

## Domestic Resource Mobilization in Somalia

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March 2020

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<sup>1</sup> The authors benefited from comments/and inputs from Fiona Davies, Geoff Handley, Guenter Heidenhof, Sher Shah Khan, Jakob Rauschendorfer, Phil Schuler and Natasha Sharma.

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## 1. Introduction

**Creating the conditions for effective and sustainable revenue mobilization is a crucial step in the state-building process, allowing governments to first and foremost generate the resources needed to function and carry out their mandate of service delivery to the people. Beyond revenue collection, it is also important to generate a space for a fiscal contract between the government and its citizenry.** Somalia is a fragile state and the revenue-to-gross domestic product (GDP) ratio remains very low at 10 percent<sup>2</sup> (or just above 5 percent without Somaliland) as compared to an average rate of 17 percent of GDP<sup>3</sup> for low-income African countries.

**This paper main objectives are to: (i) document the current taxation characteristics of Somalia starting from taxation practices on the ground; (ii) take stock of recent reforms in this area; (iii) assess the country's revenue potential; and (iv) provide some policy recommendations to increase revenue collection (over the short- and medium-term perspectives) taking into account the multiple constraints (political but also lack of capacity or corruption)<sup>4</sup>.** With this end in view, references will be made to Somalian history to better understand the hysteresis of the tax system, as well as to acknowledge the recent changes. References will also be made to the political economy of taxation in Somalia. More than any country, power relations and political economy are strong drivers of revenue collection characteristics in Somalia. Moreover, it is important to acknowledge that a more resilient economy with higher and more sustainable growth is less prone to shocks. As such, it should serve as the foundation for broadening the tax base and raising revenues.

**Regarding the main findings of this paper, the Somalia case is an exacerbation of the common features of most fragile states,** including: (i) strong heterogeneity of revenue collection and potential between the Federal Government of Somalia (FGS) and some federal member states (FMS) (from 1 to 40), mainly due to the reliance on trade taxes<sup>5</sup>, which leaves the FGS, Puntland and Jubbaland in a strong position compared to the other FMS; (ii) strong competition for taxation between the FGS, the Federal Member States, communities and armed militias, which explains why citizens and/or businesses pay much more than what is captured by official data, thus making the issue of *how* to contribute to FGS legitimacy even more important; (iii) a relatively limited revenue potential in the short term, but a much higher potential in the mid-term in the event of oil revenues flowing. In this

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<sup>2</sup> Using a revised downward GDP of US\$4,721 million makes the ratio higher than presented. This includes tax and non-tax revenues and excludes grants. The ratio over GDP should be taken with caution due to probable future GDP computation adjustments. In this paper, Somaliland revenues are included. However, it should be noted that Somaliland authorities do not consider themselves officially part of the Somalia federation.

<sup>3</sup> This is the average for 20 African low-income countries (LICs) in the year 2015. Both figures correspond to total government revenues, excluding grants. Source: International Centre for Tax and Development (ICTD), Government Revenue Dataset (GRD) 2015.

<sup>4</sup> The paper does not develop in details tax policy measures and refers to the recent analysis done by Kalyandu et al. (2020).

<sup>5</sup> The share of trade taxes in total revenues is higher than what is observed in other countries in the region. However, it is common among fragile states. It is relatively comparable to the level in Somalia in the decades preceding the 1991 collapse of the government, with around 53 to 64 percent between the late 1970s and late 1980s (Purohit 1990).

context, the revenue sharing from future oil revenues and natural resources between the FGS and the FMS is critical for the future of Somalia.

**There are at least two immediate consequences for these important findings:**

1. An equalization revenue mechanism to the newest FMS will be needed<sup>6</sup>.
2. Due to the relatively limited revenue potential in the short-to-medium term, spending increases should be cautiously applied in the coming years. They will need to be carefully prioritized according to a new conception of the role of the state in Somalia, while avoiding a return to the initial conditions characteristic of the end of the 1980s.

**Somalia's low level of domestic taxation stems in part from its long historical legacies, which can be traced back as far as the colonial period.** Throughout the decades of its rule, the British Protectorate (1888-1960) struggled to raise revenues in its Somali territory of the British Somaliland, both because of resistance from the local population and because of a lack of economic opportunities (Kakwenzire 1986). By World War II, all attempts to establish direct taxation had failed. The protectorate was generating far less revenue than required solely to support the small colonial administration. Furthermore, the absence of a good formal education system prevented the emergence of a Somali elite that could be involved in administrative and bureaucratic matters (Kakwenzire 1986). In 1960, the year of independence of the Republic of Somalia, prospects for the strengthening of tax revenues in the short-term were grim: "Revenues from indirect taxation, graduated income tax, or the flat twenty percent tax on company profits have remained consistently inadequate, and are likely to continue so," notes a contemporary (Reyner 1960).

**After Siad Barre took power in the 1969 coup d'Etat, the country first turned toward Soviet support (which lasted until the mid-1970s); later, after abandoning the Socialist doctrine, the country depended on donors, mostly international financial institutions — this at a time of extremely high levels of public debt** (Powell and others 2008). As a consequence of the external sources of funding, limited investment was made in terms of domestic fiscal capacity. Additionally, under the Barre regime, the central government only weakly penetrated the Somali society, which was characterized by a mainly pastoralist population, a strong informal economy and a strong reliance on clans. In the last years of the regime, a surge in informal economic activities, accompanied by a strong mistrust in the predatory government, led to a total absence of tax culture (Jamal 1988; Mubarak 1997; and Powell and others 2008). Indeed, it was one of the lowest tax-to-GDP ratios in the late 1980s, amounting to 5-6 percent (World Bank 2017). In 1989, the ratio was at 5.3 percent (World Bank 1991)<sup>7</sup>.

**The idea that increased taxation can foster an engagement between the State and its citizens initially stems from the historical literature shedding light on this process in modern Europe (Levi 1988; Tilly 1990); however, more recent work has established that similar patterns are at play in contemporary developing countries, potentially leading to improvements in governance and institutions.** For instance, Bräutigam and others (2008) show the strong interactions between taxation and political systems in a wide range of developing countries. They also highlight the state-building implications of increased taxation. Prichard (2015) uses three case studies of post-colonial African

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<sup>6</sup> Intergovernmental fiscal relations are more developed in a separate PER module.

