the two countries to achieve mutual cooperation in advancing their development agenda. It is in this context that the Bank has undertaken this study on bilateral trade, which seeks to promote trade-related economic cooperation between the two countries, by generating a deeper understanding of their bilateral trade-related benefits as well as associated opportunities and challenges.

This systematic analysis of implementable trade-related policy actions comes in handy to assist the two countries adopt appropriate policies and interventions that are imperative for the realization of their bilateral trade potentials. In particular, the analysis of the complex issues around border management including capacity gaps, macroeconomic and governance challenges, concrete steps towards realizing the export diversification potential in both countries, legal and administrative bottlenecks to openness and the role
of innovations and development partners, is a significant contribution towards advancing trade-related cooperation between them. The requisite policy actions, which remain imperative for vibrant bilateral trade cooperation between the two countries feature out prominently in the recommendations.

I am confident that the Governments of Sudan and South Sudan will step up their engagement to ensure that the recommendations of this study are implemented fully. The African Development Bank will remain steadfast in its support to this process, in an effort to ensure that Sudan and South Sudan fully realize their respective economic potentials.

Mr. Gabriel Negatu
Director General, Regional Development, Integration and Business Delivery (EAST)
PREFACE

The study on “Sudan–South Sudan Bilateral Trade” was undertaken at a time when the two countries were implementing the “Cooperation Agreement” signed in September 2012 to address the post-secession issues. Trade and trade-related issues featured prominently in the agreement, which rigorously underscored the longstanding historical and commercial ties between them. Cognizant of the potential benefits of cross-border trade with South Sudan, the Government of Sudan made a request to the African Development Bank to undertake this study.

The study reviews the regulatory and macroeconomic environment, the benefits of bilateral trade agreements in a global context, and uses this assessment to analyze the instrumental role of open bilateral trade-related efficiency gains that could spur economic diversification to accelerate growth in both countries. Noting their diverging natural and production characteristics, the study reveals an overwhelming scope for both countries to diversify their economies to expand the range of tradable goods and services. A detailed assessment of the current nature and dynamics of cross-border trade, including challenges and constraints is presented, along with potential areas for export diversification and development. The analysis thus provides a solid platform for the government, the private sector and development partners in both countries with the opportunity to engage in meaningful policy dialogue on trade and trade-related policy issues. It makes key recommendations for improving the competitiveness of both economies and enhancing their export orientation.

Among others, Sudan is strongly encouraged to broaden the scope of its exports in the quest to diversify its economy and boost trade, while emphasis is made for South Sudan to formulate a trade policy that is conducive for accelerating its integration into the global economy. The formulation of export promotion strategies is proffered as an economic imperative for both countries, accompanied by explicit guidelines for such strategies. For effective engagement to optimize trade-related benefits, the study proposes tangible steps towards improving bilateral trade governance as well as macroeconomic adjustments to improve the enabling environment for trade. It then proffers guidelines towards designing and implementing a comprehensive program for broadening the scope of tradable goods and services produced in each country, with special emphasis on the role of the private sector in this process.

In the context of its existing cooperation with the two countries, the African Development Bank will continue to engage with the two countries, and to provide technical assistance that advance their bilateral trade relations, especially as they seek to operationalize their “soft-border” approach. I hope that the two countries will endeavor to attain utmost cooperation in the implementation of the recommendations of this study.

Abdul B. Kamara
Resident Representative, Sudan Country Office (COSD)
ACKNOWLEDGEMENTS

The Study is an outcome of the realization by both the Governments of Sudan and South Sudan that the existence of two “viable states” is both a political and an economic imperative, especially for strengthening ties in the area of trade. It was against this background that the Bank responded swiftly to the request for a study on Bilateral Trade between Sudan and the then newly born country of South Sudan.

The report was prepared under the overall guidance of the Resident Representative of the Sudan Country Office, Dr. Abdul B. Kamara, with the assistance of the task manager Mr. Suwareh Darbo, Principal Country Economist and Messrs Yousif Eltahir, Senior Country Economist and Kenneth Onyango, Principal Program Officer. Their efforts are duly recognized and appreciated.

A comprehensive study like this entails extensive desk and literature reviews as well as interviews involving various ministries, agencies and departments concerned with trade and trade-related issues. Special thanks are due to these various agencies and departments in Sudan for providing valuable information and data. These include the Federal Ministry of Trade; Federal Ministry of Petroleum; Federal Ministry of Minerals; Ministry of Finance and Economic Planning; and Department of Customs Police, Chamber of Commerce, among others. A word of gratitude is also due to a number of institutions in South Sudan for their collaboration and technical inputs. These include the Ministry of Finance and National Planning; Ministry of Foreign Affairs and International Cooperation; Office of the President; Ministry for National Security; Ministry of Justice; Ministry of Commerce, Industry and Investment, as well as the South Sudan Customs Service.

The report has been greatly enriched by the peer reviewers in Regional Integration Department (RDRI) who added great value to the substance and provided technical inputs and reference documents. Their immense contributions are greatly appreciated.

A rigorous research and analysis of this quality could only have been produced by a top notch professional and a specialist in the field of trade. In this regard, the Bank would like to thank the consultant, Dr. Omotunde Johnson for preparing this solid and comprehensive report.
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ACRONYMS AND ABBREVIATIONS

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<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>AfDB</td>
<td>African Development Bank</td>
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<tr>
<td>ASYCUDA</td>
<td>Automated Systems for Customs Data and Management</td>
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<td>BAT</td>
<td>Bilateral Agreement on Trade</td>
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<td>BATA</td>
<td>Bilateral Agreement on Trade Authority</td>
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<td>BCMC</td>
<td>Border Corridors Management Committee</td>
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<td>BIA</td>
<td>Border Issues Agreement</td>
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<tr>
<td>CAR</td>
<td>Central African Republic</td>
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<td>COMESA</td>
<td>Common Market for Eastern and Southern Africa</td>
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<td>DFID</td>
<td>Department for International Development</td>
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<td>DRC</td>
<td>Democratic Republic of Congo</td>
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<td>EAC</td>
<td>East African Economic Community</td>
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<td>ECCAS</td>
<td>Economic Community of Central African States</td>
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<td>ESW</td>
<td>Economic and Sector Work</td>
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<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>IGAD</td>
<td>Intergovernmental Authority on Development</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>JICA</td>
<td>Japanese International Cooperation Agency</td>
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<td>JTCTR</td>
<td>Joint Technical Committee on Trade Relations</td>
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<td>LPI</td>
<td>Logistics Performance Index</td>
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<tr>
<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
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<td>OSBPs</td>
<td>One Stop Border Posts</td>
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<tr>
<td>SADC</td>
<td>Southern African Development Community</td>
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<td>SMEs</td>
<td>Small and Medium scale Enterprises</td>
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<td>SSP</td>
<td>South Sudanese Pound</td>
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<td>STP</td>
<td>Sudan Trade Point</td>
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<tr>
<td>UAE</td>
<td>United Arab Emirates</td>
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<tr>
<td>UN</td>
<td>United Nations</td>
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<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
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<tr>
<td>USAID</td>
<td>United States Agency for International Development</td>
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<tr>
<td>WTOAC</td>
<td>World Trade Organization Accession Commission</td>
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<td>WTPF</td>
<td>World Trade Point Federation</td>
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EXECUTIVE SUMMARY

The secession of South Sudan from Sudan and the plethora of unresolved post-secession issues continue to weigh heavily on the political and economic prospects of both countries. The post-secession issues relate to oil, security, border demarcation, the status of Abyei, the so-called Two Protocol Areas (Blue Nile and South Kordofan States), external debt and arrears, as well as a host of economic issues critical for cooperation and economic viability of the two countries, among which bilateral trade features very prominently. Therefore, trade and trade-related matters were central in the Cooperation Agreement signed in September 2012 in Addis Ababa, to which the two countries demonstrated commitment to building two viable independent but interdependent sovereign states.

The September 2012 Agreement makes provision for the pursuit of an independent trade policy by each country with respect to the other. The inextricable interdependence, as well as common historical and geographical ties, creates a compelling case for the two countries to engage in open trade, with a view to promoting the commercial interests and welfare of the citizens of the two countries. To understand the benefits from trade and trade related agreements between the two countries, and the associated challenges and opportunities, the Bank has undertaken a study on bilateral trade between Sudan and South Sudan, in order to support economic cooperation activities between the two countries.

The study reveals that the realization of the potential of trade between the two countries is bound to be a tall order given the paucity of physical and technological infrastructure that supports bilateral trade. For instance, few border posts have been opened. On the Sudanese side, only two of those opened are equipped with computer and electronic facilities, while operations at the other posts are handled manually. The Southern side is yet to acquire such electronic facilities. Putting such physical and technological infrastructure in place will be an important element of the capacity required to perform the relevant customs clearing tasks and trade facilitation processes.

The analysis reveals that Sudan has made some progress in improving the environment for trade and investments, including opening up the trade regime; phasing out food and fuel subsidies, repealing the negative list of imports (apart from those banned for religious, health and security reasons); rationalizing expenditures, downsizing the government, unifying the exchange rate; and addressing balance of payments and debt problems, among others. However, a lot remains to be done, including the need to avoid export restrictions that can be a combination of outright and temporary bans, high export duty, or setting a price on the exports that is higher than the prevailing international market price. In South Sudan, some major macroeconomic problems need immediate attention, including, certain elements of budget spending—particularly wages and salaries—need to be strictly subjected to realistic limits.

There are a number of uncertain welfare effects of trade policy reform which need to be considered in bilateral trade between the two countries. These include adjustment costs,
implementation costs as well as economic development and other policy considerations such as balance of payments (BOP) adjustment policy, fiscal challenges in trade policy reform, income and wealth distributional changes across individuals and businesses.

Policies that enhance diversification (and hence global trade competitiveness) of the economies of Sudan and South Sudan will also promote and expand bilateral trade beyond that achieved by simply creating the enabling conditions for trade discussed above. Efficient economic diversification policies will substantially enhance economic growth in the immediate future and for many years afterwards, raise per capita incomes, and expand offer curves in international trade (in other words, more goods and greater quantities to offer at possible terms of trade). The private sector in both countries would be essential in achieving economic diversification ambitions. Private sector development is an intermediate objective for policymakers pursuing diversification, as it helps to promote and raise the efficiency of investment and enhance technological change and innovation.

The study makes a set of recommendations for enhancing bilateral trade between the two countries. These include improving governance; addressing the urgent macroeconomic adjustment problems; improving the enabling environment for trade; designing and implementing a comprehensive program for economic diversification and paying particular attention to private sector development policies.

In terms of assistance, the Bank has already made an indelible mark on the development landscape in Sudan and South Sudan, with myriad interventions. Going forward, both Sudan and South Sudan could benefit from the Bank’s interventions by taking advantage of opportunities related to regional operations, especially in the area of trade. These could include project operations to address the infrastructure, technical and capacity constraints related to the development of cross border trade between the two countries.
1. BACKGROUND

1.1 Introduction

The objective of this Economic and Sector Work (ESW) is to come up with implementable actions that both Sudan and South Sudan can take to promote bilateral trade between them. The ESW dwells on exploring the potential gains from economic cooperation and from bilateral trade between the two countries, and exploring the conditions under which such gains can be expected to materialize. The ESW concludes with a set of recommendations for enhancing trade between the two countries.

1.2 Bilateral Trade Between Sudan and South Sudan

Prior to South Sudan’s secession in July 2011, no trade statistics were compiled between the two regions as they were then one country. Since that date, the flow of trade between the two countries has not been regular enough for the authorities to start compiling normal trade statistics. However, Sudan gathers some information on the commodities that have been traded so far, both formally and informally, including smuggling activities.

Based on those records, the flow of commerce between the two countries is indirect from Sudan to South Sudan, with informal flow of goods comprising petroleum products, sugar, sorghum, medicines, and various food items. Based on history, once normal trade resumes, the General Administration of Customs of Sudan expects trade between the two countries to be quite vibrant, with the flow of commerce from Sudan to South Sudan comprising more than two hundred types of goods: mainly, agricultural products and foodstuffs, medicines, fuel, clothes, shoes, building materials, and furniture, among others. There is no record of trade between the two countries of goods destined for third countries, with the exception of South Sudan’s oil transiting through Sudanese pipeline and port. The two countries are now working on a draft agreement that will permit such broader transit trade.

The two countries share Africa’s longest land border of over 2,000 km, as such, border management issues, especially the “soft borders” approach, is a fundamental principle enshrined in the Border Issues Agreement (BIA) of September 2012. The BIA will be implemented along the extensive, resource-rich, diverse and heavily populated border areas, where approximately 60% of the collective population of the two states lives. Thus, proper management of the common border is a priority of the two countries as they seek to develop bilateral trade which is critical for their development prospects. A Joint Technical Border Corridors Committee has thus been formed which agreed to ten border crossing points (corridors) between the two countries. Four states of Sudan (White Nile, South Kordofan, South Darfur and Blue Nile) will have common crossing points with five states

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1 From another source, we know that the cross-border trade from Sudan to South Sudan in 2011 was dominated by agricultural items—maize flour and grain, wheat flour, sorghum flour, sugar, groundnuts, lentils, rice, onions, and dates (DCDM, 2012). We do not have data on the flow in the other direction (from South Sudan to Sudan). In any event, many officials in Sudan estimate that 99 percent of the trade currently occurring between the two countries is via smuggling.
of South Sudan (Unity State, Upper Nile, Warrap, Northern Bahr-el Ghazal, and Western Bahr-el Ghazal). The means of transport across these points will be road (trucks), railways and river (steamers).

At each crossing point, the Sudanese authorities will inspect goods in accordance with customs regulation including quality and health standards—hence, type, quantity, and value of goods will be noted—and duties and fees collected, as will be value added tax. In addition to customs, other agencies involved in the inspection for Sudan will include, the Sudan standards organization, and health and plant quarantine authorities. Similar institutional structures also exist on the South Sudan side.

Despite the progress in setting up these regulatory structures, realizing the potential of trade between the two countries is bound to be a tall order given the paucity of physical and technological infrastructure that supports bilateral trade. For instance, only seven of the ten earmarked border posts have been opened. On the Sudanese side, only two of those opened are equipped with computer and electronic facilities, while the operations at the other opened posts are handled manually. The Southern side is yet to acquire any computer or electronic facilities. Putting such physical and technological infrastructure in place will be important elements of the capacity required to perform the relevant customs clearing tasks and trade facilitation processes. This will require clear functions being specified in law regarding the provision of infrastructure by the private sector and the public sector, including the central and the local governments.

1.3 Regional Perspectives of Sudan–South Sudan Bilateral Trade

Both Sudan and South Sudan have neighboring border countries apart from each other—six for Sudan and five in the case of South Sudan. The two countries would benefit from keeping their neighbors apprised of the trading relations agreed between the two, as these relations evolve. That way, the other neighbors would let them know of any concerns about unfairness that they might have and thereby prevent any potential damage to the relationships all around. Neighboring relations are also critical given the landlocked status of South Sudan, and given the potential of either Sudan or South Sudan to serve as a transit for commerce destined to, or originating from, other countries.

More specifically, South Sudan has vibrant and long-lasting trade relations with its neighbors, namely, Central African Republic (CAR), Democratic Republic of Congo (DRC), Ethiopia, Kenya, and Uganda. Prima facie, there does not seem to be any welfare economic rationale, in this context, for giving special preference to bilateral trade with Sudan, as compared with the rules governing trade with these other countries. Naturally, the treatments in these bilateral relationships will be mutual. For instance, if Sudan and South Sudan agree on free trade with each other, then South Sudan, for instance, would
not find it in its interest to automatically give free trade to its other neighbors unless they offer free trade to South Sudan as well.

Sudan, for its part, is a member of the Intergovernmental Authority on Development (IGAD) as well as COMESA. Apart from the Central African Republic (CAR) which is a member of the Economic Community of Central African States (ECCAS), all the other states bordering South Sudan are members of either COMESA or IGAD or both. Sudan, may, for example, also want to offer special trade arrangement with South Sudan to some of its COMESA members with which it does sizable bilateral trade or want to promote such trade. If it does, as part of mutual equal treatment, this will not violate COMESA rules.
2. BILATERAL TRADE AND INCENTIVES

The nature of bilateral trade activities in general is fairly well known and following a brief general discussion, some facts about the content of the current bilateral trading activities between Sudan and South Sudan are presented. Given the sizes of two countries’ economies, the degrees of diversification of their economies, their global competitiveness, and trade costs resulting from their existing policies, what factors will determine bilateral trade (volume, composition, and trading activities) between them? Basically, the answer is comparative advantage, economies of scale, and ‘gravity.’

2.1 Bilateral Trade Activities

International trade could be *formal trade* or *informal trade* and when the countries border each other, trade between them is often termed *cross-border*. Cross-border trade can go through official crossing/shipping points (border posts, ports, stations); but cross-border trade, in particular, often goes through unofficial crossing points, which may or not be legal, depending on the laws of both countries. At official crossing points, even cross-border traders (both importers and exporters) can be subjected to licensing, inspection, tariffs and other taxes. All formal trading is subjected to such conditions, whether the trade is between bordering states or not.

Producers of goods (commodities and services)—whether formal or informal—can be exporters as well. Alternatively, they could sell all or part of their products to other firms, enterprises or business persons who then do the exporting, with or without some domestic distribution. Exports can be smuggled to avoid certain trade costs—particularly official inspections, fees and taxes— or to violate prohibitions and/or quotas. In the process, the traders must find ways to reduce other trade costs associated with smuggling, including bribes to official enforcers of rules and payment for protection against those who might want to attack or rob them, particularly if the exporters are using unofficial exporting channels and routes.

Any export from Country X to Country Y, particularly in the case of states bordering each other, could be of use in Y or for re-exports to a third country or countries, W. This redirection could be legal or illegal. When illegal, it is an act of smuggling. When legal, it is typically because of transportation or facilitation and the official records will show that X, for example, has exported to a third country or set of countries, W, but has paid some handling or transit fees to Y. This kind of re-exportation activity is not of major importance or concern in this paper. However, smuggling from X to W or Y to W that goes via Y or X, respectively, will be affected by the policy focus in the paper.