<sup>7</sup> Against 5.4 percent in 2018 if Somaliland is excluded.

countries to illustrate how taxation triggered political engagement and debate leading to more accountability in the long run. Revenues raised through taxation are more likely to be spent in sectors of the economy directly responsive to citizens' needs, as opposed to revenues accruing with no tax bargaining, such as natural resource revenues and/or aid revenues (Ross 2001, 2012). Indeed, a growing number of empirical studies demonstrate these mechanisms across the developing world. For instance, Gadenne (2017) shows that Brazilian local governmental spending on education and health is more efficient when financed by direct tax revenues than by natural resource revenues. Martin (2016) shows that taxation reduces citizen tolerance of governmental non-accountability in an experimental setting in Uganda. Finally, Paler (2013) shows that taxation increased citizen scrutiny of governmental activities in Indonesia.

**There are reasons to believe that similar tax bargaining already occurs (at a local level) and could be leveraged across the various governmental entities in the Somali context — despite country specificity.** Building on a case study of the parking tax in Garowe, Somalia, Varming (2017) shows how disputes over a specific local tax reveal a more general process of definition of the state's scope and authority. Eubank (2012) focused on Somaliland and demonstrated that limited external financing had positive consequences. Specifically, it created the need for revenue bargaining at the level of the Somaliland government, as well as at the more local levels, thereby contributing to the establishment of stable institutions. After many years of statelessness in the 1990s and 2000s, economic activity — which survived nonetheless — reached a stage beyond which the need and demand for an effective government was stronger (Mubarak 1997; Powell and others 2008).

**The positive feedback loop between taxation and improved governance is not automatic. Across Somalia, informal taxation remains widespread, which creates accountability lines between citizens and local leaders that are stronger than those with federal authorities** (Santoro and Van den Boogaard 2019). Along these lines, Moore and others (2018) emphasize that “who pays taxes, how they are collected, and how the government uses the revenues” are important determinants in shaping a fiscal contract. Thus, it is not only the ‘how much’ that is collected. This is even more salient in the Somalia context, where governmental entities were only relatively recently reestablished (between 1991 and 2012). This occurred at a time when the central government had been nonexistent or weak for more than two decades. During these years, however, some economic and social activities did not totally break down. In fact, to some extent, they thrived more easily than under the regime of Siad Barre. This created a situation in which economic agents have relied almost exclusively on informal and local institutions (including clans, pastoralist customary regulations, local militias) rather than on a formal, national State (Mubarak 1997; Powell and others 2008). This makes the task of reinforcing the federal state's legitimacy to tax — and of creating consensual revenue generation — even more delicate. Therefore, gaining a detailed and accurate understanding of the mechanisms of revenue mobilization across Somalia<sup>8</sup> appears to be essential in reflecting on the country's broader political economy and governance.

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<sup>8</sup> Presumably in large areas of south-central Somalia, for some years, only local governments operated. Policy dialogue largely ignores local governments altogether, layering mostly two levels of government (that is, the FGS and FMS). Regarding revenue collection, local government taxation data are very difficult to collect. Further investigations should be conducted in this regard.

**Due to the current and future revenue characteristics of Somalia, attention to revenue sharing and potential equalization of revenues between members of the federation<sup>9</sup> will be critical to making the federation of Somalia viable.** Moreover, ongoing reforms will have to be strengthened in order to generate more revenues. More importantly, they will have to be strengthened to increase equity and transparency. Furthermore, linking them to expenditures will help to contribute to state legitimacy.

**The paper is organized as follows:** the next section presents the recent reforms and tax revenue trends for the FGS and other member states (including Somaliland). The third section offers some brief assessments of revenue potential for the FGS and the FMS. The fourth section outlines the main internal and external challenges to increasing revenue collection in Somalia. The final section describes the main policy recommendations, distinguishing between the main short- and long-term perspectives. In addition, it raises the main questions related to revenue relations between the FGS and the FMS<sup>10</sup>.

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<sup>9</sup> It will also be important that FMS spending be cascaded to local governments and ultimately to citizens.

<sup>10</sup> Intergovernmental fiscal relations are developed further in a separate PER module. Further investigation is also however needed regarding taxation of local governments.

## 2. Taxation Reforms and Trends

### A. Recent Tax Reforms

**The current legal framework for the tax system combines elements from the 2012 Provisional Constitution, and legal provisions dating from before 1990 – including some as old as the 1960s, which were established when Somalia was still a unitary State.** The 2012 Constitution states that: “The responsibility for the raising of revenue shall be given to the level of government where it is likely to be most effectively exercised” (Article 50). Additionally, the FMS have their own constitutions and tax regulations or decrees<sup>11</sup>. The Provisional Constitution also states that pre-existing laws, which have not been completely redefined, remain in place. This creates a situation in which tax rates, valuation methods, the definition of taxable goods, lists of taxpayer categories and tax or exempted goods and services, have (for the most part) remained unchanged over the last thirty to fifty years. Some of the main tax laws include: Law No. 1 of March 31, 1961 on customs; the Legislative Decree No. 5 of November 1966 on direct taxes; and Law No. 2 of January 7, 1984 on sales tax. As an example, customs duties continue to be based specifically on packaging or units.

**The government has taken initiatives to modernize and clarify the legal framework. The Somalia Revenue Administration Act was enacted in December 2019. The enactment of the Revenue Administration Law and supporting measures to improve tax administration are expected to boost revenue collection, albeit from a low base.** It enables the modernization of tax administration by covering taxpayer registration, assessment, refunds, certificates of tax clearance, tax agents (and is applicable to customs<sup>12</sup>). This is important for future tax revenues. The Revenue Act states that laws governing the major taxes (including taxes on international trade) should be made at the Federal level, and ‘the Ministry (of Finance) is to be responsible for the administration and the implementation of the revenue laws in line with the articles of the National Revenue Law.’<sup>13</sup> Although the law does not stipulate which level of government will administer or retain any given tax, it nonetheless provides a legal basis for the federal government to work with the member states to harmonize tax policies across the country. It also calls for an additional law that would designate which level of government would collect the revenues from each source, keeping in line with Article 125 of the Provisional Constitution.<sup>14</sup> Additional legislation governing customs taxes has been approved by Parliament and (as of March 1, 2020) awaits the President’s signature.

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<sup>11</sup> Local governments, which continue to collect taxes, are virtually absent from the current picture.

<sup>12</sup> However, customs duties continue to be governed by the 1961 Act (as amended) in the same way that sales tax is still governed by the 1984 Act. For instance, the Revenue Act does not determine tax rates, tax thresholds, taxable goods or exempted items.

<sup>13</sup> Although the Revenue Act refers to a National Revenue Law, the taxes it refers to are those listed in the former Revenue Harmonization and Revenue Authority bills.