When X producers/traders export to Y, directly or via other distributors, they could get payment in cash or credit, in the currency of X or the currency of Y, or the currency of a third country, W. For example the “representative” currency of W could be ‘dollars’ (in practice, typically US dollars). The exporters from X could bring back the funds and spend
in X or, instead, spend some or all buying commodities and/or services from Y or W. This is especially true for small cross-border traders. The expenditure desires of the exporters/traders from X would be among the factors influencing the currency composition of the funds they would demand in payment for their commodities and services exported from X to Y or to W (through X).

2.2 Comparative Advantage

Of major importance in explaining international trade, including bilateral trade, is the existence of comparative advantage in the classical and neo-classical sense. A country’s comparative advantage can result from geography, natural resources and/or factor endowments—namely, soil, climate, types of mineral deposits, rivers, lakes and ocean, and forest. Comparative advantage can also emerge and change over time with population density (and hence, among other things, available land space for agriculture and other goods heavy in the use of land, etc.), development history and experience, and/or wages relative to labour productivity in particular activities. Thus, even where countries X and Y are neighbors, and hence similar in many respects, part of their trade may be due to comparative advantage in this basic sense. For instance, if the two countries differ in factor endowments, say due mainly to different natural resources or types of skilled labor, then each will have a comparative advantage (relative to the other) in producing the goods that are most intensive in the use of the factors of production in which each is relatively well-endowed.

2.3 Economies of Scale

Much bilateral trade, in today’s world, is intra-industry/intra-commodity group trade, or what some call the bilateral trade of similar products, or “the similar-similar problem;” that is, the trade is essentially two-way exchanges within narrowly defined product categories (Dunn and Mutti, 2000, and Krugman, 2009). An important reason for this is economies of scale. Countries that are very similar in development, natural resources, etc., from the perspective of comparative advantage, could trade with each other, not because of comparative advantage in the classical or neoclassical sense but because of economies of scale.

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3 Imagine two countries, i and j that can both produce two commodities, k and w, using only their labor and capital. Suppose in country i the labour and capital that can produce one unit of commodity k, if used in producing commodity w, can produce 5 units of commodity w, whereas in country j the labour and capital that can produce one unit of commodity k can produce 10 units of commodity w. Then, given the demand for the commodities in the two countries, countries i and j may stand to benefit from country i concentrating its resources more heavily in the production of commodity k, country j concentrating its resources more heavily in the production of commodity w, and then both countries engaging in international trade with each other. Country i is said to have a comparative advantage in producing k and country j has a comparative advantage in producing w. Some or all of the labour and capital producing commodity w, in country i, can then be diverted to producing commodity k. The example being used here indicates that, in the absence of trade, in country i the labour and capital that can produce 10 units of w can produce 2 units of k as compared to one unit of k (as in country j). With 2 units of k, country i can get more than 10 units of w from country j. Similarly, some or all of the labour and capital producing commodity k in country j can be diverted to producing commodity w. By giving 10 units of w to country i, country j can get more than one unit of k, which is a lower sacrifice (opportunity cost) than what country j can achieve with only local production of k. The total (aggregate) production of both commodities will increase with the same labour and capital of both countries. Under competitive conditions, the prices of commodities k and w under trade will settle somewhere between the prices in the two countries before the trade.
With economies of scale the average cost of production (cost per unit of output) declines as output increases. In discussing economies of scale, economists differentiate between external economies of scale and internal economies of scale. External economies of scale are realized at the level of the industry and not necessarily at the level of the individual firm; hence increases in output do not necessarily lead to domination of the industry by one or just a few firms. In contrast, with internal economies of scale, the economies are realized within individual firms as they grow larger, which often result in domination of an industry by one or a few firms—in other words the emergence of a monopolistic or oligopolistic market structure.

External economies of scale are often the consequence of collective efficiency that can accrue to clustered firms (agglomeration of enterprises). In general, collective efficiency comes from two factors, namely: external economies and joint action. At least four types of external economies have been outlined in the literature: (1) market access (2) labor market pooling (3) intermediate input effects and (4) technological (or knowledge, in general) spillovers (Oyelaran-Oyeyinka, et al, 2007, and Yusuf, et al, 2008).

Market access has to do with the ability to attract buyers and thus the benefit of locating within the cluster. Labor market pooling is the concentration of specialized skills that often develop within the clusters. The pooling occurs through skills upgrading within a cluster and the attraction to the cluster of persons who already have relevant skills. Intermediate input effects are externalities associated with the emergence of specialized suppliers of inputs and services. This could be due to changes and specialization among existing firms in the cluster or attraction of new firms from outside. Technological spillovers involve the diffusion of technological knowledge and ideas among the firms in the cluster.

As for joint action of firms within a cluster, it is the rapid communication as well as the cooperation among the firms that often create the opportunities for doing so. Such joint action, among other advantages, can greatly foster innovation.

Over time, of course, the above forces can influence the emergence (and hence location) of clusters (especially industrial clusters), as countries move forward in their development. In other words, path dependence (initial conditions and evolutionary forces, given those conditions) matter in the evolution of clusters and the emergence of external economies of scale. More simply put, the benefits from the above collective efficiency increase with the size of the industry; hence external economies of scale are realized by the industry as a whole and each firm, irrespective of its size, benefits from those economies of industry scale.

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4 For the role of external economies in international trade, (Krugman 2009), and Krugman et al (2012).
5 Brian Arthur (1994), Chapter 7 : Self-reinforcing Mechanisms in Economics,” for discussion of path dependence and its evolutionary effects on increasing returns.
A consequence of economies of scale is that, if bilateral trade between two countries that are fairly ‘similar’ becomes much freer and fairer\(^6\) than before, both countries should definitely gain from economies of scale because, with the economies of scale, the prices of the goods that both countries produce and can now also import from each other will tend to fall with the larger market size which can be exploited by the most efficient producers of the various goods. However, in the realignment, some producers in both countries will lose some and even all of their domestic markets to the other country’s producers. Transport and other trade costs, which will still exist, will, of course, continue to play an important role in how the realignment plays out as will the new set of other economic policies.\(^7\)

Apart from realignment due to effects traceable to external economies—due in turn to the effects of clustering—an interesting challenge that will also ensue from an appropriately reformed trade policy is that of the optimal location for a single producer that can serve the two markets but is not really benefiting from being part of a cluster. The producer can locate in the two markets and bear the fixed costs in each one of doing so. Alternatively, the producer (perhaps even benefiting from internal economies of scale) can locate in one of the two markets and then ship supplies to the other market with an associated transport cost. Not surprisingly, the interaction of transport cost with economies of scale/increasing returns can create a comparative advantage for one locality in the production of the good. The optimal solution often becomes to locate production close to (that is, in) the larger market, from which the commodity is then exported to the other market (Krugman, 2009). Again, economic policies and trade costs play important roles in determining the optimal solution for the producer.

Now, if economies of scale (in this case, perhaps only internal economies of scale) are indeed large enough compared to trade costs, so that production tends to be concentrated in the larger market (an element of the so-called home market effect hypothesis, which says that big countries produce more of goods with scale economies), other things being equal, then buyers of the commodity living in the smaller market do indeed gain from the trade. Without clear countervailing benefits, there would be a welfare loss to the residents of the smaller market if the policy environment and prohibitive trade costs of one or both of the countries force production for local demand in the smaller market to take place in that smaller market.

Interestingly, this also means that there could be situations in which a producer of a good in Country i for which there is demand in Country j (perhaps not exploited before by the producer in Country i) can increase the welfare of citizens in Country j by opening production facilities in Country j. This will be optimal if the cost per unit of producing what is demanded in Country j is lower when produced in that country than the cost per

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\(^6\) The notion of fair trade is elaborated below, in the main text.

\(^7\) For example, both South Sudan and Sudan could be able to produce two food items F1 and F2. But suppose total consumption of F1 in the two countries is F1\(^*\), with F1\(^s\) consumed in Sudan and F1\(^s\) in South Sudan and suppose F1\(^s\)=.75F1\(^*\). Suppose the exact opposite is the case for F2; in other words, F2\(^s\)=.75F2\(^*\), where F2\(^*\) is total consumption of F2 in the two countries. Then it could make sense, given economies of scale and other benefits of specialization—and with the appropriate transport and other trade costs as well as economic policies in the two countries—for F1 to be produced in Sudan and F2 in South Sudan and the two countries trade with each other to satisfy the demands in their countries.
unit of producing it in Country i plus the cost of transporting/shipping the commodity from Country i to Country j.

More generally, even if there are increasing returns to scale, for particular cases they may or may not be big enough to counterbalance the effects of existing trade costs. If the trade costs can be reduced by policy changes, both countries i and j would benefit from such policy changes, even though in some particular case(s) the smaller of the two markets (say j) could then lose the opportunity of benefitting from foreign direct investment—that is, by the firm of Country i investing in Country j— that would have occurred under the old regime of trade costs.8

2.4 Gravity

A third broad factor affecting trade flows is an attraction similar to gravitational pull. In the context of the gravity model of international trade (Anderson 2011),9 one can say that a good k supplied at its origin i, with the available supply identified as $X_i^k$, is attracted by a potential demand (expenditure) for (on) that good at destination j, to be identified as $X_j^k$. But the bilateral flow from i to j, $T_{ij}$, is affected by (1) the origin-destination distance, $d_{ij}$; (2) other associated trade costs (including trade facilitation costs),10 due mainly to the policy environment in i, j and other countries supplying k; (3) the prices and the qualities of k from alternative origins (alternative suppliers to j); and (4) the nature and severity of bilateral frictions or ‘closeness’ between i and j.11 The gravity model thus brings out the importance of distance and economies’ sizes12 in explaining bilateral trade flows.

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8 As a simple example, suppose the firm is in country i, the bigger market, and is considering whether to set up facilities in Country j to which it also exports the good. Then let K be the additional fixed cost of operating the facilities in j and let the marginal costs be expected to be the same whether production takes place in facilities in i or j. Then suppose, for the foreseeable future, demand in j is expected to be Q (perhaps based on current sales experience). Suppose t is the trade cost per unit of the commodity. Then, if t is sufficiently high before the trade reform, it is possible that $Q > K/t$ before the trade policy reform. If t is lowered by the trade reform, then it is possible that $Q < K/t$ after the trade reform. In that case, after the trade reform it is better for the producer to locate in the bigger market and export to the smaller market rather than set up facilities in the smaller market (Krugman 2009).

9 Of interest, for those unfamiliar with the Gravity model, is Head (2000).

10 Trade costs, broadly defined, include all costs incurred in getting a good to a final user other than the marginal cost of producing the good itself: transportation costs (both freight costs and time costs), policy barriers (tariffs and nontariff barriers), information costs, contract enforcement costs, costs associated with the use of different currencies, legal and regulatory costs, and local distribution costs (wholesale and retail). Trade costs are reported in terms of their ad-valorem tax equivalent” (Anderson and van Wincoop, 2004, pp. 691-2).

11 Trade facilitation costs, for instance, would be affected by various infrastructure facilities (‘visible’ and ‘invisible’). As regards the ‘invisible infrastructure’, see, for introduction, the discussion in Staples (2002). Special attention is often given to trade facilitation costs because of the great ability of policymakers to affect them directly; but all trade costs are affected in varying degrees by policymakers.

12 Empirical studies have found support for the following equation, other things being equal, which forms the core of one version of the basic Gravity model: $T_{ij} \sim Y_i Y_j / D_{ij}^\gamma$, where $T_{ij}$ is the value of trade between countries i and j; $Y_i$ and $Y_j$ are the gross domestic products of countries i and j respectively; and A is a constant term (Krugman, Obstfeld, and Melitz (2012). The ‘•’ symbol, of course, represents multiplication. Even more generally, the gravity equation to be estimated can be specified as:

$T_{ij} \sim \frac{A Y_i Y_j}{D_{ij}^\gamma}$

Here $\alpha$, $\beta$, and $\gamma$ are estimated directly from the data, without assuming that they are equal to 1. The distance effect, $D_{ij}^\gamma$, is mainly via transport costs but can also reflect ‘distance’ other than physical distance—for example, ‘ease of contact.’
‘Bilateral frictions’ and ‘closeness’ matter greatly in this framework, causing potentially identifiable discrimination in bilateral trade flows (given appropriately adequate and reliable data). In other words, after controlling for distance, other trade costs, as well as quality, and relative supply prices (of k by all suppliers), the share of good k bought by j from i, in the total purchases of k by j, should equal the share of i in the total world production (or production capacity) of k. If j’s purchases from i are greater than this “fair equilibrium” quantity, then closeness is apparent. If it is less, then “bilateral frictions” could be the explanation.13

‘Closeness,’ can result from ‘cultural affinity.’ However, other logical factors that can bring about the sort of closeness that fosters preferential treatment in bilateral trade include information (and hence knowledge) about the trading partner, mutual trust whatever its origin, and joint membership in a regional trading bloc.

Bilateral frictions and closeness often work through effective discriminatory trade costs, due to policy actions in Country i, Country j or both. Such policy actions would typically involve policy measures that are not uniformly applied to all other trading partners.

Not surprisingly, gravity and economies of scale often interact with comparative advantage to determine bilateral trade flows. Most notably, in our present context, by drastically reducing bilateral frictions and the associated trade costs, in favor of fairness, welfare can be enhanced in both Sudan and South Sudan, exploiting the distance advantage and enabling the full effects of comparative advantage, gravity and economies of scale to come into play. In other words, under fair trade, shares in the trade of similar goods among states bordering Sudan and South Sudan will reflect normal trade costs, productive capacity in the countries and relative prices (the prices charged by a country relative to the average of the other neighboring countries, given quality). Otherwise, such trade will reflect traditional comparative advantage.14

The gains from bilateral trade between Sudan and South Sudan would be even greater as the two economies diversify, which among For, as countries become more advanced (with improved labor skills, more developed infrastructure, and more business-friendly institutional and organizational environments) they also become candidates for greater integration into international production chains and global trading networks. Other things should help increase their international trade competitiveness in general. They can then benefit from the operations of multinationals that outsource production, and engage

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13 Suppose, is spending by j on good k produced in i, is total expenditure (world-wide) by j on k, is total world-wide sales/production by i of k and is world-wide production/sales of k from all sources/suppliers. Then, one can hypothesize that, after controlling for the other determinants of bilateral trade flows, mentioned in the text, particularly distance and trade costs, then in the absence of closeness and bilateral frictions, which bias trade, in the resulting “fair equilibrium,” . In that case there would be support for hypothesizing closeness, if , and there would be support for hypothesizing bilateral friction, if .

14 In other words, the ‘attractiveness’ of bilateral flows between Sudan and South Sudan will, for different goods, be affected by the attractiveness (due to, relative prices, trade costs, and quality) of ‘similar goods’ between Ethiopia, Eritrea, Egypt, Libya, Chad, Central African Republic (CAR) and Sudan, on the one hand, and between South Sudan and CAR, Democratic Republic of Congo, Uganda, Kenya, and Ethiopia on the other.
in horizontal and vertical foreign direct investment (FDI)\textsuperscript{15} and offshoring, in order to exploit production cost and productivity differences as well as the advantages (via saving in trade and transport costs) of proximity to major regional markets for specific products. Closeness and gravitational pull can enhance the ability of both countries (Sudan and South Sudan) to gain from exploiting such opportunities, including via cooperation arrangements, with welfare gains to both. The ability to qualify for acceptance into global value chains (and hence to benefit from vertical FDI) is one of the most important forces in the flows of FDI from developed to developing countries.\textsuperscript{16}

2.5 Cross-border Trade, Tax and Exchange Rate Regimes, and Smuggling

There is often substantial legal and illegal trade in regular marketable goods across most borders of African countries; the nature and volume of such trade typically depend on the structure of trade taxes, the laws regulating trade and the operation of exchange markets (Johnson, 1987). Of particular interest in this trade is the smuggling that occurs, especially to avoid domestic taxes on exports and domestic bans on exports of certain goods, as well as to import from neighboring countries without payment of import tariffs. Smuggling activity becomes optimal for the trader when the extra marketing costs due to smuggling activity are lower than the official taxes and fees avoided. Rather than trading via ‘official’ channels, the smuggler self-exports or self-imports via ‘unofficial’ channels. Another alternative, which can be identified as pseudo smuggling, is for the producer to operate via official channels but then bribe the state officials in order to avoid export/import bans, licensing fees, tariffs and domestic taxes.\textsuperscript{17} The bribery, in this case, can substitute for outright smuggling and hence for certain extra transport and other costs incurred in full-scale smuggling.

\textsuperscript{15}In horizontal foreign direct investment (horizontal FDI), the parent firm sets up a subsidiary/affiliate which replicates what the parent does but which is in another location/country. In the case of vertical FDI, the foreign subsidiary/affiliate is simply part of a value chain, and hence is engaged in only part(s) of the production process, which has been broken up by the parent firm. In fact, sometimes the affiliate is an independent firm which could even be serving more than one multinational firm or conglomerate. For the broader economics of trade and production decisions of multinationals, with regard to location of production, outsourcing, and horizontal and vertical foreign direct investment, (Bernard, et al, 2007; Feenstra, 1998; Helpman, 2006; and Markusen, 1995).

\textsuperscript{16}One can think of production as involving a ‘chain’ of activities ranging from conceptualizing of the product to bringing it to market. The concept of a ‘global value chain’ highlights not only the activities themselves and their inter-linkages, but also the value addition that occurs at each step in the production process (McCormick, 2007).

\textsuperscript{17}See, also, Azam (2007).
For instance, suppose we have countries i and j, with currencies ci and cj, and we have a world numéraire currency — say the dollar ($)—and suppose the spot exchange rate for the dollar is determined in a unified domestic exchange market in each country and the exchange rate between the two currencies reflects their official (cross) exchange rates into dollars. Then, in the case of exports the smuggler is concerned simply with the extra revenue per commodity unit obtained by avoiding taxes, fees and bans domestically. He/she smuggles up to the point where the extra revenue equals the extra ‘marketing cost’ due to smuggling (including payment for protection and bribing). When the exporter’s country has a parallel exchange market in which the dollar is valued more than in the official market, he/she can get some additional revenue by smuggling if he/she can obtain receipts for the smuggled exports in dollars to bring back and sell in the domestic parallel market. It is important to note that some of the goods smuggled from i to j could be destined for a third country or set of countries W.