<sup>14</sup> In September 2018, a Revenue Authority (Establishment) Act was drafted, which would have established a central revenue authority responsible for administering the taxes listed in the Revenue Administration Law. These include the Customs Law (Law No. 1 of March 31, 1961); the Road Tax Law (Law No. 4 of December 28, 1965); the Income Tax Law (Law No. 5 of November 5, 1966) the Stamp Duty Law (Law No. 6 of December 6, 1966), the Sales Tax Law (Law No. 2 of January 7, 1984), and the Excise Tax Law (Law No. 3 of May 23, 1985). However, the Cabinet declined to approve the draft law. Therefore, it was not submitted to Parliament.

**Each FMS maintains its inland revenue and customs receipts (with different tax rates across ports<sup>15</sup>).** Furthermore, local authorities collect municipal taxes. In some cases, this results in double taxation<sup>16</sup> if the State (the FGS or the FMS, depending on the area) collects an equivalent tax in the same municipalities (Haas 2017; World Bank 2017).

**The revised Constitution can be expected to clarify the approach to revenue sharing (including revenues from natural resources) between levels of government; primary legislation and regulations will then be needed to further detail this approach.** If the Constitution is not revised any time soon, then primary legislation will need to be drafted to address the sharing of tax revenues. (The sharing of natural resource revenues will continue to be governed by Article 44 of the Provisional Constitution).

**Several important tax administration (and policy) reforms have been, however, undertaken in the last two years (and explain increased tax and non-tax revenues). Some administrative measures taken in 2017 and 2018 include the creation of a Large and Medium Taxpayer Office (LMTO) in FGS (which currently has 80 registered taxpayers) (IMF 2019), as well as the transfer of the collection of certain fees from specific Ministries to the Ministry of Finance.**

**The FGS has recently undertaken initiatives toward increased automation.** In 2016, a Financial Management Information System (the Somalia FMIS or SFMIS) was established with the support of development partners. It allows for the registration of business activities, the generation of basic revenue statistics, and the production of invoices for payroll taxes (IMF 2017; World Bank 2017). In addition, a system allowing for the automation of property transfer taxes has been piloted since 2016 and has yielded satisfactory results (World Bank 2017).

**Tax policy changes passed also include the establishment of a 5 percent sales tax on goods at the point of import, and a sales tax on hotels, tickets and consumer water — both of which were enacted in 2018.** Licensing fees for telecommunications companies were established. The excise rate on *khat* was also increased. Finally, a higher and more progressive rate for the tax on rental income was introduced (that is, from 5 to 15-22 percent).

Several additional reforms have been undertaken subsequently with tangible impact on revenue collection (see Box 1 on some concrete examples).

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<sup>15</sup> *Khat* and cigarette taxation is an exception and was harmonized across ports.

<sup>16</sup> There is no common Tax Identification Number (TIN) across Somalia. The TIN number harmonization dialogue, supported by the World Bank, began in October 2019 between FGS and Puntland. In future, the FGS plans to extend the Puntland TIN structure to the other FMS. This important process is supported by the Domestic Resource Mobilization lending projects financed by the World Bank (P151492/P166206).



#### Box 1 : The Main Tax Administration and Policy Reforms in 2019-2020 (for FGS)

Some important tax reforms have had some tangible results on tax and non-tax revenues. The list is non-exhaustive but appears to have been the most impactful:

1. introduction of a sales tax for import goods and reform of the personal income tax,
- 2- enforcement of Tax Identification Number (TIN) requirement and tax compliance certificate being subjected to renewal of annual licenses and anyone transacting with government,
- 3-restrictions and reduction of tax exemptions,
- 4- customs efficiency gains thanks to the introduction of electronic declarations and manifests,
- 5- automation of visa fees and working permits collection,
- 6- collection of fly-over fees (IATA collecting on behalf of the government and directly remits fees to government account)<sup>17</sup>.

## B. Overview

**Overall fiscal revenues remain at very low levels; however, they have been rapidly increasing since 2012 when the Federal Government of Somalia was established.** Consolidated total revenues — including Somaliland, all five FMS, <sup>18</sup> and the Federal Government — amounted to US\$ 484.2 million in 2018, corresponding to 10 percent of total GDP<sup>19</sup>. The revenue-to-GDP ratio is lower than in neighboring countries,<sup>20</sup> as well as in other fragile states in the region<sup>21</sup>. Excluding Somaliland, total revenues amount to US\$254.8 million or 5.4 percent of GDP<sup>22</sup>. Moreover, compared to donor funding (including humanitarian aid), it amounts from 12.5 to 25 percent of total revenues, depending on whether Somaliland is included.

**Revenues are disaggregated in the following way: 38 percent of total consolidated revenues are collected by the FGS; 47 percent accrue from Somaliland; and the remaining 15 percent from the five FMS.** Tax revenues account for the largest share, with US\$400.9 million (85 percent of total revenues) generated from taxes in 2018. Non-tax revenues accounted for the remaining 15 percent. The relative importance of tax revenues is considered to be a positive feature in the dynamics linking revenues to governance outcomes, as well as in the tax bargaining literature more generally. Within tax revenues, trade taxes hold a dominant position, with 63 percent of tax revenues (US\$251.9 million). These customs revenues are collected separately by the FMS and the FGS.

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<sup>17</sup> It has also been legally agreed that airspace revenues will be collected by the International Air Transport Association (IATA) and transferred directly to the FGS from August 1, 2019.

<sup>18</sup> The five Federal Member States are: Galmudug, Hirshabelle, Jubbaland, Puntland, and the Southwest State.

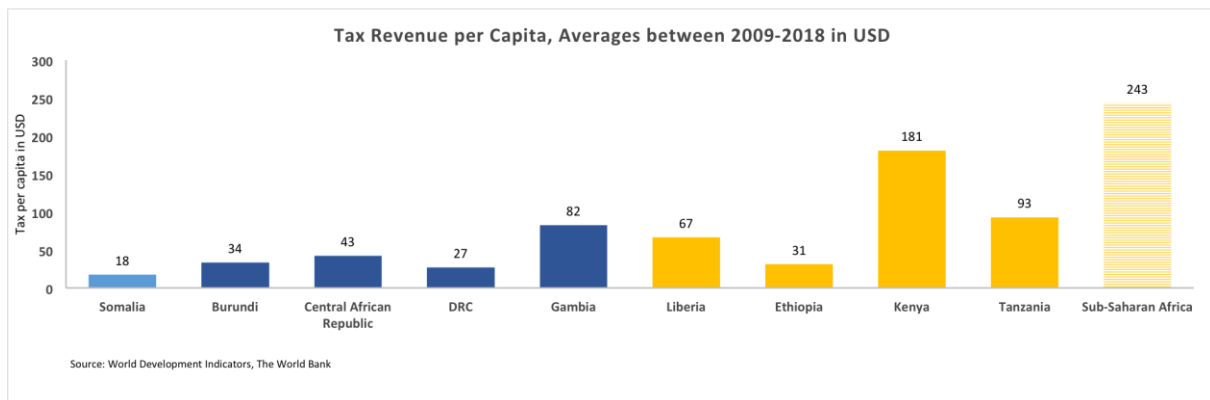
<sup>19</sup> This includes tax and non-tax revenues and excludes grants. Excluding Somaliland, total revenues amount to US\$254.8 million or 5.4 percent of GDP.