18 In other words, suppose in the exchange market, say at the border, the number of units of currency i per unit of currency j, is:

\[ \frac{c_i}{c_j} = \left( \frac{S}{S'} \right)_i \left( \frac{S}{S'} \right)_j \]

where \( S/S' \) and \( S'/S \) are the exchange rates of the two currencies into the dollar at the official unified exchange markets. Then there is no premium for either currency in the market over the official rates. In that case, ignoring normal exchange conversion costs, if the exporter from i sells in j and receives the amount \( c_i \), then after conversion into $ in j, she brings it to i and converts into the local currency, \( c_j \), she will then receive the amount:

\[ \frac{c_i}{c_j} \cdot \frac{c_j}{S} \]

But suppose, instead, in the market at the border (or in some local parallel/black market) the exchange rates of the two currencies differ significantly from the official rates such that:

\[ \frac{c_i}{c_j} = \left( \frac{S}{S'} \right)_i \left( \frac{S}{S'} \right)_j \theta > 1 \]

Then the j currency has a premium in the unofficial market over the i currency.

19 Suppose \( t_x \) and \( t_x \), are the per unit trade taxes experienced by the official border trader in country i and country j, respectively; \( m_x \) and \( m_x \), are the marketing costs; \( \theta \) is the premium of the \( c_i \) currency in the relevant parallel market (if there is no parallel market \( \theta = 1 \), if there is a parallel market with premium of the \( c_i \) currency, then \( \theta > 1 \)). Suppose also \( \varepsilon(X) \) is the function representing the smuggling/pseudo smuggling cost of ‘illegal’ border operations (including bribing) from i to j; \( \varepsilon' \) and is the first derivative of the \( \varepsilon \) function. Then the first-order condition for maximization of receipts of the smuggler/pseudo smuggler is (see Johnson, 1987): (1 - \( t_x - m_x \))\( \theta \) - (1 - \( t_x - m_x \)) = \( \varepsilon' \)

20 For instance, South Sudan exports goods to Uganda that are re-exports (goods not produced in South Sudan): e.g., dredgers, stainless steel scrap, motor spirit, self-propelled bulldozers, warm clothing (DCDM, 2012). These, of course, are not necessarily smuggled; but they could be if the incentives are strong enough.
On the importing side, the smuggler or pseudo-smuggler wants to minimize cost of the basket of goods imported, where cost will include import taxation. Analogous to the case of exports, the goods imported from \( j \) to \( i \) could originate not only in \( j \) but also from a third country or set of countries \( W \). Importers, traders, producers, and consumers in Country \( i \) in this case find themselves in a situation in which they could import officially (directly or through licensed importers and traders), from \( j \), goods that are produced in Country \( j \) or in \( W \), or they could smuggle the imported goods through \( j \) via the border. They will mix up their importation activities so as to minimize cost.\(^{21}\)

*Bilateral frictions* discussed earlier will, for example, encourage smuggling, because on both sides of the border traders are being prevented by political forces (and hence sub-optimal high trade costs) from engaging in a mutually beneficial trade. If they do not smuggle, economic agents (consumers and producers as relevant) on each side of the border will now spend additional resources to produce domestically (or purchase from alternative suppliers in other countries) goods they can obtain more cheaply under a regime of freer and fairer trade. In addition, the societies’ resources are also being wasted by the national authorities’ trying to enforce trade restrictions that do not make economic sense for the citizenry as a whole. With adequate data, there are easily quantifiable elements of this economic loss.\(^{22}\)

\(^{21}\) With imports into \( i \), whatever their origin, done through official channels, producers and consumers in \( i \) pay import tax at a rate \( t_{mi} \). With imports through or from \( j \), smuggled into \( i \), producers and consumers in \( i \) may pay tax in \( j \) at a rate \( t_{mj} \). Suppose now that the cost function for smuggling or pseudo smuggling, by \( i \) residents from or via \( j \), \( g(M_j) \), is. Then the first order condition for cost minimization is (Johnson, 1987):

\[
(1 + t_{mj}) - (1 + t_{mi}) \phi = 0
\]

Here \( \phi \) is the first derivative of the \( g(M_j) \) function.

\(^{22}\) The quantifiable elements will include, for example, the extra price residents have to pay to other suppliers of the goods affected by bilateral frictions, which now are coming instead from more expensive suppliers (after including trade costs) in other countries; the reduction in other domestic goods’ production if resources get diverted to produce domestically some of the restricted imports from the undesirable neighbor; and the resources used to police the trade restrictions and the smuggling thereby encouraged.
3. PROMOTING BILATERAL TRADE: ENABLING POLICY ENVIRONMENT

Given the existing state of development of their economies, including their diversification and international competitiveness, a major objective of the country authorities of Sudan and South Sudan should be to create conditions for trade, in general and between them, which would be welfare-enhancing in both countries. For this, it would be useful for both countries: (1) to put in place certain fundamental economic policies (microeconomic and macroeconomic); (2) to take actions that enable trade costs, in general—that is, with all countries—to be as low as economically rational; and (3) to create an environment of fair trade vis-à-vis all trading partners, while taking into consideration commitments within regional trade arrangements of which they are members.

3.1 Microeconomic Incentives to Enterprises

Policies to create the appropriate microeconomic incentives to enterprises, in order to foster welfare-enhancing trade, will be discussed, a little more, later in this paper. Note that such policies can be grouped under the following categories:

- **Openness of the environment** within which production and trade activities of firms take place (this environment constituting markets, institutions, immigration laws, information flows, state ideology, and access to the authorities);
- **Administrative barriers to trade** (that is licenses, approvals, permits and other requirements that affect trade costs);
- **Legal environment** (the efficiency of the courts and the legal system in dealing with business enterprises, in general, and international trade activities, in particular); and
- **Taxation** (all forms of taxation that affect international trade activities of enterprises).

3.2 Governance Policies Affecting Trade

Good governance, ultimately, is about putting in place processes, rules and organizational arrangements to ensure that policies are optimal (from an economic welfare perspective) and that implementation is as full and complete as possible. Selected aspects of good governance policies, mentioned here, will also be further elaborated a little later in the paper. Meanwhile, note that the relevant governance policies can be grouped within the following categories:

- **Macroeconomic policies** (in particular, inflation, exchange rate, currency convertibility, and capital mobility);
- **Sociopolitical governance** (corruption, government efficiency, maintenance of the rule of law, the sustainability of policies, and, in general, political stability); and
- **Compliance with appropriate international standards and codes** (these being international standards and codes that relate to economic governance and management)

23 Full discussion of the topics requires a separate study on private sector development.
in general as well to particular areas such as the financial sector, monetary and fiscal policies, and international trade).24

3.3 Nonfinancial Business Regulation

A coherent policy towards business regulation needs to take into account the costs and benefits to businesses of compliance as well as the costs and benefits to the rest of the society of specific regulations. In this area, the issues to be addressed by policymakers, as will be briefly elaborated later in the paper, will be mainly the following:

• **Standards**, especially with respect to safety, health, risks, and corporate governance; and
• **Market regulation** (especially maintaining the integrity of the market place, and appropriate laws regarding certain codes of conduct by firms including full and accurate business information disclosure and transparency by the firms to market participants, particularly investors and clients).

3.4 Financial Sector Support for Trade

Policymakers in many African countries are of the view that the availability and cost of finance to many businesses, particularly small and medium scale enterprises (SMEs), from the formal financial sector, primarily banks, are a major constraint on the performance of the businesses—that is, output and productivity. In other words, the argument is that the supply of finance is small relative to the effective demand, at the observed interest rates. In addition, the cost of finance in real terms is said to be “high” when compared to international trade levels.

One view is that, the above situation exists because of the “conservatism” of the banks and their unwillingness to invest in understanding the local firms (especially the SMEs) and developing appropriate instruments to supply them with greater financial instruments at reasonable cost and with comparatively low risk.

Another view is that the effective demand for bank loans by the businesses is low and that the low supply and high charges reflect risk, opportunity cost and administration/servicing cost of making those loans.

A third view is that the low supply reflects the underdevelopment of the financial system and the inability of the regulatory and legal framework to address specific and well-known problem areas which continue to daunt the incentives of banks to lend to the neglected businesses, including via developing suitable instruments to extend loans to those business.

If there is suboptimal supply of credit to small and medium scale enterprises, in particular,

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24 A full discussion on compliance will not be done in this study; indeed, this can be a very big topic on its own.
in both Sudan and South Sudan, then all three of the above views must be contributing to the explanation. Given the importance of finance in the development of much export activity, especially for those producers and/or exporters that want to move towards nontraditional exports, the authorities are encouraged to investigate, via a specific study in each country (Sudan and South Sudan), how these various factors operate and what policies can be put in place by public policy, the financial institutions and the businesses themselves to effect a rise in the effective demand for, and in the supply of, loanable funds to the businesses. The focus, no doubt, should commence with commercial banks. However, the role of an existing Stock Exchange (in Sudan) should also be considered, in particular to see if that organization can make a contribution in this area in the near future, whether directly or indirectly; for example commercial banks could raise funds in the Stock Exchange dedicated for lending to SMEs. However, the author would advise the authorities to avoid selective/quantitative credit controls, which attempt to force banks to lend a certain fraction (or certain amounts) of their credit/investment portfolios to certain enterprises.25

3.5 Fairness of Trade Policies

Given trade costs, an important theme of this paper is that fair trade is welfare-enhancing. Another theme is that government policies should aim at minimizing trade costs, as much as is rational to do—that is, reducing such costs up to the point where the marginal benefits of additional reduction equals the marginal cost of doing so. This is also welfare-enhancing.

These themes will underline much of the discussion in this paper.

3.6 Selected Noteworthy Characteristics of an Enabling Environment

When Sudan and South Sudan succeed in putting in place, and fully implementing, policies that bring about environments enabling optimal welfare-enhancing international trade, including bilateral trade between the two countries, a characterization of their environments will include the following:

- Low trade facilitation costs (relative to the import and export prices of goods); 26
- Absence of delays, bribery and harassment in official trade, due to behavior of customs and border and tax officials;
- High degree of safety in cross-border trade activities, including insignificant damage and theft of goods in transit;

25 In this area of access to credit/finance, see, as an introduction, the analyses in Johnson (1974, 1975) and Karlan and Morduch (2010).

26 An important component of trade facilitation, and hence a major contributor to trade facilitation costs, is what has come to be known as ‘invisible infrastructure,’ which essentially comprise automated procedures, software and systems—information and communication technologies (ICT)—that simplify and speed up data management, processing and communications in economic transactions (Staples, 2002).
• Absence of quantitative restrictions on exports and imports (such as quotas or banning of certain exports), except under special circumstances (such as religion, public health, and security);
• Absence of subsidies or price controls on traded goods;
• Absence of monopoly marketing boards (or price stabilization funds/boards) with implicit taxation in their pricing policies;
• Open entry and exit into trade activities (exporting and importing) in both countries;
• Unified domestic exchange markets—that is, no parallel exchange market or multiple official exchange rates/markets;
• Neither currency is (significantly) overvalued or undervalued, relative to some relevant world convertible currency such as the US dollar;
• Low nominal tariff rates on all imports and tax rates on all exports, and these tariff and tax rates are set purely for revenue purposes and not for protection or trade restrictions, as relevant; and
• Neither country uses trade taxes, subsidies or other impediments to trade for balance of payments reasons.

In short, this is precisely the kind of environment that both countries should aim at creating as soon as possible.

3.7 Note on the Welfare Effects of an Enabling Environment

If the enabling environments are welfare-maximizing, then, in a welfare economics sense, bilateral trade will be optimal in volume, direction, and composition. The mix of trading channels (official versus unofficial) will also be optimal. Traders, consumers, and exporters are able to do, legally, what they would like to do, given their resources and their individual opportunities. Even more importantly, it would not be possible to improve the welfare of some individual or firm by changing some price or policy instrument without making some other individual or firm worse off. At the equilibrium trade point, therefore:

• Net of trade costs, the relative prices of tradable goods of the two countries will tend to be the same;
• The open market exchange rates of the two countries’ currencies will, in both markets, reflect monetary and balance of payments conditions in the two countries, including expected inflation and interest rate movements in the two countries; and
• Both countries will be able to avoid the welfare losses resulting from incentives for smuggling and corruption.

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27 Given all other (nontrade) economic policies of a country, a trade policy change increases welfare of the country by enabling the country’s residence to attain higher levels of real consumption (move to higher indifference curves). This can happen because the trade policy change enables the country’s production of goods and services to expand (the production possibility curve moves outwards). It can also happen because the production mix of the country changes in reaction to the changes in relative prices engendered by the trade policy reform (that is, the optimal production mix moves to a different point on the same production possibility curve). If trade policy is really optimal, it will not be possible to reform trade policy of the country, other things being equal, in such a way that the welfare of the residents increase. Note that changes in other economic policies can affect trade and hence welfare.

28 In other words, with optimal trade policy, a country will also have achieved so-called Pareto optimality.
4. THE ENABLING ENVIRONMENTS IN THE TWO SUDANS

The current conditions in Sudan and South Sudan have some way to go to become environments that are welfare maximizing in the sense just elaborated. However, it would appear that it is feasible for them, without too much difficulty, to attain such environments. Much of the current sub-optimality is due to the current economic stresses to which they have not fully responded with optimal policies, as well as the political and security strains to which they are currently subjected.

4.1 Sudan

Sudan’s trade regime has opened up considerably since the reforms of the 1990s, when the government reduced tariffs, abolished most export monopolies and eliminated exchange rate controls. The maximum import duty was lowered from 45 per cent to 40 percent. Sudan’s import tariff rates currently is in five categories: (i) generally zero percent for capital goods and fixtures; (ii) three percent for raw materials; (iii) ten percent for intermediate goods; (iv) twenty-five percent for semi-finished goods; and (v) forty percent for finished goods. Sudan’s rates for the last two categories, in particular, are high, even by African standards.

It would seem that both Sudan and South Sudan should aim for phased reduction of tariff rates that, at worst, are in the 10-12 percent range, within a reasonably short time period of say 1-3 years at the most. This is based on the assumption that trade expansion takes place with their new efforts to promote trade; their collection of tariff revenue is more successful, especially because of reduced incentives (resulting from lower tariff rates) to evade tariff via smuggling and bribery; and, finally, that the authorities are able to put in place greater tax-administration efforts, particularly in the direction of income taxation. As a minimum, both the IMF and the World Bank can give technical assistance in this last area.

Meanwhile, as a positive step towards improving the trade-enabling environment, it is also noteworthy that Sudan has repealed the negative list (apart from imports banned for religious, health or security reasons) that has been used to limit imports and replaced it by import tariffs. In the past, Sudan has used import restrictions on some 400 products—sometimes for short periods of a few months only—for political reasons or as part of import substitution policy. This policy seems to be on the way out in favor of the alternative of only import tariff.

Sudan also sometimes imposes export restrictions that can be a combination of outright

29 In 1994 the country applied for WTO membership, and the process is still on-going.
30 These have included, sugar, plastic products, furniture (wood and metal), marine products, biscuits and cakes, and milk (JICA, 2012).
ban, temporary ban, high export duty, or setting a price on the export that is higher than the prevailing international market price. Leather goods (including raw leather) and scrap metals have been particularly subjected to this sort of regime. This policy is not conducive to export promotion and should be suppressed, in favor of policies that promote domestic production. In this regard, it is noteworthy that companies that obtain licenses under Sudan’s Investment Encouragement Act are allowed to export freely, even when the Ministry of Trade imposes export restrictions (JICA, 2012).

In this context, it is recommended that a general principle be maintained: namely, rather than restrict exports (through quantitative restrictions, taxation or price controls), policymakers should provide efficient incentives for increases in domestic production of the goods concerned. Apart from neutral incentives to all producers in the context of economic diversification policies, selective intervention in markets to boost production of certain products and services can take the form of tax relief, subsidies, entrepreneurial and other types of training, market research, assistance with raising standards, access to finance and fostering of joint ventures and clusters. Unfortunately, the economics of such intervention (including ensuring their efficiency, in terms of value for money) needs to be explored in a different study from this one.

Sudan needs to review its export licensing procedures to make sure that they do not impose unnecessary costs or simply discourage some potential exporters. For instance, there is no reason why the Ministry of Trade should need to “endorse” the export contract after checking, for example, to make sure that the contract terms are “fair.” Interestingly, this same endorsement process is not required for border trade (JICA, 2012).

Decision making in Sudan on trade policies will no doubt be made difficult over the next few years by the country’s challenging macroeconomic policy environment.31 Given the current policies, as well as the general economic and security outlook for the country, Sudan’s growth prospects will continue to be shrouded in uncertainty. There is risk of inflation, the exchange rate will continue to depreciate significantly, and the balance of payments will be under severe pressure, including a current account deficit relative to Gross Domestic Product (GDP) that could, at best, be around the 6-8 percent range, even after painful and substantial adjustment by all concerned. Under the circumstances, more adjustment is likely to be inevitable; export promotion is certainly one area where adjustment policies can begin to bear fruit in the near term. In this light, Sudan can do more to improve the enabling environment for trade expansion in general and for bilateral trade with all its neighbors, including South Sudan.

Whereas trade expansion, will, by itself, help improve the macroeconomic picture for Sudan, with the pressure to reduce expenditure, for fiscal, balance of payments and debt management reasons, reducing tariffs may appear difficult for a while. In the meantime,

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31 This situation, of course, has arisen partly because of the breakaway of South Sudan and the associated loss of substantial oil receipts and partly because of the actual or potential military skirmishes and insecurity in Darfur, Southern Kordofan, Blue Nile States and certain other parts of the country.
fiscal measures of the authorities, with a positive outlook for ‘adjustment,’ include reduction of subsidies (on food and energy); consolidation of ministries; increased tax revenue from export-oriented activities like oil and gold production; reduced expenditure as some of the internal rebellious conflicts subside; and the prospects of recovery in the tertiary sub-sectors (restaurants, health, education, transport, and banking, among these). However, certain expenditures, especially the wage bill, are not easy to reduce either. In addition, with new states rather recently established, the pressure on expenditures will continue.32

In resolving the fiscal problems, better budgetary management will clearly help. The indications are that budgetary management needs improvement both at the level of the central government and at the states, especially the latter. Among other things, budgetary monitoring and control systems need to improve, including auditing; and the oversight by Sudan’s legislature and Sudan’s Supreme Audit Institution need to be strengthened. Raise tax rates relentlessly is not likely to be good for developing the private sector. In that context, policies that raise GDP growth via methods that do not depend heavily on government direct fiscal expenditure should be sought, at least for some period of time.

The IMF in its 2012 Article IV consultations discussions with Sudan stressed that weaknesses persist in financial management and revenue mobilization.33 For example, the IMF staff welcomed the moderate tax increases, but felt that there was need for a concerted effort to expand the tax base “through tax policy and administration measures.” The IMF staff also felt that while gold producers currently were paying a 7 percent royalty, they should in addition be subjected to the business profit tax. On the expenditure side, the IMF staff, for example, noted that the budgeted increase in social safety nets was not targeted and hence could affect efficiency in its management, while the general wage increase in the civil service could be inflationary. The IMF staff also recommended limiting transfers to states to 30 percent of total revenues, in keeping with the constitutional provisions. Moreover, the IMF staff recommended that reforms be put in place for managing the development budget, including project selection and monitoring procedures [IMF 2012 (2)].

Sudan’s balance of payments and debt problems are indeed being addressed (AfDB, 2013), although more could be done. In particular, as regards the balance of payments, monetary policy is being tightened;34 the exchange rate is being adjusted in steps despite continued exchange rate overvaluation; and additional export promotion measures to address specific disincentives are being put in place—including especially elimination of restrictions on exporters’ use of their export proceeds. Investigating specific market opportunities for export expansion, particularly with countries in COMESA, IGAD, the

32 The increases in tax rates on income, on telecommunications, and on consumer imports, that were supposedly recently implemented (AfDB, 2012), should, nevertheless, be reconsidered by the authorities, since they are likely to encourage increased tax evasion, with little or no revenue gain.
33 The key fiscal measures adopted in June 2012 (revenue, expenditure, and social spending measures) are listed in IMF 2012 (2), p. 13.
34 Among monetary instruments being used, important seem to be liquidity management using Bank of Sudan bonds or Musharaka Certificates (GMCs) and reserve requirements. For example, the central bank raised reserve ratio from 11 to 12 percent in 2012. However, this is a blunt instrument, should be used very sparingly, and the central bank should permit averaging of the ratio during the reserve period.
Arab League, and the European Union, should inform policy makers about additional policy measures that could ease the balance of payments constraints. As regards, external debt, Sudan is cooperating with the IMF and the World Bank not only to benefit from technical assistance but also to be able to obtain some relief and financing (AfDB, 2013).

A major issue is exchange rate policy. Sudan needs to unify the official exchange market and constrain any active management of the official rate in a way that speedily eliminates the curb market or, at worst, make such a market very small and insignificant. Apart from recommending unification of the four rates of the official regime, the IMF staff also recommends extending the commercial banks rate to all transactions and allowing “greater exchange rate flexibility” to facilitate adjustment while “safeguarding” foreign exchange reserves (IMF 2012 (2)). The authorities apparently want some kind of managed float when unification is achieved; the required flexibility could still be obtained within such a regime. The IMF will, no doubt, be happy to render advice on this.

In its efforts, so far, at grappling with its fiscal and balance of payments difficulties, Sudan has not increased tariffs, highlighting its commitment to trade openness and perhaps its suspicion that increases in its tariffs from their already high levels are unlikely to yield fiscal or balance of payments rewards. Hence, Sudan should be very receptive to discussing substantial reductions of tariffs on imports, as part of a trade policy agreement with South Sudan.

From a broader governance perspective, the Sudan authorities will need to address, as resolutely as possible, their many internal political challenges, as they try to adjust economically to the country’s new reality and implement policies over which they have control, to bring about economic diversification, including export diversification. Without addressing these challenges successfully, the cost of achieving any degree of diversification could be quite high—to the citizens, the private business sector, the government, and to the aid organizations supporting Sudan. A major dilemma for the authorities is the simultaneity in the relationship between economic growth and political instability. Political instability adversely affects economic growth and poor economic performance aggravates political instability. In this process, the transmission mechanisms work through the adverse effects on the level of investment and on the efficiency of investment.

Sudan’s relations with the outside world also need improvement; such improvement will benefit investment and the efficiency of investment and thus the ability and the cost of achieving any degree of diversification. In particular, normalization of relations between Sudan and South Sudan will benefit both countries. Such normalization is desirable, inter alia, as it will help to reduce military expenditure by both countries and create conditions for

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35 The official exchange regime has four rates: a central rate, a subsidized rate for wheat, a gold exchange rate used by the central bank in its gold transactions; and a commercial banks rate (IMF 2012 (2)). The central rate is used for fuel importation, payment of government obligations, and valuation assessment at customs. The commercial banks rate applies to all other transactions.

36 For instance, economic sanctions by the US limit access to international financial markets. Moreover, the external debt situation is stifling and debt relief will be welcomed. With little to no access to concessional loans the government can borrow mainly from Non-Paris Club bilateral creditors. Being in arrears to the AfDB also does not help here.
improvement in trade relations between the two countries. In addition, the normalization will help in solving Sudan’s debt overhang problem by improving the chances of timely debt relief. As a contribution to this process, Sudan should, as a minimum, avoid closing its borders, for any reason, with South Sudan. Sudan should, also, do its part in implementing the various agreements the two countries signed on September 27, 2012.37

4.2 South Sudan

South Sudan is heavily dependent on oil for its foreign exchange. Subsistence agriculture and informal employment are the dominant sources of livelihood, with some 42 percent of the working population engaged in agriculture (AfDB, 2012). Essentially, the country needs, in particular, to put in place fundamental strategies in education, infrastructure, skills training, and governance and economic management capacity building to get the development process going in an orderly way.

Meanwhile, the country has had to adjust to budgetary and balance of payments problems emanating from disruptions in oil flow through Sudan and the closing of borders on occasions by Sudan. In addition, some major macroeconomic problems need immediate attention. In particular, certain elements of budget spending—particularly wages and salaries—need to be strictly subjected to realistic limits, and the exchange rate regime needs reform. With respect to the latter, the central bank has been operating a fixed peg to the US dollar, since the introduction of the South Sudan Pound (SSP), even though there is not adequate foreign exchange to meet the demand at the rate set by the bank. Hence a sizeable parallel exchange market has emerged, where the SSP is seriously depreciated relative to the official rate.

No doubt, coherent development policies to diversify the economy, including export promotion policies will help in addressing the balance of payments and macroeconomic challenges. Detailed treatment of the coherent development and export promotion and diversification policies that each of these two countries should pursue is not an objective in this paper.

From a broader governance perspective, ways must be found to help the policy makers of South Sudan to appreciate, given all the development experience of the last one-half century at least, that they have major challenges, as their country confronts the enormous task of building basic institutions of governance, in addition to creating a sound economic policymaking environment, including one that can wrestle with the current macroeconomic adjustment while at the same time designing appropriate inclusive growth policies .38 In that context, for South Sudan, if there is one lesson of economic history of which its citizens should be aware, it is path dependence and the attendant risks and costs of setting

37 No doubt, the agreement on the final status of Abyei and the final border demarcation will take some time to resolve. But, in the meanwhile, normal relations in other respects can occur, as is seen from various examples throughout the African continent for the past several decades.
38 (IDA-IFC, 2013).
off on the wrong path. In other words, there are self-reinforcing mechanisms operating in such a way that, institutional changes or failures, once began along a particular track tend to shape the path of future institutional changes. Changing course can then become extremely costly—economically, politically, and socially.

South Sudan can learn from the experience of other countries of Africa South of the Sahara. To begin with, a major (probably the leading) underlying reason for poor economic policy environments is weak societal demand (demand outside the state) for good economic policies pursued by the state, in the face of political elites with no effective external constraints on them to make it in their own self-interest to pursue good policies without domestic demand pressures.

Mistakes at the dawn of independence in deciding on political and economic institutions and organizational structures can send a country off on noncooperation tracks, where ethnicity, poor political leadership, government corruption, and absence of appropriate rights of citizens to consultation on economic matters become serious obstacles to the emergence of a good (state) policy environment in the country. That's path dependence of the unfortunate kind (Johnson, 2004).

In brief, the South Sudanese need to establish their institutions using processes that take proper account of the pluralism of their society and create institutions to control the state. Political leaders need to have self-interest in pursuing good economic policies. Hence, they need strong pressure on them to effect rapid economic growth and transformation of the economy. This means that there should be, continuously, strong societal demand for such policies; otherwise political leaders will be able to maximize their utility, without instituting good economic policy environments. Pressure to build the appropriate institutions, in the first place— institutions that, among other things, will enable societal demand within South Sudan to influence policymaking— can also come from many outside players, such as international organizations like the African Development Bank, the World Bank and the IMF.

Apart from the significance of path dependence, the importance of cooperation is another lesson of economic history that the South Sudanese must learn. The role of institutions in the development process has come to be greatly appreciated over several decades now. Institutions are rules governing behavior in human interaction. Institutions coordinate expectations and constrain behavior in interactions of individuals. They also affect the transaction costs (information, negotiation, policing, and enforcement costs) of such interactions, and help determine the distribution of the costs and benefits that ensue from the interactions. Hence institutions are at the core of the incentive structure that motivates behavior of the kind that creates wealth.

39 Typically they are categorized into economic, educational, religious, political, kinship, and legal. Institutions are also classified in forms such as norms, constitutions, and property rights.
However, institutions are themselves outcomes of cooperation. In other words, they are elements of the order that cooperation brings about. A powerful argument, then, is that a country succeeds in the development process when its citizens are able to cooperate to bring about political, legal, and social institutions that are favorable to economic development and growth. Both trust (especially generalized trust) and self-interest play major roles in all forms of cooperation. Cooperation in this context is the willingness to communicate, negotiate, and reach agreement, on the design and maintenance of institutional and organizational arrangements, procedures, and mechanisms, including how to share the ensuing benefits and costs, without fighting, coercion, or total domination by one party.40

After decades of civil war and the consequent displacement and mixing of populations, aggravated by the returning refugees, the challenge of cooperation is enormous, especially since issues like land rights and the conflict between and among pastoralists and farmers compound the problem in many areas. Another cooperation challenge is how to deal with the security forces and militia, from a budgetary standpoint as well as trying to build a conventional cohesive national defense force of a modern state.

A third lesson of economic history for the South Sudanese is the imperative of country ownership for program success: country ownership of policies and programs will contribute to improving the policy environment in South Sudan. The essence of ownership is the acceptance of full responsibility for the consequences of a program or policy. Country ownership of a program exists when there is general belief by citizens of the country as well as by noncitizens that the country representatives freely choose the program to be implemented, and when there is at the same time general acceptance of the citizens of the country of full responsibility for the outcome of the program. When a country “owns” a program, it willingly accepts the costs of any failure. A country with a rational decision-making process will then act consistently with this belief and acceptance of responsibility. A rational decision-making process is one that is generally expected to result in a program that is in the best interest of the citizens of the country as a whole; in other words, an expected outcome of such a process is a program that maximizes the expected utility of the citizens, subject to unavoidable economic and other constraints (Johnson, 2005).

Program success tends to be correlated with degree of ownership, because the commitment to implementation tends to be stronger and indeed the program is typically more realistic in its objectives and in using instruments that could more assuredly attain the objectives. In trying to ensure ownership of its policies and programs, the South Sudanese authorities should be resolute in seeking proper domestic legitimation for the policies and programs.

40 In the development process, two forms of order emerge from cooperation, namely, spontaneous order and authoritarian order. Spontaneous order emerges without central direction by the state. Generalized trust and self-interest facilitate such cooperation, while corruption, free riding, and ethnicity hinder it. Civil society leadership can accelerate cooperation by promoting mutual respect among groups, generalized trust, and self-help organizations, as well as helping to motivate the state to provide an enabling environment. Authoritarian order occurs when individuals and groups in the society agree to grant authority to a central body or individual to coordinate institutional and organizational activities and to enforce the rules and oversee the organizational structures that flow from such coordination. Under authoritarian order, the emergence of institutions is no longer spontaneous and rules are not necessarily self-enforcing. Instead, the process of change is coercive—rules, regulations, and orders are prescribed and enforced by the state.
5. DESIGN OF TRADE POLICY REFORMS IN BOTH SUDANS: CHALLENGES

Designing trade policy environments that are optimally enabling to bilateral trade, which in turn is welfare-enhancing and fair to both countries, may be challenging because of real world concerns and developments that both countries’ policymakers may face. The authorities of both countries must prepare themselves to address those challenges if they emerge during the reform process. The nature of these challenges will be discussed in this section and how the authorities can address them.

5.1 Uncertain Welfare Effects of Trade Policy Reform

As an overarching problem, the welfare effects of trade policy reform, especially the short to medium-term effects, are often of great concern to policymakers, because of uncertainty. This in turn may result in a delay in the decision making of the authorities. In general, a major source of concern would be that both the volume and the structure of the country’s trade could be affected, by the policy reforms to be proposed, in such a way that there may be large adjustment costs to individuals, firms and certain regions of the country. The adjustment costs could include: changing residence and sectors of employment; skills training and/or retraining; and loss in value of certain fixed and/or immobile assets (land, and machinery, for example).

The problem to be addressed, in this context, would be of even greater concern if the reform relates to bilateral trade and one of the two countries perceive that it has by far (per capita or relative to its GDP) the greater total adjustment cost to bear.

When adjustment costs are identifiable and large, even if not completely quantified, policies (including government budgetary support) could be proposed to address them, in order to encourage acceptance of the policy reform by the population at large. In that case, the distribution of the burden of the adjustment costs (directly and indirectly), among members of the country’s population, becomes an issue that policy makers will not be able to ignore, because elements of the population will raise the issue. In making the case for implementing reform, without delay, policy makers will need to be clear about the benefit of the reform and indicate how they intend to address the adjustment costs.

5.2 Implementation Costs

Both for effecting and sustaining policy reform measures, there will be need for personnel (technical experts, managers in government departments, etc.), physical infrastructure (roads, one-stop border posts, and the like), so-called invisible infrastructure (import licensing procedures, pre-shipment inspection, and various procedures at customs), and various materials and supplies that would be continuously replenished as part of the operational (running) cost of business regulation, oversight, and trade facilitation.
Countries, therefore, often find it financially burdensome to design, implement and sustain major trade policy reform to bring about the “ideal order” in trade relations, particularly bilateral trade relations.

Indeed, in the case of Sudan and South Sudan, as both countries are finding out, to bring about orderly trade relations, there are major reforms that both countries need to make. It is not possible, in a paper like this one, to attempt full costing, ex ante. In a few cases (such as for one-stop border posts to be discussed below), the authorities will find such costing useful, to facilitate cost-benefit calculations.

As part of the governance process, the authorities may also need to put in place processes, rules, and organizational structures that are subjected to continuous auditing and reviews to ensure sustainability of the reform. In addition, keeping tract, and informing both populations, of the gains from instituting the reform and sustaining it, will be essential. One beneficial factor that operates here, and needs stressing, is that the direct costs (to government and the private sector) of maintaining a suboptimal trade policy regime is typically much greater than the cost of reform and its sustenance, and the reform brings additional benefits to production, consumption and trade.

Various “user” charges, in the form of “processing fees,” “tolls” “licensing fees,” etc., may need to be levied under the reformed regime. A challenge then would be to keep them low enough so as to discourage corruption, bribery, and smuggling. The benefit to the “users” could be made clear via sufficient education and information. That way, even informal cross-border traders would welcome the new facilities.

5.3 Economic development policy considerations

In the Agreement on Trade and Trade Related Issues Between The Republic of the Sudan and The Republic of South Sudan, signed on September 27, 2012, paragraph 1 (1) states: “Each State shall pursue an independent national trade policy with respect to the other State.” Emerging from what was in essence a free trade area between Sudan and South Sudan, South Sudan, in particular, was keen to enjoy its new freedom in the direction of trade, namely to go to other sources than Sudan for certain imports and, in the case of exports, to sell exportable to other countries. Hence, it did not, in particular, want to have a free-trade policy with Sudan while imposing tariffs on imports from other countries, especially other neighboring countries.

An important consequence, also, is that, in the present situation, each country has effectively given itself the freedom to use trade protection as a development tool. Indeed, even though Sudan is the more developed of the two countries, it may, nevertheless, have goods that it also may want to protect from imports from South Sudan. With further investigation, it may be possible to find out if in fact either country has goods that they would like to protect from competition of firms/products coming from the other country, on development grounds (the so-called infant-industry argument, for example). While
this author doubts this, in any event, in direct negotiations between the two countries, each country is free to make this known. For, as a matter of principle, despite the loss in consumer welfare by the protecting state, both countries, via negotiation, may still permit such protection, as long as it applies to imports from all sources.

There still may be a major issue to address. Namely, either country (Sudan or South Sudan) may initially want to protect (under the influence of certain special interests) domestic producers against importation of one or more of the goods that the other country can sell to it. In that case, goodwill may be lost and an agreement for policy coordination and fair trade between the two countries may not be possible. It may then be necessary to bring up the argument that protection does not stand on solid economics ground, especially since more often than not the “infant industry” never grows up. Here, the argument would be that, both from a fiscal and welfare standpoint, there are superior direct selective intervention tools that governments can use to foster efficient production in any particular activity. Protection is an economically inefficient tool.

5.4 Balance of payments ‘Adjustment’ Policy

Sometimes countries choose to use trade tax policies (in particular tariffs and quotas) for balance of payments reasons. It is noteworthy that neither country is explicitly using trade tariffs, quotas or other trade policy instruments directly to cut down on imports, for balance of payments reasons. Hopefully, both countries will continue that policy approach and remain committed to using monetary (including exchange rate) and fiscal policies—that is, macroeconomic policy tools—instead, in addition to production policies to stimulate exports. As regards the macroeconomic policies, it is recommended to closely follow the advice of the IMF in this area.41

5.5 Fiscal Challenges in Trade Policy Reform

Many African countries have a high dependence on revenue from international trade in their fiscal operations. This leads to high import tariffs and export taxes, the latter especially on agricultural commodities and minerals. Any trade policy reform must address this issue, since these governments are typically constrained in their ability to raise fiscal revenue from other sources.