<sup>20</sup> Specifically, 14.4 percent in Ethiopia and 17.8 percent in Kenya. (ICTD 2015).

<sup>21</sup> Specifically, 10.7 percent in Sudan, 10.9 percent in the Central African Republic (2012), and 12 percent in the Democratic Republic of the Congo (2011).

<sup>22</sup> Somaliland figures are presented in this part to have consolidated data but, in the subsequent sections, it is not covered due to a lack of information.

Figure 1 : Tax Revenues per Capita in Somalia and other Sub-Saharan Countries (between 2009 and 2018), in \$US

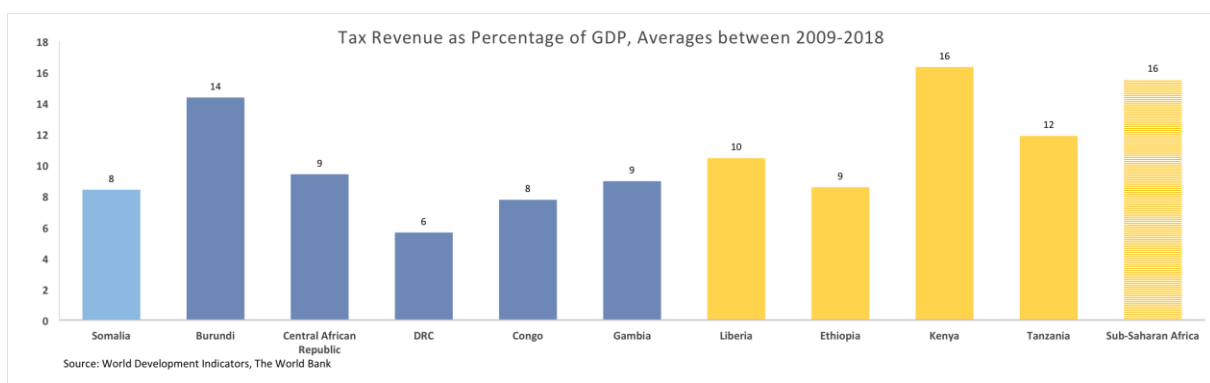


Source: Authors’ computations based on official statistics and population estimates.

Note: Population figures are estimates.

DRC= Democratic Republic of Congo.

Figure 2 : Tax Revenues as a Share of GDP in Somalia and other Sub-Saharan Countries (between 2009 and 2018), in \$US



Source: Authors’ computations based on official statistics and GDP estimates.

Note: DRC= Democratic Republic of Congo.

### C. Positive Trends in Domestic Revenue Mobilization

Revenues have been steadily increasing in recent years, and all tax instruments have evidenced a positive trend since 2014. Total (consolidated) revenues grew by nearly 30 percent in the last three years (from US\$ 368.9 million in 2015 to US\$ 484.2 million in 2018), corresponding to an increase in the tax-to-GDP ratio from 7.6 to 8.5 percent (Figure 2), as well as a stable non-tax-revenue-to-GDP ratio of around 1.5 percent. If only the FGS is considered, then the revenue-to-GDP ratio grew by 77 percent in four years (that is, from 2.2 percent in 2014 to 3.9 percent in 2018). This increase is largely driven by a rise in customs revenues, which increased from US\$177 million in 2015 to US\$251.9 million in 2018. Taxes on goods and services, other indirect taxes, and non-tax revenues have grown regularly since 2013. They have also grown at a similar pace and reached comparable levels (respectively, US\$67.6 million, US\$57.3 million, and US\$81.6 million).

## D. Heterogeneity across States

Each governmental entity (FGS, Somaliland, and FMS) raises some revenues of its own, to which domestic transfers from the FGS are then added in the case of the FMS. In practice, all revenues of the FGS are collected from the Mogadishu (Benadir) region<sup>23</sup>. Whereas some tax instruments may be considered as transitional for FMS, numerous tax instruments are taxable in the FGS and FMS, which creates some potential for multiple taxation (Table 1).

**Table 1: Breakdown of Total Revenues for the Federal Government of Somalia, Federal Member States and Somaliland (US\$ millions, 2018)**

	Consolidated	FGS	Federal Member States					Somaliland
			Galmudug	Hirshabelle	Jubbaland	Puntland	Southwest State	
<b>DOMESTIC REVENUE</b>	484.2	183.4	0.6	0.7	11.1	56.3	2.7	229.4
<b>Tax Revenue</b>	402.6	138.9	0.6	0.7	10.6	42.4	2.7	206.7
Tax on Incomes, Profits and Capital Gains	25.67	8.6	0	0	0.6	2.9	0.2	13.37
Tax on Goods and Services	67.6	22.1	0.6	0.5	3.6	5.4	1.6	33.8
Tax on International Trade and Transactions	251.9	100.3	0	0.1	6.1	32.2	0.9	112.3
Other Taxes	57.3	7.9	0	0	0.3	1.9	0	47.2
<b>Non-Tax Revenue</b>	81.6	44.5	0	0	0.5	13.9	0	22.7

Note:

All figures are in millions of USD, and for year 2018. Source: World Bank.

Source: Authors' compilation based on official statistics.

Moreover, there are strong heterogeneities across these regional entities, both in terms of levels of taxation and fiscal instruments. The relatively better performance of Somaliland, and to a lesser extent Puntland, are in part related to the fact that these States have existed and engaged in strategies to raise revenues for a longer period of time than the other FMS and the FGS, respectively. This has been the case since 1991 and 1998 and is possibly due to more developed economies and larger investments (Power and others 2008; Varming 2017).

Total consolidated revenues for Somalia amount to US\$31 per capita (2018), but this ranges from US\$0.4 per capita (Galmudug) to US\$74 per capita (FGS)<sup>24</sup>, followed by Somaliland with US\$53 per capita (Table 1).<sup>25</sup> Somaliland appears to be performing relatively well compared to the FMS, with levels of taxes comparable to those of the FGS, that is, US\$ 48 per capita as compared to US\$56 per capita for the FGS. As such, taxes account for nearly 90 percent of total revenues in Somaliland as compared to 76 percent for the FGS.