This problem, by itself, will not prevent fair trade from being implemented. However, in general, it may reduce the gains from trade. Even more delicate, if one of the two countries is more dependent on such tariff revenue than the other, negotiating an agreement on trade policy may be more difficult than if both were equally dependent. For example, the high dependence on oil by South Sudan for budgetary income may give it more leeway to set low import tariffs, while Sudan may have less flexibility in this area, at least in the near future. In general, it is advisable for these countries to improve their tax regimes, if necessary, so that they are not very dependent on international trade taxes but rather on income taxation.

41 In the case of Sudan, IMF 2012 (1) and IMF 2012 (2).
Heavy dependence on import tariff revenue often leads to countries having rates on international trade that are sometimes set so high that they are not even revenue maximizing for the activities concerned, for reasons including tax avoidance via corruption and smuggling. In addition, high tariff rates discourage social optimal bilateral trade. Thus, from the point of view of fiscal revenue and welfare enhancement, fairly low tariff rates can be far more optimal.

The same applies to export taxation. It may be far more welfare enhancing to tax the profit of the exporter than to tax the gross revenue from exportation. The taxing of profits will not typically discourage exportation or encourage tax avoidance as much as the export taxation of gross revenue, at least for profit tax rates that are internationally competitive. Indeed, export taxation encourages smuggling and underreporting of exports, especially in the case of minerals/oil and agricultural commodities, which right now are important in the exports of the two countries.

5.6 Income Distribution

Trade policy reform, enabling freer and fairer trade, can engender long-term changes in relative profitability of different activities, with major income and employment effects for the economy as a whole, and hence for a significant fraction of the population of individuals and businesses. In other words, trade policy reform can have significant effects on income and wealth distribution. Since it is typically not too difficult to demonstrate that the country as a whole will benefit from the reform, it is possible, in principle, to have those who benefit from the trade policy reform to assist, financially, those who experience long-term adverse wealth consequences. However, apart from some major exceptions—especially owners of businesses and activities that are forced to disappear—it is not usually easy to identify the long-term losers. This is particularly true, since most losers will bear only short-term to medium-term adjustment costs discussed above.

However, the fear of long-term wealth loss for some, combined with inadequate assistance with adjustment costs, has traditionally posed serious problems for advocates of major trade policy reforms. Certain elements of the population often actively resist the policy changes, by various devices, including social and political action. In particular, from world-wide experience, the producers who see or foresee losses and/or the need for costly adjustment to the trade policy reform could organize, to impede the reforms, far more readily than the gainers, even though the latter are in the majority.

The authorities need to have a policy response when such opposing groups are likely to be powerful and willing to unite and take political or social action. The authorities will have to decide on how to address such a challenge. One obvious strategy, apart from clear and widely disseminated information on the gains from the reform, is to get the population to focus mainly on the adjustment costs and to try to convince those who are faced with those costs that long-term costs would be minimal, if not insignificant. That way, policy actions could include various subsidy and loan programs (subsidized skills training, relocation
programs, unemployment grants and the like) if the authorities are convinced that such assistance makes sense economically and politically. However, that also means that the authorities must have the fiscal tools to collect these funds from those who benefit directly (and immediately) from the trade policy reforms.

The above issues are not likely to pose challenges for either Sudan or South Sudan as they try to reform their trade policies, inter alia, to promote bilateral trade between the two, as the income effects of the reforms will be positive both absolutely and in terms of distribution. In South Sudan, for example, many subsistence farmers will find themselves drawn into the market with the expanding market opportunities. Those in the market already will find demand for their business increasing. All in all, job opportunities will, therefore, expand. The benefits of trade expansion with Sudan, the peace dividend, and any cooperation in policymaking and implementation between the two countries will all definitely help income distribution by expanding employment (in agriculture, livestock, fishery, forestry, and tourism, for example) and increasing the incomes of the poor, particularly in the rural areas. There will also be benefits to education as school attendance will be favorably affected, which will also help reduce income inequality.

5. 7 Nationalism, Culture, Self-sufficiency

For various reasons—mainly non-economic (such as nationalism, culture, and a desire for self-sufficiency)—countries sometimes want to use trade taxes and quantitative restrictions to foster domestic production of some goods (commodities and services), discouraging importation of substitutes.

There are two interesting analytical issues here. First is the issue of whether trade taxes and quantitative restrictions are the optimal methods of selective intervention in such situations. Typically, ‘no’ is the answer. Instead, direct and socially efficient intervention policies (such as explicit subsidies to domestic producers) are superior. The main reason is that, with direct intervention policies, the costs of the policies will be explicit allowing rational social choice to be made.

The design of such selective intervention policies can, of course, pose its own challenges. From basic economic theory, we would advise that the objectives of intervention, the extent of the intervention, and the instruments chosen in the intervention, should all be calibrated taking into account three interrelated principles, in order to ensure good value for money. These principles are: making sure that the objectives of a particular intervention policy make economic sense; that the policy supports strong firms, which by definition can be competitive in open markets; and that normally the focus, in assessing value, should be on production and output.

The idea that the intervention policy should make economic sense, should encourage thinking in terms of some expected social rate of return on the ‘resources’ expended in intervention, taking a medium- to long-term view. One way of having the benefits of
intervention accrue to firms that will produce the best results (in terms of social rate of return)—that is, strong firms—is by ensuring that there is openness for all firms to compete for the ‘rights’ and privileges under the intervention regime and that the selection process which decides the winners meets generally acceptable criteria of objectivity. Finally, the focus on output should help to minimize any loss in gross domestic product (GDP) or reduction in gains from trade in the attempt to achieve the chosen noneconomic gain which, hopefully, will be made explicit to all.

The second analytical issue is that if the restrictions on imports via taxes and/or quantitative restrictions apply uniformly to all countries then there is no unfairness in trade in the strict sense. However, the policy may adversely affect the trade of particular countries, especially, in this case either Sudan or South Sudan. In that case, that fact would need to be considered in the trade agreement between the two countries. The nature of “appropriate compensation” or “countervailing policy” may need to be made explicit.
6. NEGOTIATING AND IMPLEMENTING A NEW AGREEMENT ON BILATERAL TRADE POLICIES BETWEEN SUDAN AND SOUTH SUDAN: COOPERATION, POLICY COORDINATION, SELF-INTEREST AND TRUST

Given the reality of their history, for certain normal economic relations between the two countries, including active and legal bilateral trading relations, some formal effort is needed to make possible the required cooperation and policy coordination/harmonization. Since both sides are showing signs that they see the benefits of normal bilateral trade between the two, such requirement, in principle, should be possible to achieve, reasonably soon.

Despite this optimism, there still seems to be a need to reach a fairly tight and well-structured agreement between the two countries on the design of trade policies in both countries. This would include enforcement mechanisms, namely, reporting to each other and sometimes jointly working on enforcement procedures. In addition, such an agreement should include the topic of data collection—bilateral trade statistics (including what to collect, how to share information, and, if relevant, how to share the associated costs).

Such aim for policy harmonization and coordination is not new in the African context. Most notably, in this case, Sudan belongs to the Intergovernmental Authority on Development (IGAD) where, among other objectives, aim at harmonizing policies with regard to trade, customs, transport, communication, agriculture and natural resources (see IGAD, Profile). In the context of this paper, there is need to be clear about the strategies in the design process, the details to be contained in the overriding agreement, as well as how to build trust that both sides will fully implement the agreement. In this process, self-interest will play a major role.

6.1 The Evolution of Cooperation: Incentive Compatibility, Focal Points and Leadership

Cooperation, as stated earlier, is the willingness to communicate, negotiate and reach agreement on the design and maintenance of institutional and organizational arrangements, procedures, and mechanisms, which are then fully implemented in good faith, by all parties, without fighting, coercion, or total domination by one party. Both trust and self-interest play important roles in this process.

Both at the design and implementation stages of any particular agreement, building trust between the parties is important. The two parties will be in a classic game situation where, especially at the early stages, self-interest will play an important role in determining cooperation. In that context, it is useful to have a governance arrangement that encourages

42 The other members are: Djibouti, Eritrea, Ethiopia, Kenya, Somalia, and Uganda.
truth-telling and a willingness to follow the rules established, voluntarily—that is, without the need for costly enforcement mechanisms. In other words, the aim is to come up with agreement(s) that is (are) incentive compatible.\textsuperscript{43} Mutual trust is easier to emerge and to build when it is obvious to both parties that any agreement is incentive compatible.

In the early stages of cooperation, when trust is low, self-interest has to dominate trust. During that period, having arrangements—rules, procedures and mechanisms—that are self-enforcing should therefore be preferable, when they are possible, to get the cooperation process going. \textit{Self-enforcement} emerges from the fact that, since it is in the self-interest of the parties concerned to comply voluntarily, there is no need for elaborate enforcement mechanisms. That is what incentive compatibility is all about. What this all means, also, is that cooperation must start with areas where narrow self-interest is clear for all parties and the required contractual relations between the two parties, in this case, are not complex in their design requirements or costly to enforce.

Self-interest will be at three levels, namely, individual self-interest within each country; the collective self-interest within each country; and the collective self-interest between both countries. For instance, the collective self-interest within and between both countries can arise in the face of exogenous constraints (that is, from the outside world) or common interests vis-à-vis the rest of the world.

Collective self-interest is facilitated by focal points. Focal points are clues that provide a key to the possible solutions to the ‘game.’ In general, characteristics of focal points in coordination and/or bargaining situations (games) include prominence, uniqueness, simplicity and precedence. The shared colonial history of these two countries, the cultural connections among certain segments of their populations, or the obvious dependence on each other in reducing the costs to each of achieving certain economic objectives, give them opportunities for coming up with many clues from which to forge mutually agreed solutions in many areas of economic cooperation.

Over time, as the desire for greater and more complex cooperative arrangements come into play, appropriate enforcement mechanisms need to be developed. Given the cost of designing and enforcing complex contracts and arrangements, \textit{trust must, therefore, be increasing over time for cooperation to grow and widen}. Basically, \textit{trust} lowers transaction costs, as all the details of arrangements do not have to be explicitly agreed. In addition, supervisory and management costs are lowered when there is significant trust.

In cooperation and in building trust, \textit{transforming leadership} does matter. Such leadership will be in business, government and civil society. Such leadership will stress the gains to cooperation, and hence solidify collective self-interests. As already intimated, the gains to cooperation will constitute an important focal point. The leadership in both countries can stress the material gains to individuals and to businesses that result from trade, peace, and cooperation in economic policymaking.

\textsuperscript{43} Gibbons, 1992, pp. 164-66.
An important advice that emerges from this analysis is that both countries should deeply involve the private business sectors and civil societies of both countries, in discussions between the two countries and in negotiating agreements (the overriding agreement and the subsequent ones that flow from that). Thus the chambers of commerce of both countries should be actively involved as should the major business establishments in international trade, commerce, agriculture, industry, tourism, and minerals. Labor organizations should also be invited to participate in the discussions. Finally, civil society organizations and groups should be invited to participate in the negotiations and discussions involved. As regards civil society, the universities should be particularly invited to join the discussions.

6.2 The Bilateral Agreement on Trade (BAT) and the Replacement of the September 27, 2012 Agreement on Trade and Trade Related Issues

The contracting parties (Sudan and South Sudan) need to be clear about the overall objectives of any overarching agreement, as well as about the nature of the rules, processes and organizational arrangements in the agreement(s), including the governance structure(s) for implementation.

6.2.1 Bilateral Tariffs

The two countries should agree on a simple structure of low tariffs to be applied on all imports from each other. Each country will then decide whether the bilaterally agreed tariff rates will apply to goods when imported from any other country in the world. The country (Sudan or South Sudan) that decides on applying the same tariff rates to all other countries in the world will not need to develop rules of origin for customs inspection. In addition, for that country, all trade promoted between the two countries (Sudan and South Sudan) results in trade creation and there is no trade diversion. This proposal also means that the two countries can agree on having free trade between the two and one of them can then apply the free trade privilege to other countries while the other country does not. This could, of course, put pressure on the latter country to negotiate free trade arrangements with other countries as well.

6.2.2 Transparency of Trade Costs

The two countries will provide information to each other on all aspects of trade costs, sign a memorandum of understanding on the elements of trade costs (tariffs, fees and special taxes, sanitary and phytosanitary and other standards, and other trade facilitation elements of trade costs). The rules and understandings could relate also to specific levels of rates and charges, trade procedures and standards, and goods that are banned for

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44 Indeed, some government representatives in Sudan have mentioned to AfDB staff that, to facilitate economic cooperation between the two countries, a joint business council could be formed by the two countries; apart from trade promotion such a council could also promote private sector investments.

45 One obvious implication is that, if Sudan is in a free trade arrangement within COMESA, it may make sense for South Sudan, as a minimum, to negotiate free trade arrangements with COMESA members it borders, if it does not want to join COMESA and participate in the free trade arrangement.
importation for reasons such as religion, public health or security. In this context, any special charges for exportation and importation, such as license fees or ‘wharf charges,’ should be made transparent. Trade procedures will relate to documents to be submitted (such as health certificate, commercial invoice, certificate of origin, bill of lading, packing list); company registration document before being allowed to legally engage in importation or exportation; and licenses, fees, or official endorsement/stamp needed for permission to proceed with a contract or transaction under consideration.

In the spirit of the September 27, 2012 agreement on trade and trade-related issues, both countries are cooperating on customs procedures to ensure that laws are obeyed and that they are able to control smuggling, fraud and outright customs violations. Hence, following discussions, the two countries have recently drafted an agreement that would ensure cooperation in enforcing their customs laws, including enabling planned efforts on either side to prevent smuggling. The countries will inform each other about their laws, assist each other in enforcing their laws, and share technical knowledge about activities of criminal activity and ways of identifying such activities (Government of South Sudan and Government of Sudan, 2013).

Both countries should also understand and agree on their foreign exchange regimes (including any requirement of advance deposits for imports or surrender requirements for exports). This is extremely important in ensuring fairness in the trade relations between the two countries.

The Bilateral Agreement on Trade Authority (BATA), discussed below, should be granted oversight responsibility for the observance of the rules and understandings discussed here as well as for any other matters not mentioned here that either country believes are important because they can affect trade costs and fairness in trade relations between the two countries. In that context, complaints about trade costs can be filed against each other and submitted to the BATA for resolution. The complaints should preferably be in a form that specifies and/or shows clearly that any identified violations or policies, resulting from official/government action or inaction, have adverse effects on trade costs and hence bilateral trade. Increases in trade costs resulting from real economic factors, unrelated to official policies, or which are outside the control of the authorities, cannot be the subjects of complaints.

6.2.3 Permissible Government Intervention in Private Sector Activities

Both governments should be free to intervene in their domestic markets and address, directly, perceived market failures. Otherwise, the governments should not be free (that is in the context of a bilateral agreement) to intervene in the market, outside of the terms of the bilateral agreement, using trade policy instruments such as tariffs and quotas.

Market failures, inducing the government intervention of relevance, could be the result of externalities (e.g., knowledge, information generation, beneficial effects of experience
of particular firms), all resulting in tangible ‘inputs’ freely available for capture by other firms (domestic or foreign) that have not spent resources to bring about the beneficial externalities. The instruments of government intervention could be in the form of direct or indirect subsidies to the externality generating firms or some other instrument that the authorities view as socially efficient (copyright, patents, etc.).

6.2.4 Scope of BATA

Commodities (physical goods), services (such as banking, insurance, shipping, transportation, tourism, and consulting), and trade-related aspects of intellectual property rights should be covered in the agreement.

6.2.5 Government Procurement Rules

Both countries should agree to a set of rules to ensure that neither government protects its own producers against competition from the other country’s producers in bidding for government contracts.

6.2.6 Agreement on Non-tariff Instruments of Trade Policy

Non-tariff instruments of trade policy should be avoided, in principle. These instruments would include: import and export restraints such as import quotas, export quotas, and prohibitions and local content requirements. If either country wants to use any such instruments, it must seek the consent of the other country. An objective in such consultation would be to ensure that the instruments do not, as a minimum, affect bilateral trade between the two countries.

6.2.7 Bilateral Agreement on Trade Authority

The parties shall establish a Bilateral Agreement on Trade Authority (BATA), with appropriate autonomy and accountability. There will be no further need for a Joint Technical Committee on Trade Relations (JTCTR) as contained in the 27 September 2012 agreement. Indeed, the JTCTR over-politicizes the whole cooperation arrangement and downplays the interests of business and civil society in trade relations between the two countries.

The BATA could be established for a predetermined fixed term or it could exist until the authorities in both countries agree that trade is normalized and there is no need for a special authority for this purpose.

The BATA should have four types of functions:

- Overseeing implementation of policies agreed to by both countries’ governments;
- Making recommendations for new policies or policy modifications in the interest of
promoting bilateral trade between the two countries;

• Investigating complaints and arbitrating trade-related disputes between the two countries’ governments, businesses, or citizens; and

• Organizing and coordinating research to monitor developments in trade between the two countries, including the nature and volume of such trade and the associated trade costs.

The BATA could be constituted as a board comprising members nominated by the governments and approved by the parliaments. Board members could be appointed for periods of two years, which can be renewed, without limit, as the country authorities wish. A board member could also be recalled by a government before his or her term ends, with majority approval by parliament. BATA members, who should be technically qualified to perform the tasks required, could originate from business, civil society or government, and preferably from all three. A board membership of four (two from each country) is being recommended. The chairmanship of the board could rotate on an annual basis. Decision making within the BATA will be either by consensus or by a three-fourth majority among the four members when voting becomes necessary.

Accountability of the BATA will be to the parliaments of Sudan and South Sudan. In addition to annual reports to the parliaments, with copies to the ministries responsible for trade, finance and international cooperation, the parliaments of the two countries can request regular presentations by the chairman to an authorized parliamentary committee, up to three times a calendar year.

The two countries must decide whether the BATA should, during its existence, be a regular organization with a small staff. Alternatively, the BATA could work with the appropriate departments of the two countries that provide the requisite information and analyses. The BATA could simply meet as necessary and the board members need not be full-time. The countries will need to decide and then establish clear protocols on such matters.

The governments will jointly propose the compensations of the BATA members, the budgets of the BATA, and the physical location or locations of the BATA meetings, for approval by their parliaments.

6.2.8 Border Management

It is recommended that a Border Corridors Management Committee (BCMC) be established which will be accountable to the BATA. There are three overarching physical dimensions to consider, namely: (1) official overland border posts; (2) paths and unofficial border crossings; and (3) official water ports and crossing points. The BCMC will need to develop and implement clear policies for each of these elements of border management. The BCMC would take over the duties of the current Joint Technical Border Corridors Committee mentioned earlier.

In the case of paths and unofficial border crossings, in the early stages of the cooperation process, the BCMC should be in a research and investigative mode. Namely, it should
investigate the dominant locations of such crossing points and the nature of the activities that take place at those points. It is very unlikely that the commercial activities of individuals that use these crossings are of great value. Hence, just as in the case of arrivals at airports and at official overland crossings, individuals would be allowed to import merchandise freely up to some value. If the assumption is correct that not much commercial activities take place via these crossings, then there would seem to be nothing much lost, in terms of tax revenue, by simply ignoring the commercial activity at such paths and unofficial border crossings, and allowing importation without any tariff. Of major concern, though, could be random smuggling of consequence, money laundering and terrorist activities. However, as indicated earlier in this paper, smuggling and money laundering have risks and potential heavy costs to the culprits themselves. It is very likely that only petty smugglers will use unprotected (and hence unsafe) crossings for smuggling activity. Paradoxically, as it may seem at first, it is at the major official crossing points that the authorities need to worry most about major smuggling and money laundering.

In the case of the major official overland border posts, the two countries, working within the BCMC and BATA, need to agree on policies to reduce the costs of crossing borders (time, fuel, immigration and customs procedures, transshipment and transit arrangements and fees), as well as harmonizing standards (e.g., health and safety standards, in particular).

One of the great initiatives of the past few years has been the push to establish one-stop border posts (OSBPs) in East and Southern Africa (see, e.g., FATLC, 2010). The idea is simple, even though the implementation requires enormous cooperation between the two relevant parties involved (see, EAC, 2010).Basically, the parties agree on the standards and the procedures; then both countries’ officials jointly handle matters at the post going in both direction. Hence, instead of going through two posts in each direction, there is only one post. Duplication, with its attendant costs, is avoided, while both sides are confident (that is, they trust) that the standards and the procedures are being followed.

Many challenges have to be met to get an OSBP up and running satisfactorily, apart from the construction and set-up costs (see, e.g., FATLC, 2010). In particular, the appropriate political and business support must be strong on both sides; the appropriate logistics and cooperation must exist to handle a large number of agencies of the two countries (handling issues related to people, goods and security); much harmonization of policies and documentation must take place, the need to interface certain information and

46 In that region, an initiative, the North-South Corridor Programme is aimed at reducing the costs of cross-border trade. Among other things, the programme facilitates regional projects covering roads, railway, border facilities, weigh bridges, and energy generation. The programme is an element of a SADC-EAC-COMESA Tripartite Framework initiated in 2001 to facilitate harmonization of policies among the three regional groupings. Indeed, policy harmonization is now being pursued in the context of this North-South Corridor Programme. Planned are projects like harmonization of customs procedures, information technology systems and electronic customs management systems, as well as harmonization of various regulations and charges related to road transportation. The One Stop Border Post (OSBP) projects, comprise one of the initiatives under this programme.

47 As the EAC, 2010 Act puts it: “The main objective of such one stop border posts shall, inter alia, be to enhance trade facilitation through the efficient movement of goods, persons and services within the Community and with adjoining regions.” The Act also specifies that one stop border post “means a border post established under …this Act at which all traffic utilizing the border post stops only once in each direction of travel and both exit and entry procedures are undertaken from within the same control zone.” A control zone according to the Act “means the part of the territory of the host Partner State within which Officers of the adjoining Partner States are empowered to effect border controls…”
communication technology must be met; and certain legal requirements must be met, by formal legislation, including the granting of extra-territorial authority to the border agencies.

It would seem logical that, for low-income countries, over time, the officials of one country will come to handle border crossing in one direction, while the other country’s officials handle the border crossing in the other direction. The two sets of officials will, of course, be in communication, in case there is a complex problem to be addressed. In the case of Sudan and South Sudan that should be part of the evolution of effective cooperation. Each country could also implement a program designed to build up a core of special Officers for OSBPs that receive special training to handle the procedures of more than one agency.

Both in the building and the operation of the OSBPs, it will be useful for the two countries to seek hands-on expert help and advice from some of those who are working with SADC, EAC and COMESA in the development of their OSBPs. This would greatly reduce the cost of the decision making on the appropriate designs of the OSBPs at the various borders.

Given the cost of a truly satisfactory arrangement, there are limits to how many of such posts, well-done, can be afforded at this time. South Sudan, for example, borders six countries and for each one it is possible to have multiple of such overland OSBP, if the countries involved were richer and their trade was really vibrant. The same is true for Sudan which borders seven countries.

As regards the invisible infrastructure needed for the administration, regulation and enforcement of trade policies, no doubt both countries already have many years of experience and less technical assistance is probably needed from outside the two countries. If need be, various UN agencies can provide additional assistance. This, no doubt, is known to both countries. For example, the United Nations Conference on Trade and Development (UNCTAD) has a well-known customs software—Automated System for Customs Data and Management (ASYCUDA)—and can assist with port development, development of electronic transport management tools, and advance cargo information system.

UNCTAD also has a Trade Point Global Network—the World Trade Point Federation (WTPF) in Geneva—established in November 2000. The WTPF’s overriding objective is to assist small and medium scale enterprises (SMEs) worldwide to trade internationally through the use of electronic commerce technologies, by giving them access to the most advanced e-commerce technologies and information networks. The expectation is that this will open international markets to new participants and make them more competitive. The focus of WTPF is on Small and Medium Enterprises from developing countries, especially the least developed countries (see, e.g., Dholakia and Kshetri, 2004, and UN-Business 2000). The trade points link, electronically, national centres for trade facilitation around the world, and provide trade-related information and data. There are currently some 82 countries in the network. The services provided can be classified into three categories:

48 See, for example, the discussion by Freight Africa Transport Logistics Consulting, 2010.
information, facilitation and transaction. According to information obtained by AfDB staff from the Sudan authorities, there is already a Sudan Trade Point (STP), and it is under the supervision of the Minister of Foreign Trade; it was established in 2001. South Sudan should also look into having one such trade point, by becoming part of the WTPF network.

Besides the UN, the World Bank, European Union, and a number of countries as elements of their bilateral aid, can provide technical assistance in the broad area of trade facilitation, using experts with hands-on experience.

6.2.9 Cooperation in Trade Data Collection

As an element of the Bilateral Agreement on Trade, the two countries need to formalize cooperative arrangements that would enable them to improve the collection of their desired trade-related data. This would entail, basically, each country letting the other know the type of data it wishes to collect; being willing to respond to questions of the other regarding the nature of the requested data and suggestions as to how to collect them; and each being willing to assist in the collection of data requested by the other when possible. The ongoing work in trying to improve their customs data at the border posts will help in this process, as well as information from departments that assist with trade facilitation, licensing and standards.

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49 See the discussion in Dholakia and Kshetri (op. cit.).
7. THE ROLE OF DIVERSIFICATION: EXPORT DIVERSIFICATION

Policies that enhance diversification (and hence global trade competitiveness as well) of the economies of Sudan and South Sudan will also promote and expand bilateral trade between the two countries beyond that achieved by simply creating the enabling conditions for trade discussed above. Efficient economic diversification policies will substantially enhance economic growth in the immediate future and for many years after that; raise per capita incomes significantly; and expand offer curves in international trade (that is, more goods and greater quantities to offer at possible terms of trade).

In both countries, economic diversification will raise productivity (output per unit of input) of land, labor and capital; increase the ability of the economies to adapt to changing global economic circumstances; and foster innovation. Both countries should realize significant comparative advantage and many more trading opportunities than currently is the case. Particularly if they are able to contain wages and other prices (for example, by ensuring that wage increases reflect productivity increases), and properly manage their economies (ensuring low inflation, stable and market-determined exchange rates, and positive real interest rates not higher than the real growth rates of their economies).

The subject-matter of economic diversification, in each country, is complex and deserves a different and far more elaborate study in each case. The point to be made here, is that the two countries can actually cooperate in their economic diversification policy making and implementation.

Both countries will be faced with major policy challenges in the attempt to diversify their economies. Given the reality of their geography and the socio-political reality of their populations, they could benefit from: (i) broad coordination on policy fundamentals; (ii) coordination on selective intervention in markets; and (iii) special bilateral trade and open-market relations. Major areas of focus, in such cooperation, could be: (1) private sector development, (2) financial sector development, (3) infrastructure policies, (4) agricultural sector development, (5) industrial sector policies (6) minerals and oil sectors policies and (7) export diversification and promotion.

A useful approach in such cooperation, should include, policymakers exchanging ideas on developing policy and bringing together private individuals and businesses of both countries to exchange ideas, as well as to engage in joint actions and clusters. This paper provides a brief discussion of export diversification and private sector development, because of their immediate importance for trade promotion between the two countries. However, these two topics should receive separate and more complete treatments in the context of a comprehensive study on economic diversification policies. A separate study on diversification is being finalized.
7.1 South Sudan: Export Diversification Potential

In the end, much of the management of the development process will need to be carried out by each country, independently of the other. South Sudan, for instance, has huge infrastructural and general capacity problems of which the authorities are aware. These need to be addressed resolutely and will require the cooperation of the public and private sectors of that country. In the particular area of export diversification and promotion, these development problems retard South Sudan’s ability to exploit even the opportunities currently available to it—for instance, certain crops, livestock, fishing, forestry, and mining (see DCDM, 2012).

In the immediate future, exploiting its comparative advantage due to factor endowments, South Sudan has potential [see DCDM, 2012] to increase exports in: (1) agriculture (particularly maize), (2) livestock (cattle, goats, sheep, chickens), (3) forestry (tree species include teak, mahogany, eucalyptus, acacia, neem, bamboo, ebony, and several fruit trees), (4) fisheries, and (5) minerals (gold, diamond, and marble, in particular).

In addition, with perhaps after slightly more capacity building, South Sudan can also further exploit its tourism potential (with its exotic flora, birds and other fauna), including the Nile [see DCDM, 2012]. In tourism involving the Nile, South Sudan would no doubt benefit from cooperation with Sudan.

South Sudan can, perhaps, even very soon, increase some of its current non-oil exports with some targeted capacity and infrastructure improvements, namely: (1) coniferous wood (2) Gum Arabica (Gum Africa); (3) virola mahogany and (4) meranti wood (see DCDM, 2012).

Meanwhile, some of the measures being taken by South Sudan to address its current capacity problems should no doubt help, if they are continued resolutely. For instance, opening the country’s doors to skilled labor and capital from neighboring countries like Eritrea, Ethiopia, Kenya, Somalia and Uganda is laudable particularly because of current shortages, in South Sudan, of managerial and various technical labor skills (see DCDM, 2012).

In addition, the South Sudan Chamber of Commerce, Industry and Agriculture is working on improving the capacity and indigenous supply of South Sudanese business persons. The International Finance Corporation (of the World Bank Group) is also helping with training (e.g. of local banks in credit risk management), and there are a few South Sudanese trying to put together business conglomerates (in the hope of pooling highly limited and scattered expertise). The authorities are also in the process of putting in place—implementing or planning—various policies to improve access of SMEs to finance and reduce the cost of doing business in South Sudan (see DCDM, 2012). These efforts, if well-designed and implemented resolutely, should soon help improve the ability of South Sudan to exploit many more international trade opportunities.

50 In the context of agricultural potential—for increasing both the area cultivated and land productivity—see, e.g., Diao, et al.
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7.2 Sudan: Export Diversification Potential

The World Bank’s Logistics Performance Index (LPI), an assessment of certain qualities of trade facilitation,\(^51\) in 2014, rates Sudan at 2.16 on a scale of 1 to 5 (South Sudan was not rated). The average score for Sub-Saharan African countries rated is 2.46. Among the LPI categories, Sudan’s strongest performances are in ensuring the timeliness of shipments in reaching their destination and the quality of transport and IT infrastructure for logistics, the latter apparently having improved slightly in recent years.

Sudan is a member of the Common Market for Eastern and Southern Africa (COMESA)\(^52\) and the League of Arab States.\(^53\) The country has a long coastline on the Red Sea (about 700 km) and hence a potential outlet for several landlocked neighboring countries, including South Sudan, of course. There are also growing commercial relations with China, India, and Malaysia and some Middle Eastern countries; companies from these countries may be interested not only in natural mineral and oil resources per se but also in agriculture-related activities (as seen from the evidence of large land acquisitions). For example, ethanol production reached US$ 16 million in 2010 from almost zero in 2009. There is much export potential here.\(^54\) No doubt resolute action is required to fully realize the medium-term, and certainly the longer-term, potential.

Current exports from Sudan include cotton, livestock (including live sheep), meat, fish, gum arabic, sugar, sesame, various fruits and vegetables, copper and iron scrap, oil, and minerals including gold. There is room for an expansion in all of these products, and for moving up the value chains and there are other potential exports as well such as sorghum and wheat (to the UAE and Saudi Arabia).\(^55\) In addition, groundnuts, melon seeds, hides and skins, all of which Sudan used to export in significant quantities and values, especially in the years soon after independence in 1956, could materialize as major exports again. In the manufacturing area, exports reached 10 percent of total exports by 2013.

\(^{51}\) The categories used are: customs (2.14), infrastructure (2.01), international shipments (1.93), logistics competence (2.33), tracking and tracing (1.89), and timeliness (2.31). Sudan’s scores are in parentheses.

\(^{52}\) The other members are: Burundi, Comoros, Democratic Republic of Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Libya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Swaziland, Uganda, Zambia, and Zimbabwe. According to available data, the exports of Sudan to COMESA and Arab League countries are currently very small—perhaps 2-4 percent of Sudan’s total exports. Sudan’s imports from these countries are, supposedly, normally several times greater. It is, doubtful, though, that these figures capture all of border trade, some of which is bound to be informal.

\(^{53}\) The other members of the Arab League (established in 1945) are: Algeria, Bahrain, Comoros, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Somalia, Syria, Tunisia, United Arab Emirates, and Yemen.

\(^{54}\) According to a JICA report (JICA, 2012), there is uncertainty about Sudan’s export potential in the immediate future (under current conditions and policies, of course), on at least three grounds: (1) a major fraction of Sudan’s export items are raw materials or unprocessed products with small domestic value added; (2) production costs in Sudan are high (because of costs including electricity, transportation and labour costs) and this fact tends to adversely affect Sudan’s export competitiveness in many areas of potential activity; and (3) the export market of the country seems dominated by many small countries, rather than by major countries in America and Europe.

\(^{55}\) Sudan (including South Sudan) became a net importer of cereals in the early 1980s; its self-sufficiency declined from 90 percent to 81 percent during 2000-2009. A substantial part of the additional imports was in the form of food aid, to meet the emergency needs of displaced populations during the war crisis years. The increased demand for cereals for ethanol production and the effect on world prices could have a lasting positive effect on Sudan’s export prospects in this area (Sudan, Bureau of Statistics, 2011).
With respect to invisible exports, there is potential for tourism and for a Khartoum Financial Center and both possibilities with users especially from neighboring countries. Sudan's location between Middle East and Sub-Saharan Africa, and being the country where the Blue and White Nile meet have potential for tourism industry.

Working to diversify export markets will be important in Sudan's export strategy. In 2010-11, China received 73 percent of Sudan's exports, while exports to Arab States and COMESA accounted for 14 and 6.4 percent respectively. Improving and/or normalizing relations with neighboring countries will help tourism, financial center prospects, and commodity exports by improving road and railway links to facilitate access of CAR and Chad to Port Sudan and construction of a railway to connect Chad, CAR and Sudan. Also a 26km highway linking Sudan and Eritrea inaugurated officially in October 2011.

Sudan has a great potential for export diversification. Policies related to private sector development, financial sector development, and infrastructure improvements, while directly addressing various commodity sectors, will contribute to making that potential a reality. Successful export promotion strategies around the world have clearly defined priorities, goals, and objectives, and in particular they have been able to: (1) create a favorable domestic enabling environment for potential exporters (in terms of infrastructure, regulation, access to finance, and monetary and fiscal policies); (2) foster strategic collaboration between private and public actors and cooperation among producers and exporters; (3) provide incentives to nurture innovation; (4) negotiate a favorable international environment (via multilateral relations and regional agreements); (5) work to build the country's image in foreign markets (through marketing, information provision, advocacy); and (6) offer targeted and tailored assistance to producers and exporters, relying on continuous policy evaluation.

All of these is related to the fact that export promotion is first and foremost about producing high quality, tradable goods and services at international competitive prices. The issue then becomes making sure that the right combination of neutral and selective intervention policies that help to build the capacity and create the appropriate incentives for the commodities and services in which the country can develop comparative and competitive advantage. For Sudan, it would seem that, perhaps via a properly constituted trade promotion agency, the authorities can begin to enhance the potential exporters' expertise in basics such as quality management, export packaging and export marketing competence to sell products and services in foreign markets (Belloc and DiMaio 2011, Goswami et al 2012, and Lederman, et al 2006).

In all of this time-consuming effort, Sudan can benefit from technical assistance from a large number of experts and successful export promotion agencies around the world. For this work, development partners, such as the World Bank and the AfDB, as well as bilateral assistance from various countries, can assist with financing.
From the perspective of immediate government contribution, the export promotion strategy will contain measures not only to address economic policy fundamentals as indicated above but also to design and implement appropriate selective intervention policies. Selective intervention for export promotion, directed at entrepreneurs in appropriate sectors, can include tax relief, explicit subsidies, entrepreneurial and other types of training, market research, assistance with raising standards, access to finance, fostering of joint ventures and clusters, construction of export processing zone(s), and setting up an export promotion agency.