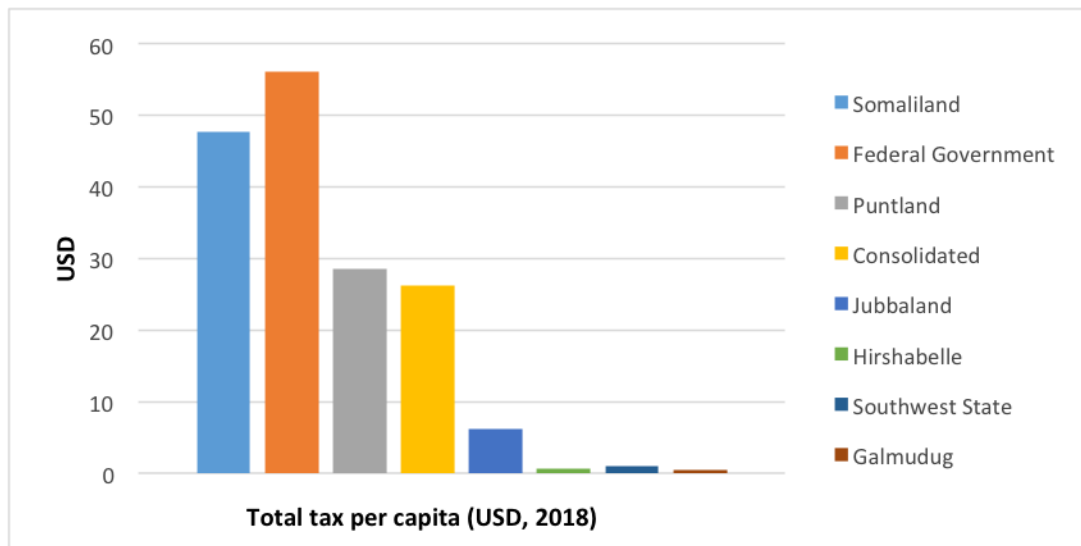
Among the FMS, Puntland raises the highest levels of revenues (that is US\$56.3 million in total revenues, and US\$42.4 million in taxes for 2018), corresponding to US\$38 per capita of total revenues (respectively, US\$29 in taxes). However, Jubbaland is far behind with US\$6.5 per capita of revenues (respectively, US\$6.2 per capita in taxes) (Figures 3 and 4).

<sup>23</sup> If airspace overflight revenues and fisheries revenues are excluded. Somaliland could possibly request a share of these revenues.

<sup>24</sup> This has been computed over Benadir/Mogadishu population and would be much lower if compared to the whole federation population.

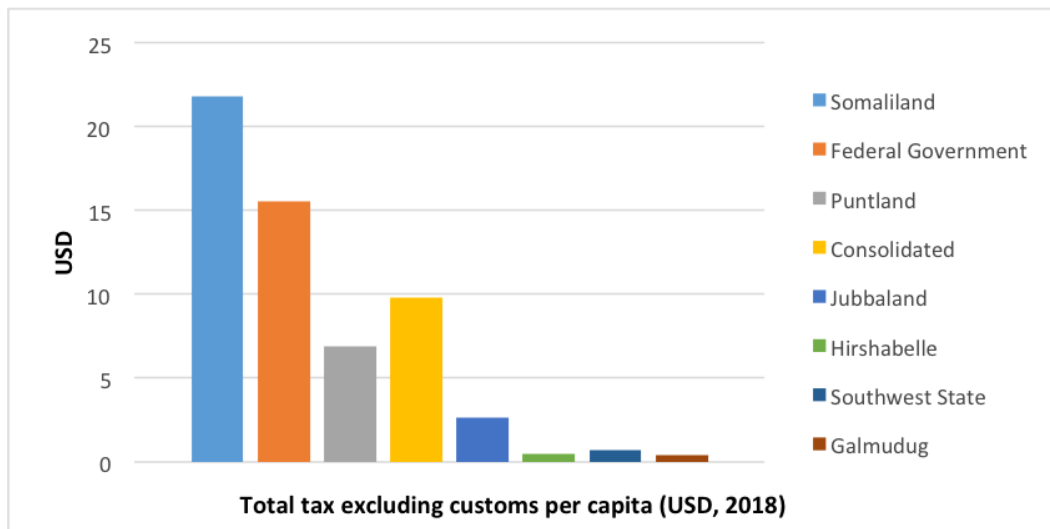
<sup>25</sup> Taxes per capita are reported because precise estimates of regional GDP are not available.

Figure 3 : Total Tax per Capita in the Federal Government of Somalia, Federal Member States and Somaliland, in US\$, 2018)



Source: Authors' computations based on official statistics and population estimates.

Figure 4 : Total Tax per Capita (excluding customs revenues) in the Federal Government of Somalia, Federal Member States and Somaliland (in US\$, 2018)



Source: Authors' computations based on official statistics and population estimates.

## E. Strong Reliance on Trade Taxes

**Taxes on international trade amounts to a large share of total revenues, whether it be at the consolidated level or for each State when considered separately.** In practice, all revenues are collected in the main ports and airports (that is, Mogadishu for the FGS, Berbera port and Hargeisa airports for Somaliland, Kismayo port for Jubbaland, and so on). In Mogadishu, import taxes are assessed through systematic physical controls and face-to-face interactions, making the process

extremely cumbersome. In addition, taxes are specific and not applied on an ad valorem basis, meaning that they are assessed based on the volume, weight or number of units for each good rather than on the price. This has some advantages, among which are potentially curbing under-invoicing and requiring lesser skills for the valuation process (Cantens 2018; E&Y 2017; World Bank 2017). Export duties are also applied on a limited number of goods (including dried fish, meat products, hides and skins, and scrap metal). However, they contribute to a minuscule share of total customs revenues. In Somaliland, the system is different, with a 3 percent ad valorem tax on imports *and* exports. A livestock export levy also exists, as in some of the FMS.<sup>26</sup>

## F. Tax Instruments

**Comparing the current situation with the prevailing situation before the 1991 breakdown of the government reveals that most of the fiscal instruments, as defined by the legal framework, remain in place. However, the relative importance of some tax instruments has evolved over the past few decades.** Table 2 displays the different fiscal instruments existing at the FGS level, in each FMS, and in Somaliland for the year 2018. In the 1970s-1980s, in the midst of economic difficulties which led the Barre regime to finally abandon Socialism in the 1980s — and while starting substantial non-profitable public investment programs (Powell and others 2008) — some tools were established to foster revenue mobilization. A development levy was added to income taxes for non-governmental employees, leading to a relatively high tax burden. Jamal (1988) estimates that in 1986 an ordinary wage earner would be required to pay 50 percent of his or her income in taxes. Thus, income and property taxes contributed more strongly to total revenues in the late 1970s than today. However, this share started to decline sharply before the collapse of the regime, that is, from 20 percent in 1975 down to 12.5 percent in 1989 (Purohit 1990). In the late 1970s, the government also relied on public entities. In this context, it introduced a turnover tax on public entities and strengthened profit-share mechanisms from the public entities. The *de facto* turnover tax on public entities no longer exists.