In all of this policymaking and implementation, coordination and cooperation within government would be important as well as appropriate capacity building to perform the tasks. In the area of coordination, for instance, it was noted, in the AfDB (2011) Draft Concept Note: Economic Diversification and Growth in the Sudan, that trade policymaking was considered to be too fragmented in Sudan, in other words, many players were involved with little coordination. In particular, in principle, the Ministry of Foreign Trade is supposed to be the responsible entity for trade policy, but in practice, its involvement is minimal. The Ministry of Finance sets tariff and imposes taxes, the Ministry of Trade is responsible for licensing, the Ministry of Investment provides duty exemptions to investors, some other Ministries set various charges and fees (and even sometimes restrict, or allow, imports). In addition, the WTO Accession Commission (WTOAC), which is responsible for issues related to the accession, operates independently in the Presidency. As a result of the lack of coordination, there are often contradictions between trade policy and other Government policies, including fiscal measures.
8. THE ROLE OF DIVERSIFICATION: PRIVATE SECTOR DEVELOPMENT

Not only should the private sectors of both countries have a major role to play in the process of negotiating an overarching bilateral trade agreement between the two countries (as already emphasized), but also the private sectors (and hence private sector development policies) of both countries would be essential in achieving their economic diversification ambitions.

Private sector development is an intermediate objective for policymakers pursuing diversification and economic growth because such development helps to promote investment, raise the efficiency of investment and enhance technological change and innovation. The relevant policies and actions typically involve, among other things, changes in the socio-political climate as well as in the economic management and governance of the country. Typically, the strategy addresses the so-called neutral fundamentals in the economic environment as well as business regulation.

A significant lag in private sector development is evidenced by several popular indicators. For example, Sudan’s performance is very low in the World Bank Ease of Doing Business report. There is also indication that, in Sudan, the respect for private property rights needs to be strengthened, including putting in place an effective intellectual property rights regime. In addition, there is evidence of serious weaknesses in the judiciary and of political interference that hamper business freedom. There are, in general, issues with microeconomic incentives, general governance, credit access and cost, infrastructure, the labor force, business regulations, and socio-political governance.

For private sector development, a diversification strategy must design policies to get certain neutral fundamentals right; these would be aimed at: (i) fostering capacity building for enterprises; (ii) putting in place a number of microeconomic incentives to enterprises; (iii) improving general economic governance within enterprises; and (iv) having businesses complying with appropriate international standards and codes.

8.1 Capacity Building

An environment that enables firms to build their productive capacity is essential by developing a strategy to put in place policies that facilitate building the capacity of the people and organizations in the economic system as a whole to perform their tasks well. The relevant capacity building will be facilitated especially by the quality of the national innovation system, the human capital in the system, the supporting infrastructure, and the steps taken to improve effectiveness and efficiency of cooperation among the firms concerned (Johnson, 2012).

8.1.1 Innovation System

The authorities in both Sudan and South Sudan would be advised to examine closely their innovation systems to ensure that they support the countries’ plans.

The concept of a national innovation system is useful in ordering one’s thinking in this

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56 Private sector development is a very big topic that needs to be handled separately from this project. Still the discussion contained in this Section IX can constitute a concept note for a project on private sector development.
regard (Nelson 1993, Oyelaran-Oyeyinka and McCormick 2007, World Bank 2010 (2)). A national innovation system is the set of institutions, organizations, and mechanisms supporting technical innovation in a country. Firms in the economic system master, use and apply processes, procedures, techniques, and technology that are new to them.

Innovation will involve lessons learnt on products and practices of others; appropriate adaption of existing products to the specific clients and/or environment; investment in new equipment; organizational reforms; learning new skills, including technical and analytical knowledge; and adopting new approaches in marketing and in cooperation with other firms. An objective of a policy on the national innovation system is to enable domestic firms to develop sufficient technological, organizational, and scientific sophistication and adaptability to function effectively when compared with some other firms in the global environment. Strengthening the national innovation system would involve looking at the quality of secondary schools; programs at universities, research centers and institutions; technical and vocational training in the country; and training and research programs within firms.

Apart from training and research facilities, there are other important factors which will influence the innovation system and which the authorities must influence. Among these, habits and practices of major actors in the economic system are important. Firms must be motivated to inculcate habits and practices which encourage innovation. In that regard, the incentive structures within the economic system as a whole matter.

The competitive environment is also important. National policies fostering open markets and safeguarding their integrity will be good for innovation. Appropriate incentives will also encourage innovation and survival of only strong firms which tend to be more innovative. Labor-management relation matter, inter-alia, because they can influence employees’ attitudes and commitments towards technical change and innovation. Moreover, availability of finance to support innovation (especially acquisition of equipment and training) is extremely important. Government policies can influence all of these elements that affect innovation, as can cooperative arrangements among firms and organizations in the system.

8.1.2 Human Capital

The quality of the human capital in the economic system will be crucial. The technical capability, innovative ability and integrity of the human beings operating in the system and overseeing its markets and organizations are important dimensions of quality. Indeed, many of the policies being implemented to boost the economic development of the country will be designed with an eye to attract high quality personnel. The indispensability of high quality of people to achieve a high degree of competitiveness has led to all rapidly growing economies, which seek to compete at the international stage, being willing to be open in their recruitment policies, and acquiring people from wherever. Both Sudan and South Sudan can benefit from adopting such an attitude.
Given sound government policy, including support for education and training of Sudanese and South Sudanese in top universities around the world, within a relatively short period of time, Sudanese, especially, will have opportunities of having a substantial share of the top positions in the leading firms in the country, without sacrificing quality. The process will take a little longer for South Sudan, but eventually materialize. Thus, both countries should be open to entry of firms from all over the world. International firms and conglomerates thrive on their diversity and on their ability to rotate their employees worldwide. The authorities in both countries should not only welcome such international firms to their countries but should also refrain from restricting their flexibility in personnel management. A high quality labor pool should enrich the countries, with appropriate efficiency gains.

Two areas with thorny issues that all sectors have to address are labor policies and personal income taxation. In the case of labor policies, the main issue is the degree of freedom and flexibility that the top management will have with respect to hiring and firing, overtime pay, minimum wage, leave, treatment of unions, and hiring of foreigners at all levels of the firm. A cautious approach would be to take a survey of what leading economic powers and rapidly growing developing countries are doing at the moment and adopt a mix of policies, in light of normal practices in those countries, which are sufficiently flexible and also would be fair to the workers in Sudan and South Sudan as the case may be.

The same can be said for personal income taxes. First and foremost, both countries should negotiate double taxation treaties with at least those countries where the risk of double taxation exists. As to the level of taxation when relevant, the advice again would be to do a survey of some leading economic powers and rapidly growing developing countries to get a good idea of their personal taxation, both of nationals and of foreign nationals who are residents in their countries. Then an attempt should be made by Sudan and South Sudan to modify their domestic taxation laws to become competitive.

8.1.3 Infrastructure and Public Services

The physical and technological infrastructure in place will be important elements of the capacity available to perform the relevant tasks, including the ability to innovate. Some of the infrastructure decisions and investments will, of course, be left to the particular sector and firms themselves. As regards to the public sector organization, the central government and the local governments will have clear functions specified in the legal framework regarding the provision of infrastructure and other public services. It would seem that the effectiveness and efficiency of the public sector organization could be enhanced if some explicit coordination is arranged within the public sector to focus on the infrastructure requirements both for private sector development in general as well as for the particular activities that the authorities ought to encourage.
8.2 Microeconomic Incentives to Enterprises

The policy environment will affect the economic returns to the people and firms that operate in the system. If these returns are low, people and firms that can earn higher returns elsewhere will leave, until an appropriate stock is left, such that the marginal returns to those who stay equals the returns they would earn elsewhere. Some of the incentive issues have already been addressed in the discussion of human capital. The quality of life also matters in attracting talent, hence, making a country attractive to live in will be a positive incentive to enterprises.

8.2.1 Openness

Both the Sudan and South Sudan economies will benefit from the presence of strong firms—once again, firms that can survive in open competitive markets and, where possible, can build the capability to export their commodities and services. In order to attract or help such firms to emerge and keep them operating, an overarching requirement is the maintenance of an economic environment (markets, institutions, immigration laws, information flows, ideology, and access to the authorities) that is open.

An open environment will exhibit several obvious characteristics. First, there will be fair and open access rights to all to locate in and/or do business within Sudan or South Sudan, as relevant, irrespective of national ownership of a firm. Hence, firms with 100 percent foreign ownership will be welcomed. Foreign firms, for example, have the potential, when properly screened using objective standards, of bringing badly needed expertise and business connections to the local economy. Second, innovation will be encouraged, that is without regulatory and other obstacles that are more stringent than those found in the leading economies of the world. Third, institutionalized procedures will exist through which policymakers and regulatory and supervisory authorities consult and elicit the opinions of private firms before implementing new or revised rules, taxes and other costly obligations for markets, private firms and individuals. The authorities must also demonstrate that they seriously consider the views and analyses of the private sector organizations before finalizing their decisions. Fourth, there must be a high degree of freedom and flexibility in the day-to-day operations of the firms. Hence, private sector development would benefit from firms being allowed capital mobility, currency convertibility in an open exchange market and, as stated before, implementation of human resource management policies that enable them to accumulate the stock of human capital they find optimal.

8.2.2 Taxation

The various kinds of taxes to be considered include corporate, wage, salaries, interest, and dividends, capital gains; and taxes on specific transactions. There are also all kinds of taxes in the form of fees which are not labeled as ‘taxes, rather as registration and transfer fees, stamp duties, (such as when shares are transferred).
Governments tax policies concerns are revenue, fairness, income distribution, protection, and efficiency. It is useful for the Sudan and South Sudanese authorities to see the problem as one in which they are trying to promote production, enable their economic systems to attract and keep talent, and to attract foreign direct investment. Hence, the taxation of the firms must not do damage to the competitiveness of Sudan or South Sudan, as relevant, in all these dimensions. The bargaining power (that is, the special non pecuniary attractions and indirect pecuniary benefits) of operating in either country is not likely to be great right now. So there will be no ‘rents’ to be partially captured. This means that the solution to the tax problem is straightforward. The taxes mentioned above cannot, in their total burden on the firms and the highly talented employees, be higher than those found in leading countries in the international arena. A general advice would be to look carefully at what others are doing and be as competitive as possible with respect to the types and levels of taxation.

8.2.3 Administrative Barriers

Clearly there should be some effort made to reduce whatever administrative barriers exist to smooth operations in the various sectors of the two economies. In brief, the barrage of licenses, approvals, permits, and other requirements should not unduly raise the costs of setting up and doing business in the different sectors.

8.2.4 Legal Environment

The law, the courts, and the police mandates need to be reviewed in each country, in light of the requirements to make the economy grow and become more efficient and competitive. Delays, corruption, lack of clarity in the law, poor implementation and high enforcement costs, all have adverse effects on incentives and transaction costs with negative impact on investment. Both countries should even consider having a Fast Track Commercial Court to expedite commercial cases, if such a court does not currently exist.

The land tenure systems also need reviews in both countries. The ultimate motivation of land tenure reform is to put in place institutional arrangements that enable each parcel of land to be put to its most economically valued use at any time, irrespective of the ownership structure. The objective is to ensure that the most productive users of land have access to land, and that all users of land use it efficiently. Apart from its direct effect on production, of importance is also the ability to use land and other real estate as collateral (for a discussion of the basic criteria that a tenure system should meet if the institutional framework is to facilitate wealth creation (Johnson 1972).

8.3 General Governance

The general policy environment of a country greatly affects its attractiveness to investors portfolio and direct investors as well as highly skilled persons. Hence, given the abundance of world-wide alternatives, strong firms, investors with fungible funds, highly talented
people (including nationals of the country), will not find it worthwhile to operate in a country that is considered poorly governed, or even to have close business relations with residents in the country, for example, value-chain relationships with firms located in the country.

The governance of a country has immediate wealth effects on the owners and employees of firms and organizations that are located in the country. Of particular importance are three components of the national governance environment, namely, macroeconomic policies, socio-political governance, and the degree of compliance with relevant international standards and codes.

### 8.3.1 Macroeconomic Policies

Macroeconomic policies are important for obvious reasons. Investors expect these policies to affect the real rate of return on their efforts; the expected real value of their investments in the system, over time; and the ability to transfer their assets and earnings from the domestic economy to another country. Thus, given economic growth, investors and skilled individuals are attracted to an economy with low inflation, stable exchange rates, capital mobility, and convertibility of the domestic currency or at least an absence of exchange controls. Capital mobility often pose challenges for low-income and low-middle-income countries, especially when, like Sudan and South Sudan, such countries are wrestling with serious budgetary and balance of payments problems. Still, a country can't be a big player in international commodities and services markets if it has stringent capital controls—inwards and/or outwards.

As mentioned earlier in this paper, both Sudan and South Sudan right now face serious constraints in their abilities to maneuver in macroeconomic policy making. They are clearly making progress in their adjustments; but there is much room for improvement over current policy implementation, as emphasized earlier.

### 8.3.2 Socio-Political Governance

One of the challenges that policymakers in both Sudan and South Sudan have to address, for perhaps different reasons, is the need to effectively pay a premium to attract strong firms and highly talented people. For Sudan, the reasons may be because of uncertainties related to political instability and governance in the country. For South Sudan, the reasons may be the very poor infrastructure and capacity problems as well uncertainties related to governance in general.

For both countries, investors worry about corruption, government efficiency, maintenance of rule of law, and sustainability of policies. For example, according to Transparency

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57 Capital mobility makes macroeconomic management more challenging for the authorities, for reasons including fostering financial integration with other countries, which in turn increases the risk of cross-border contagion. A basic strategy to address these complications and challenges is two-fold. First, is to put in a place a macroeconomic policy framework that ensures low inflation and exchange rate stability. The second is to ensure that the financial system is sound, most importantly by establishing a prudential framework appropriately designed and tailored to meet the challenge of openness.
International’s Corruption Perceptions Index, Sudan is one of the most corrupt countries—ranked 165 out of 168 in 2015 (South Sudan was not yet ranked). The inspector general has been reporting in recent years that many agencies have refused to be audited or give access to their records. There are no laws providing access to government information, and freedom of the press is very limited. The 2015 Mo Ibrahim Index of African Governance ranked Sudan at 51, reflecting especially limitations in the freedom of expression. South Sudan was ranked 53 out of 54 African countries. Strategies must, anyway, be developed to build credibility for political stability, low level of corruption and other elements of good governance.

In general, when assessing countries on corruption and various other elements of socio-political governance, many analysts will resort to worldwide surveys and indices purported to measure, for instance, risk of expropriation, general governance, and constraints on the executive. Analysts will also look at the global corruption reports of Transparency International. It would seem sensible for the authorities in Sudan and South Sudan to try and understand what goes into these reports and what they can do to improve their ratings. The authorities can then design an appropriate plan to address the particular issues that would help them improve their ratings.

Another part of the response strategy is to design a plan to improve general socio-political governance with clear objectives and instruments that make the strategy transparent, and then implement it resolutely. In designing a plan, the authorities should remember that they will need to worry about sustainability during implementation. For this reason, especially, particular attention should be paid to the deliberative process in putting the program together and the legal and organizational framework to enforce the rules and processes involved. The idea would be to ensure legitimacy of the processes, rules and organization in every case and thereby elicit adequate support during implementation.

### 8.3.3 Compliance with Appropriate International Standards and Codes

With globalization, all countries are affected, through trade and financial flows, by what other countries are doing. Hence, developments that adversely affect political and economic stability and efficiency in one country can easily spill over into other countries. In addition, countries are genuinely interested in adopting practices that have improved economic governance and management in other countries, with due modifications to adapt to the

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58 The rankings depend on four categories: safety and rule of law, participation and human rights, sustainable economic opportunity, and human development.

59 Risk of expropriation comprises survey indicators of institutional quality from the International Country Risk Guide. The data include subjective assessments of risk for international investors along such dimensions as law and order, bureaucratic quality, political corruption, risk of expropriation by the government, risk of government contract repudiation, and overall maintenance of the rule of law. The governance indicators of the World Bank currently comprise six dimensions: voice and accountability; political stability and absence of violence; government effectiveness; regulatory quality; rule of law; and control of corruption. The constraints on the executive measures come from Polity IV data set (Polity IV Project). The aim is to measure directly the limits of executive power. Constraints on the executive refer to the extent of institutionalized constraints on the decision-making powers of chief executives. The concern is with the checks and balances between and among the various parties in the decision making process.
particular socio-political-economic circumstances of the adopting country. For these reasons, countries have been cooperating in various venues and organizational settings to agree on standards and codes in a number of areas, which would be institutionalized in countries worldwide.

The standards and codes relevant to private sector development will be broad norms legitimized by the international community of especially market economies, in areas as diverse as trade, corruption and socio-political governance, money laundering, financial services supervision, payment systems, accounting and auditing, corporate governance, property rights, natural resource management, and freedom of expression. They have evolved from experience and widely accepted theory; arrived at by agreement (via open discussion); and are expected to be implemented by national authorities, without a central world authority, because such implementation is in the self-interest of the countries. The self-interest of countries emanates from two basic forces: the quest for economic growth and development and the desire to participate in the increasingly global and integrated system of trade, financial markets, and international investment flows.

To promote investment, increased efficiency of investment, and increased technological change and innovation, Sudan and South Sudan, must clearly demonstrate that they are resolutely implementing relevant norms, the standards and codes in many different areas. Otherwise, they will suffer in any assessment, as places to do business, by investors, rating organizations, international organizations, and official regulators around the world. There are a large number of important standards and codes that any modern country is thus pressured to implement, to avoid being at a disadvantage in attracting capital, talent, and offers to cooperate in value chains.

It will first and foremost be useful to develop domestic expertise to identify the relevant international standards and codes in each of the above areas mentioned and to design and help implement the full compliance processes, starting with self-assessments of the initial state of compliance. Even with such expertise, a developing country like Sudan or South Sudan will still find that, for credibility, it will have to arrange peer reviews by experts from outside, including from appropriate international organizations in essence, to validate the country’s own self-assessment and implementation of compliance agendas.