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<sup>26</sup> In Somaliland, there is both a livestock tax and a livestock export levy. It is not always clear whether livestock taxes include a livestock export levy or only taxes on livestock trade within a state.

Table 2: Existing Fiscal Instruments in the Federal Government of Somalia, Federal Member States, and Somaliland

Tax Revenue	Consolidated	Federal Government	Federal Member States					Somaliland
			Galmudug	Hirshabelle	Jubbaland	Puntland	Southwest State	
Tax on Incomes, Profits and Capital Gains		Yes.			Yes.	Yes.	Yes.	Yes.
Tax on Incomes, Wages and Salaries		Mostly on public sector employees, extended to employees of a subset of sectors in 2017-18. Four brackets (0,6,12 and 18%). Collected every three months.						Public payroll tax; private payroll tax; tax on income from individuals
Tax on Rental Income		Three rent brackets. Collected every three months.						
Corporate Profit Tax		Ten brackets (9 to 30%), but in reality not applied; fixed amounts negotiated between with companies. Collected annually.			Monthly business tax + registration and licensing fees.	Biannual business tax.		Tax on income from corporations and enterprises.
Tax on Goods and Services		Yes.	Yes.	Yes.	Yes.	Yes.	Yes.	Yes.
Sales Tax		In 2018 introduction of a 5% sales tax at point of import, and sales tax on a small subset of goods.				Existence of a sales tax.		
Excise Tax		Rate is supposed to depend on the good, but in reality, uniform 5% rate is being applied. Government unable to collect on a certain subset of goods.						
Turnover Tax		Existence of a turnover tax on services. Paid only by telecommunications firms through a lump-sum payment.			Existence of a turnover tax.			
Tax on Telecommunications		Since 2018, introduction of a 15% sales tax and a licensing fee.						Post and Telecommunications
Tax on International Trade and Transactions	No legal foundation for the collection of taxes on international trade by the FMS, but nonetheless they all collect some customs revenue which is not remitted to the Federal Government.	Almost all customs revenues are collected on imports. All collections at the Mogadishu port and airport. Specific valuation (based on volume, weight or unit). Revenues accrue from a limited number of traders. Face-to-face procedure and physical investigation of each bundle of good.	Yes.	Yes.	Yes.	Yes.	Yes.	Mainly from Berbera port and Hargeisa airport. Includes: Import Tax; Export Tax; Harbour Tax; Livestock Export Tax. Customs agents responsible for valuation of each item. Three percent ad valorem tax on imports and exports.
Other Taxes								
Livestock Tax	Exists under various forms.	Yes.	Yes.	Yes.	Yes.	Yes.	Yes.	Livestock Tax (in addition to Livestock Export Levy)
Fisheries (licenses)		License for catch and local vessels.						
Land and Property Tax			Existence of land and property taxes.		Property tax paid in larger towns.	Property tax, at least in Garoowe.		Tax on land and building value and on property transfer (Hargeisa).
Road Tax, Transportation and Checkpoint fees	Road fees and checkpoint fees widespread across Somalia. Some of them are informal (controlled by clans, militia, armed groups).	Existence of a Road Tax which yields significant revenues. Collection outsourced to a private company. Collected every four months on owners of trucks, vehicles and buses.	Existence of a road tax.	Existence of a road tax.	Transport and checkpoint fees.	Transport and checkpoint fees, although without a legal basis.	Existence of a road tax.	Road Tax. Transport and checkpoint fees.
Stamp Duty		Existence of Stamp Duties.						Existence of Stamp Duties.
Other Local or Municipal Taxes					Yes.			In Hargeisa: City Development Tax; Business License; Market Fees.
Administrative Fees		Ministries, departments, and agencies collect various user fees.			Yes.			Licensing; Registrations; Concessions.
Airport and Harbor fees		A private company has been contracted for Mogadishu port and airport			Port docking fees in Kismayo Port.			Harbour Tax
Visa charges, passport and other fees		Yes.			Yes.			Yes.
Resource Taxes								Mineral Concessions and Royalties
Tax on Specific Industries (Money Transfer, Light, Water)		Existence in legal framework but uncertainty regarding collections.						
Non-Tax Revenue								
Property Income								Rent of government buildings, landing fee, oil terminal rent, port.
Sale of Goods and Services					Yes.			Yes.
Fines and Penalties		Yes.						Yes.
Sale of Natural Resource and Immovable Assets								Yes.

Source: Authors' compilation from multiple sources (Cantens, T., 2018; E&Y, 2017 ; Haas, A, 2017 ; IMF, 2017 & 2019; Kalyundu, G. and Norregaard, J. 2020; PREMIS PFM, 2017 ; Santoro, F. and van den Boogaard, V., 2019; Somaliland Revenue Performance, 2019; World Bank 2017; World Bank Data, 2019).

Note: FGS port (harbor) and airport fees are managed under concession agreements and generate monthly revenue payments to the FGS.

**Taxes on wages, incomes and businesses are one of the flawed areas of the current Somali fiscal system.** Taxes on wages exist in the FGS and in Somaliland. However, in both cases, they are significantly biased toward the public sector, with only a limited share of private employees contributing, thereby leading to equity problems (for instance, 60 percent of taxes are from the public sector in Somaliland). Under the FGS, this tax is progressive with three non-zero tax brackets, and it is collected every three months. In 2017, the FGS managed to bring employees of hotels, telecommunications and electricity companies into the tax net. In the following year, employees of non-governmental organizations were also included.

**The taxation of corporate profits exists, but it most often occurs differently than as defined in the legal framework.** In theory, under the FGS fiscal legislation, ten tax brackets exist for the annual Corporate Profit Tax. However, in practice, lump-sum amounts are negotiated between companies and the administration, depending on the sector and size of the firm. Somaliland collects a limited amount of revenues from its tax on income from corporations and enterprises. Jubbaland and Puntland also have a business tax in place (respectively, biannually and monthly), although their yields are almost negligible. Although taxes on incomes and businesses perform relatively poorly overall (they amounted to around 5 percent of total revenues in 2018), they have been growing rapidly in recent years, especially relative to their very low initial levels. For example, they increased by 82 percent between 2015 and 2018 as compared to 42 percent for trade taxes over the same period.

**A certain number of taxes on goods and services exist, contributing to total revenues, with over two times more than taxes on wages, incomes and businesses** (at the consolidated level, and separately for the FGS and Somaliland). These include: sales tax, excise tax, turnover tax and taxes on telecommunications. Under the FGS, revenue collection is hindered by the fact that these indirect taxes do not apply to all the goods and sectors that should fall under it. In addition, instead of the variation in rates that should be applied depending on the goods and sectors, uniform rates or lump-sum payments are implemented.

**Other types of taxes play a substantial role in total revenue collection (notably in Somaliland).** As an example, livestock taxes and livestock export levies exist, and they are particularly salient in a strongly pastoralist economy (as in Jubbaland, Puntland, and Somaliland<sup>27</sup>). Some form of road tax and/or transportation fees exist in each State — although it does *not* appear that revenues collected are transferred to the Treasury (Powell and others 2008; Santoro and Van den Boogaard 2019; and Varming 2017). Checkpoints and checkpoint payments are widespread across Somalia and have been for decades. However, they do not all stem from formal governmental entities, since some are controlled by clans or militias. This is an example of an area in which citizens are long used to making payments to a ruling group for a specific activity. Paradoxically, this happens without necessarily bringing about any engagement between them and the *formal* governmental entities (Powell and others 2008).

**Land and property taxes are defined in the legal framework of the FGS, Somaliland and the FMS, but they are mainly limited to towns and cities.** Additionally, there is no clear distinction between the responsibilities of the central State governments and the municipalities with respect to these local

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<sup>27</sup> The taxation of livestock trade and exports constituted a relatively major source of revenues in Puntland and Somaliland, although the precise figure is not available.

taxes. This leads to possible cases of double taxation, and a lack of consensus about the modalities of transfers (Haas 2017; World Bank 2017).



### 3. Some Elements of Revenue Potential in Somalia and Lessons of Tax Reforms in FCVs

**Although revenue potential remains relatively high in Somalia, the potential remains fairly focused spatially (that is, in FGS and/or Puntland/Jubbaland) over the short-to-medium term and for some instruments (such as trade taxes, personal income taxes, and corporate taxes (E&Y 2017), or some non-tax revenues, such as road user taxes). According to IMF forecasts, it is possible to expect in the next years a 30% increase in domestic revenues, which would be equivalent to around 1.5 percent point over GDP (or approximately 75 million). It is along what is being known on tax reforms impact on revenues for a sustainable increase in fragile states (see Box 2).**

#### Box 2 : Stylized Facts about Tax Reforms Impact on Revenues in the World

Based on a long-term analysis of revenue trends all over the world over several decades of tax reforms, Drummond and others (2012) made the following findings:

- *Countries can aim at modest increases in revenue ratios* in the short-to-medium term, and somewhat larger increases in the long term. The frequency distribution of changes in revenue ratios for Sub-Saharan African (SSA) Low-Income Countries (LICs) peaks at a pace of about ½–2 percentage points of GDP in the short-to-medium term, and at a pace of about 2–3½ percentage points of GDP in the long term.
- *Fragility matters*. Fragile countries were able to raise the revenue ratios only marginally (0–½ percentage point of GDP) compared to non-fragile ones (½–1½ percentage points of GDP) in the short term.
- *Sustainability can be an issue*. Most non-fragile SSA-LICs were able to sustain their short- to medium-term revenue gains, whereas fragile SSA-LICs struggled. Countries were more successful in sustaining moderate gains than gains from exceptional increases.

Source: authors' summary based on Drummond (2012).

**In the mid-term, customs revenues have probably the highest potential due to currently very low applied rates, especially for goods such as cars or electronics. Competition between ports for some products (such as sugar between Mogadishu and Kismayo) also contributes to explain low realization of customs revenues potential. If Somaliland is excluded, applied average tariff rate for Somalia is at 3.9 percent of total imports<sup>28</sup>, which is very low. When compared to fragile and non-fragile comparators in Sub-Saharan Africa, the trade weighted average tariff is at 12.2 percent<sup>29</sup>. In theory, it could then mean that the customs revenue potential to be at par with SSA countries should be with an extra 300 million \$US equivalent to multiply by almost a factor of 3<sup>30</sup>. This estimate is rather consistent with Cantens (2018), who had found an estimate of 385 million \$US if the Common Market for Eastern and Southern Africa (COMESA) external tariff was used for Somalia.**

<sup>28</sup> Import data source is IMF Staff Report.

<sup>29</sup> It is from 7.9 percent for Burundi to 18.1 percent for Gambia; CAR, Ethiopia, Kenya and Tanzania were also included in the sample. Weighted mean applied tariff is the average of effectively applied rates weighted by the product import shares corresponding to each partner country. Data source is World Bank (<https://data.worldbank.org/indicator/TM.TAX.MRCH.WM.AR.ZS>). Applied rates may be actually lower but only of a couple of percentage points.

<sup>30</sup> Somaliland is excluded from those computations. The total would be 439 million \$US.

However, such revenue increases are unlikely to materialize in the short-term given that Somalia has three *de facto* customs administrations with different applied rates and competing with each other for some goods<sup>31</sup>.

Regarding FMS revenue potential, a detailed study was carried out in 2017 to estimate revenue gaps (including customs duties) for four FMS<sup>32</sup> in 2017 (PREMIS 2017). Although the level of ambition was high, with some estimates based on several assumptions (on increasing tax administration efficiency), four main findings can be highlighted:

- Jubbaland has a revenue potential that equals all three of the other states combined.
- Customs duties are the largest source of revenues (which may create a possible tension with the FGS because customs duties are supposed to be assigned to the FGS).
- At more than 200 percent, the revenue gap is high for Jubbaland and the Southwest.
- Despite a large revenue gap, it is estimated that revenues would not be beyond US\$5 million per year for the Southwest or Galmudug, and US\$10 million for Hirshabelle— or less than US\$2 per capita per year for the Southwest or Galmudug and US\$5 for Hirshabelle. Jubbaland would have a potential of more than US\$20 per capita.

These findings confirm the current trends related to taxation in Somalia with concentrated revenues in the FGS/Puntland and to a lesser extent in Jubbaland. These derive mostly from trade taxes (although domestic taxation has also increased). FMS without ports therefore have a limited revenue potential, which is likely to remain in the future due to current limited size of markets<sup>33</sup>. Moreover, the practice of ‘inland tariffs’ is also present between FMS and exacerbates further inequalities and impair the sustainability of the tax system (as highlighted in Kalyandu et al. 2020).