8.4 Non-Financial Business Regulations

A strategy for private sector development will include a coherent policy toward business regulation that takes into account the costs and benefits to businesses of compliance as well as the costs and benefits to the rest of the society of the regulations. Sudanese and South Sudanese societies, via their representatives in government, Parliament, civil society organizations, and businesses, must then decide on: (1) the standards they want to have in place; (2) what they will leave to market discipline to ensure and what they will try to achieve via regulation; and (3) how they will organize the regulatory frameworks in the different areas.
8.4.1 Regulation versus the Market

In an optimal regulatory framework, both regulation and market discipline will complement each other when it comes to certain standards, particularly with respect to safety, health, and risks. However, when it comes to environmental standards and or maintaining the integrity of the market place (especially with respect to openness and competition), regulation is typically preferred, to ensure certain minimum standards compared to what market processes are likely to bring about. Regulation is also preferred when it comes to imposing certain values—cultural or aesthetic, for example.

A general advice would be to find out what the leading countries of the world are doing in the area of standards regulation and learn as much as feasible in order to stay competitive. This approach copying good practices and following agreed international standards and codes has the additional advantage of saving money in designing certain elements of such regulations from scratch, a process that would normally require time-consuming analyses by relevant experts. However, before the local regulations are finalized, it would make sense to have discussions with local entrepreneurs and businesses in order to obtain their views. Indeed, before new regulations are put in place, it is always useful to discuss them with the businesses that are already there and would be affected by the new regulations.

The authorities also have a role in ensuring that market discipline is effective. This will be achieved partly through the regulatory agency maintaining openness and competitiveness in markets in other words, maintaining the integrity of the market place. It is in this context that country authorities maintain anti-trust regulations and have laws against collusion and price-fixing arrangements.

Furthermore, the authorities should insist, via appropriate law, on certain codes of conduct by firms, including full and accurate business information disclosure and transparency by the firms to market participants, particularly investors and clients. Governments, via freedom of the press and the educational system should also try to build the level of sophistication of the pool of those who could monitor the management of firms such as owners, customers, auditing firms, and rating agencies. These actions will all tend to enhance the effectiveness of market discipline.

8.4.2 Regulatory Structure

In refining their nonfinancial business regulatory structures, the authorities of Sudan and South Sudan need to examine the organizational aspects for the implementation. There are three overriding considerations in that regard. One is deciding on the elements of national regulation that should be managed at the central government level and the aspects that should be managed at the state level.

The second consideration has to do with the authority and the governance of the regulatory bodies. It is obvious that, from an organizational perspective, a regulatory/
agency must have clear objectives, autonomy, and expertise to do its job, as well as be accountable to government, parliament, businesses, and civil society at large. Autonomy includes budgetary and instrument autonomy. Instrument autonomy includes authority and power to enforce its rules and to sanction for noncompliance, as well as immunity from prosecution of its officials for official actions taken in the line of duty.

The third consideration has to do with the scope, and hence agenda, of each organization. For instance, are the food and drug regulators in one agency? Does the country have one unified regulatory agency governing environmental issues in fishing, agriculture, mining, oil etc.? Is there a need for a separate consumer protection agency? Who handles safety and health standards in the work place?

Just as in the financial sector where discussions of this sort of subject-matter has been at the forefront, an important factor favoring consolidation as much as possible will be efficiency gains, namely, economies of scale in regulatory activity in the form of savings on administration, infrastructure, data collection and knowledge management; absence of a need for modalities to share information and establish cooperative committees and the like with other agencies; efficient use of highly trained and experienced experts in short supply coupled with the ability to pay them well and hence to retain them in the public sector; ability to finance continuous training of staff in-house or externally; and externalities in knowledge and information sharing among staff of varied expertise in close proximity to each other (clustering effect).

8.5 Corporate Governance Issues

Good corporate governance is important for economic growth and for economic and socio-political stability (for principles in this area (OECD 2004). These days, most experts in the field of corporate governance start from the view that a corporation is “a complex web or ‘nexus’ of contractual relationships among the various claimants to the cash flow of the enterprise” (Macey and O’Hara, 2003). Particularly in the context of a developing country, the fiduciary duties of managers and directors of firms should be broader than maximizing the value of the firm for shareholders. Loyalty of the organization’s officers to shareholders should not have external harmful effects on the larger community for which those shareholders do not pay. The beneficiaries of directors’ fiduciary duties (in particular, of care and loyalty) should extend beyond shareholders.

The requirement of fiduciary duties of senior officers of firms, organizations and markets should then hold the officers liable not so much for mistakes of judgment or wrong decisions but rather for actions and inactions that manifest fraud, illegality, gross negligence, and conflicts of interests or wrong decisions not made in good faith. The authorities of both countries, in their private sector development policies to foster diversification, would need to review the state of regulation in their countries and the general approach to corporate governance that they have taken so far. Among other things, they should ensure that they make the point that it is not only shareholders that should take action to enforce
the fiduciary rules but also the regulatory authorities. In that regard, for at least the most important firms in the different sectors, the internal supervision of those firms, their information reporting systems, and their decision-making processes, research facilities and standards, should all be matters of supervision/oversight by the authorities.
CHAPTER IX: THE RELEVANCE OF BILATERAL TRADE RELATIONS WITH OTHER BORDER STATES OF THE TWO COUNTRIES

9. THE RELEVANCE OF BILATERAL TRADE RELATIONS WITH OTHER BORDER STATES OF THE TWO COUNTRIES

Both Sudan and South Sudan have neighboring border states apart from each other—six for Sudan and five in the case of South Sudan. The two countries would benefit from keeping their neighbors apprised of the trading relations agreed between the two, as these relations evolve. That way, the other neighbors would let them know of any concerns about unfairness that they might have and thereby prevent any potential damage to the relationships all around.

More specifically, South Sudan has vibrant and long-lasting trading relations with its neighbors, namely, Central African Republic (CAR), Democratic Republic of Congo (DRC), Ethiopia, Kenya, and Uganda. Prima facie, there does not seem to be any welfare economic rationale, in this context, for giving special preference to bilateral trade with Sudan, as compared with the rules governing trade with these other countries. Naturally, the treatments in these bilateral relationships will be mutual. For instance, if Sudan and South Sudan agree on free trade with each other, then South Sudan, for instance, would not find it in its interest to automatically give free trade to its other neighbors unless they offer free trade to South Sudan as well.

Sudan, for its part, is a member of the Intergovernmental Authority on Development (IGAD) as well as COMESA. Apart from CAR, which is a member of the Economic Community of Central African States (ECCAS), all the other states bordering South Sudan mentioned above are members of either COMESA or IGAD or both. Sudan, may, for example, also want to offer any special trade arrangement with South Sudan to some of its COMESA members with which it does sizable bilateral trade or want to promote such trade. If it does, as part of mutual equal treatment, this will not violate COMESA rules.
10. POSSIBLE ROLE OF EXTERNAL FINANCE IN AIDING THE PROCESS

There are always various areas in which both Sudan and South Sudan could benefit from external finance from AfDB. Unfortunately, some financing may not be possible for Sudan until it clears its arrears with the organization.

Financing for technical assistance could come for all the studies and advice related to diversification of the economies, namely: private sector development, financial sector development, infrastructure development, agriculture, industry, minerals and oil, construction and other nonfinancial services, as well as export diversification. There are also particular elements of the bilateral trade relations that can benefit from some finance to support various aspects of technical assistance (trade facilitation mechanics and details, legal issues, IT, and general capacity building —particularly personnel training) as well as technical feasibility studies, hardware and software equipment required for logistics, miscellaneous materials, and cost of construction and set-up for major undertakings such as one-stop border posts. South Sudan should also benefit from technical assistance as it puts together its governance framework and sets up for the implementation, to address the elements mentioned in the body of this paper.

Apart from AfDB, there are many bilateral and multilateral sources of finance for both Sudan and South Sudan to assist with general development (including technical assistance), in specific policy areas such as debt relief, trade, agriculture, infrastructure, and governance. The authorities of both countries must be fully aware of these sources. Otherwise, they can simply approach the usual sources, such as the World Bank, IMF, UNCTAD, Food and Agriculture Organization, European Commission, USAID, DFID (of UK), China, and JICA.60

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60 The IMF, for instance, is supporting both Sudan and South Sudan with technical assistance, training, and policy advice, in areas such as monetary and fiscal policies, exchange rate policy and operations, tax and customs administration, public financial management, central banking, and macroeconomic statistics. (IMF Executive Board 2012 (1), IMF Executive Board 2012 (2), IMF 2012 (1), and IMF 2012 (2)).
CHAPTER XI: CONCLUSION AND RECOMMENDATIONS

11. CONCLUSION AND RECOMMENDATIONS

Below is a summary of conclusions and the main set of actions proposed for the countries’ authorities. It includes issues relating to governance, macroeconomic policies, enabling environment for trade, a new agreement on bilateral trade, programs of economic diversification and private sector development policies in economic diversification.

11.1. Set the Stage for Cooperation between the two Countries

- Both countries should deeply involve the private business sectors and civil societies of their countries, in discussions between the two countries and in negotiating agreements.
- The chambers of commerce of both countries should be actively involved as should the major business establishments in international trade, commerce, agriculture, industry, tourism, and minerals.
- Labor organizations should also be invited to participate in the discussions.
- Finally, civil society organizations should be invited to participate in the negotiations and discussions involved. As part of civil society, learning institutions should be invited to join the discussions.

11.2 Improve General Governance

- Sudan should address, resolutely, the many internal political challenges the country faces. Political instability adversely affects economic growth just as poor economic performance aggravates political instability.
- Sudan should also improve its political relations with the outside world. This will help facilitate its economic diversification efforts, for reasons including debt relief, capital inflows and export expansion.
- South Sudan should work very hard to establish institutions of governance using processes that take proper account of the pluralism of their society while ensuring adequate control of the state. Mistakes, at this crucial time in its history can send the country off track, where ethnicity, poor political leadership, government corruption, and absence of appropriate rights of citizens to consultation on economic matters become serious obstacles to the emergence of a good policy environment in the country. It is extremely difficult to change direction, once a young country like South Sudan sets off on a path of poor governance.
- Despite technical and other forms of assistance from outside, South Sudan must ensure that it has ownership of its adjustment and development programs. The essence of ownership is the acceptance of full responsibility for the consequences of a program or policy. As part of the process of ensuring ownership of its policies and programs, the South Sudanese authorities should be resolute in seeking proper domestic legitimation for those policies and programs.
11.3 *Address the Urgent Macroeconomic Adjustment Problems*

- Both countries should resolutely address budgetary, monetary, exchange rate, balance of payments and debt issues. In this context, following the advice of the IMF is recommended.

11.4 *Improve the Enabling Environment for Trade*

- *Address microeconomic incentives to enterprises*: openness of the environment, administrative barriers to trade, legal environment, and taxation.
- *Address governance policies affecting trade*: macroeconomic policies; socio-political governance; compliance with appropriate international standards and codes.
- *Address nonfinancial business regulation*: standards with respect to safety, health, risks, and corporate governance; as well as market regulation issues—to maintain the integrity of the market place, and to implement appropriate laws regarding certain codes of conduct by firms.
- *Address, particularly via research and analysis: the issue of access to finance for SMEs*. There is a lot of knowledge that is available for the authorities to tap on such as technical assistance with financial support from organizations like the AfDB. SMEs are extremely important in the current state of development of both countries. Doing everything possible to strengthen them will surely produce good results for economic growth.
- *Address trade facilitation costs*: dialogue with traders in official markets about the trade procedures (customs, banking, standards, licensing), export restrictions, controls, fees and charges they see as discouraging to exporting and importing activities. Obtain the traders’ suggestions as to what the authorities should modify, reform, or eliminate.
- *Address smuggling, bribery and corruption*: carry out a survey about traders in the official markets to obtain information on their experience as to the forms in which these activities take place, their views on the causes, and what the authorities can do about reducing them.
- *Verify that the trade environment is, indeed, enabling*: start with the characteristics listed in sub-section 3.6 of the paper.

11.5 *Negotiate and Implement a New Agreement on Bilateral Trade*

- The new agreement will replace the September 27, 2012 agreement between the two countries.

- The details on the nature and content of the proposed new agreement, including the creation of a Bilateral Agreement on Trade Authority (BATA) and a Border Corridors Management Committee (BCMC), both accountable to the BATA, are discussed at some length in the body of the paper, especially in Section 6.2.
11.6 Design and Implement Comprehensive Programs for Economic Diversification

- Both countries should do so and would require teams on both sides. Major areas of focus would be: (1) private sector development, (2) financial sector development, (3) infrastructure, (4) agriculture, (5) industry (6) minerals and oil and (7) export diversification and promotion.
- The two countries are encouraged to cooperate in this huge project. A useful approach would be for the policymakers to take the leadership in exchanging ideas on policy making and in bringing together the private individuals and businesses of both countries not only to exchange ideas but also to discuss possible engagements in joint actions and clusters.

11.7 Focus on Private Sector Development Policies in the Diversification Programs

- From the perspectives of both economic diversification, in general, and export promotion and diversification, in particular, both countries should give special attention to the design and resolute implementation of sound private sector development policies.
- As a conceptual background, this paper, in Section IX, has discussed crucial elements of the issues to be analyzed in guiding policy making in this extremely important area of private sector development such as capacity building (innovation system, human capital, infrastructure and public services), microeconomic incentives (openness, taxation policies, administrative barriers, legal environment), general governance (macroeconomic policies, socio-political governance, compliance with appropriate international standards and codes), nonfinancial business regulations (regulation versus the market, regulatory structure), and corporate governance issues.
ANNEXES

Annex1: The Role of Diversification: Export Diversification & Private Sector Development

| BOX 1: The Role of Diversification of the Two Economies-Export Diversification |
|------------------------------|----------------------------------|
| South Sudan                  | Action required or taken         |
| Issue                        |                                  |
| Capacity constraints         | Interventions by both the public & private sectors. IGAD is assisting in this area. The government is opening its doors to skill labor and capital from neighboring countries (Eritrea, Ethiopia, Kenya, Somalia and Uganda). South Sudan’s Chamber of Commerce, Industry and Agriculture is working on improving the capacity and indigenous supply of South Sudanese business persons. The International Finance Corporation is also helping with training of local banks in credit risk management. The government is working on improving access of SMEs to finance and reducing the cost of doing business in the country. |
| Infrastructure               | Infrastructure is one of the areas in the National Development Plan, 2011-2013 |
| Sudan                        | Action                           |
| Issue                        |                                  |
| Improving and normalizing relations with neighboring countries to facilitate the development of tourism, financial center prospects and commodity exports | The country is improving road and railway networks to facilitate access of CAR and Chad to Port Sudan and construction of a railway to connect Chad. Also a 26km highway linking Sudan and Eritrea was inaugurated officially in October 2011. |
| Policies related to private sector development, financial sector development, and infrastructure improvements | The government is: (1) creating a favorable domestic enabling environment for potential exporters (in terms of infrastructure, regulation, access to finance, and monetary and fiscal policies); (2) fostering strategic collaboration between private and public actors and cooperation among producers and among exporters; (3) providing incentives to nurture innovation; (4) negotiating a favorable international environment (via multilateral relations and regional agreements); (5) building the country’s image in foreign markets (through marketing, information provision, advocacy); and (6) offering targeted and tailored assistance to producers and exporters, relying on continuous policy evaluation. |
| Need to produce high quality, tradable goods and services at internationally competitive prices. | A properly constituted trade promotion agency—aimed at enhancing the potential exporters’ expertise in basics such as quality management, export packaging and export marketing competence to sell products and services in foreign markets—should be considered. Seek technical assistance from a large number of experts and successful export promotion agencies around the world. Organizations, such as the World Bank and the AfDB, as well bilateral assistance of various countries can assist with financing. Design and implement appropriate selective intervention policies, including tax relief, explicit subsidies, entrepreneurial and other types of training, market research, assistance with raising standards, access to finance, fostering of joint ventures and clusters, and perhaps construction of export processing zone(s). |

| Coordination and cooperation within government would be important as well as appropriate capacity building to perform the tasks | Need to improve domestic policy coordination: There are many players in trade policy making with little coordination. In principle, the Ministry of Foreign Trade is supposed to be the responsible agency for trade policy, but in practice, its involvement is minimal. The Ministry of Finance sets tariff, the Ministry of Trade is responsible for licensing, the Ministry of Investment provides duty exemptions to investors, some other Ministries set various charges and fees (and even sometimes restrict, or allow, imports), and the Ministry of Finance imposes taxes. In addition, the WTO Accession Commission (WTOAC), which is responsible for issues related to the accession, operates independently in the presidential office. As a result of the lack of coordination, there are often contradictions between trade policy and other government policies including fiscal measures. |
## BOX 2: The Role of Diversification of the Two Economies: Private Sector Development

<table>
<thead>
<tr>
<th>Issue</th>
<th>Action required or taken</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capacity Building: innovation systems, human capital, Infrastructure</td>
<td>An environment that enables firms to build their productive capacity is essential. A strategy should be put in place and implement policies that facilitate building the capacity of the people and organizations in the economic system as a whole to perform their tasks well. The relevant capacity building will be facilitated especially by the quality of the national innovation system, the human capital in the system, supporting infrastructure, and steps taken to improve effectiveness and efficiency of cooperation among the firms concerned (Johnson, 2012(1)).</td>
</tr>
<tr>
<td>Microeconomic incentives to enterprises: openness, taxation, administrative barriers, legal environment</td>
<td>The policy environment will affect the economic returns to the people and firms that operate in the system and this includes issues of openness, taxation, administrative obstacles, and the legal environment.</td>
</tr>
<tr>
<td>General Governance: macroeconomic policies, socio-political governance, compliance with appropriate international standards and codes</td>
<td>The general policy environment of a country greatly affects its attractiveness to investors—portfolio and direct investors—as well as highly skilled persons. Investors will not find it worthwhile to operate in a country that is considered poorly governed, or even to have close business relations with residents in the country—for example, value-chain relationships with firms located in the country. Of particular importance are three components of the national governance environment, namely, macroeconomic policies, socio-political governance, and the degree of compliance with relevant international standards and codes.</td>
</tr>
<tr>
<td>Non-financial business regulations: regulation versus the market, regulatory structure</td>
<td>A strategy for private sector development will include a coherent policy toward business regulation that takes into account the costs and benefits to businesses of compliance as well as the costs and benefits to the rest of the society of the regulations. The authorities in both countries will decide on: (1) the standards they want to have in place; (2) what they will leave to market discipline to ensure and what they will try to achieve via regulation; and (3) how they will organize the regulatory frameworks in the different areas.</td>
</tr>
</tbody>
</table>
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