Finally, in terms of future revenues, oil revenues remain the most promising and should fundamentally change the taxation picture in Somalia (at the condition that oil companies are taxed adequately and revenues collected effectively). Moreover, the legal framework and revenue-sharing mechanism would need to be agreed based on good international practices<sup>34</sup> (see Annex 1 for more details). Production and logistical constraints also need to be considered. As such, the revenue potential is large over the long term — assuming the probable reserves are confirmed. With a minimal estimated reserve of 600 million barrels of oil equivalent, revenues are estimated at more than US\$20 billion (World Bank estimates). When production begins, it could quite rapidly be the largest source of revenues in Somalia. Therefore, revenue sharing between the FGS and the FMS and at the local level will be crucial for socioeconomic development as well as for state-building (see Annex 1 for more details about desirable revenue-sharing mechanisms).

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<sup>31</sup> It would also require a move to an *ad valorem* system with customs to have a well-functioning valuation system, including the possibility of detecting customs evasion based on lowered declared values.

<sup>32</sup> This includes Galmudug, Hirshabelle, Jubaland, and the Southwest, but excludes Puntland.

<sup>33</sup> It does not justify to develop large ports for each FMS as suggested by some FMS authorities

<sup>34</sup> An amendment to the 2008 Petroleum Act was adopted in February 2020, which establishes a revenue-sharing mechanism, which would potentially create further equity problems.

## 4. Main Tax Administration Challenges

### A. FGS in Competition for Taxation

**In general, local taxation is not necessarily prioritized by donors over the mobilization of central government revenues. However, multiple taxation at the sub-national level (that is, at the FMS, district and/or community levels) is often a major constraint for micro and small enterprises.** It is these enterprises that provide income generation and growth. Multiple taxes, fees, charges, licenses, and so on make it difficult to establish new businesses and enter new markets. In this context, the various levels of government do not coordinate well regarding issues of taxation (Fjeldstad 2018).

**Somalia is not an exception among countries in terms of multiple taxation.** Indeed, in many cases, it applies to both individuals and businesses. In Somalia, in numerous areas, taxpayers are liable for federal taxes or FMS taxes. However, they may also contribute to local governments, communities and even militias.

**From a trade tax perspective, the three main ports of Mogadishu, Kismayo and Bosasso are effectively in competition— especially Mogadishu and Kismayo.** (Cantens 2018). Due to the various *de facto* tax rates<sup>35</sup> (exacerbated with the introduction of a sales tax in Mogadishu), it can be more profitable for a trader to import some goods to Kismayo rather than Mogadishu, especially if such goods are destined to markets in the south of the country. Consequently, at a national level, customs revenues are reduced. Furthermore, port competition is an incentive for the FMS authorities to go even further to reduce their rates to capture more flows to *possibly* collect more revenues — to the detriment of Mogadishu port. However, if this trend persists, import flows would continue to increase, but with an overall decline in revenues for both ports, creating a lose-lose situation.

**Citizens pay a larger share of taxes than indicated by the data due to important informal taxation. Competition exists between formal and informal authorities. Santoro and others (2019) explain the difficulties for formal authorities in taxing because of low legitimacy and poor perception by the citizenry.** In an experiment carried out in South Somalia in almost 100 rural villages, the authors highlighted the following in their baseline study. First, the bulk of taxation is informal (for instance, clan or clergy contributions). Second, the only formal tax paid is the livestock tax. Third, it is interesting to note that the most formal authorities are the least trusted at the local level. Indeed, according to the authors, district authorities are trusted by 41 percent of the surveyed population, followed by religious leaders (57 percent), clan elders (61 percent) and village councils (74 percent). Finally, taxation is usually perceived to be a social duty, but equity is also an important concern for the villagers.

**Along the same lines, based on interviews in Mogadishu, social researchers have found that taxation is seen as linked to the colonial past by part of the population** (Rift Valley 2019). As in most fragile states, in recent decades, economists have demonstrated how regressive the taxation system in Somalia has been. Consumers mainly bear the cost of taxation, whereas corporate or high-income individuals are significantly less taxed on a proportionate basis (Moore and others 2018 [for Somaliland]; Purohit 1990).

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<sup>35</sup> Duties are goods-specific and not ad valorem tax rates.

**Beyond competition between the FGS and the FMS, taxation also fuels the ongoing conflict situation in Somalia. Militant groups — with the largest being Al Shabab — raise substantial amounts through informal taxation, notably from businesses (at the Mogadishu port) and at road checkpoints** (Faruk and Bearak 2019). Al Shabab’s strong enforcement power undermines taxpayer morale, and it is an obstacle to the establishment of a fiscal contract with formal authorities. A July 2018 report on Al-Shabaab financed by the Hiraal Institute (2015) estimates their annual revenues at US\$ 27 million, of which US\$ 15 million is collected at checkpoints across the country. Also, US\$ 8 million is collected as livestock *zakawaat* (collected from pastoralists during the month of Ramadan) across south and central Somalia. Another US\$ 3.5 million is collected from Mogadishu businesses, and US\$ 500,000 from Bossaso-based businesses. This report makes two other interesting points. First, Al-Shabaab is able to collect taxes in non-Al Shabab territories. For example, Bakara Market business owners are summoned by Al Shabab finance officials to come to areas under their control and pay the relevant amounts. They do this, or risk having their files handed over to the *Amniyaat* [the Al-Shabaab intelligence wing] for enforcement (Hiraal Institute 2015). Second, the report describes a highly organized and centralized system of revenue generation that moves from district to region and then to the central Finance Office (Rift Valley 2019). A frequently told story about al-Shabaab taxation is the predictability of checkpoint fees, particularly the issuance of receipts that allow a traveler to pay once and pass through subsequent al-Shabaab posts without paying any additional amounts. It explains why some traders avoid the main roads and sometimes use al-Shabaab-controlled rough roads to reduce checkpoint costs (Rift Valley 2019).

**Private companies also play an ambivalent role vis-à-vis taxation.** Numerous wealthy individuals or companies expect service delivery and investment from the FGS. However, in the meantime, they resist paying taxes and/or evade taxes in collusion with tax collectors, which ultimately leads to lower tax collection. This is a vicious circle with a low-level equilibrium at the expense of the State, and instead profits corporates and tax collectors. Although the number of taxpayers has increased, their number remains limited to approximately 430 for FGS and 500 for Puntland according to authorities. The total number of other FMS seems higher, but with limited tax collection.

## B. Main Tax Administration Weaknesses

**Apart from legal imprecisions, severe administrative weaknesses further impede revenue collection. They originate in part from the particularities of the revenue department within the FGS government.** Tax gaps remain large, especially for income and corporate taxes. For both categories, collected revenues account for less than 50 percent of projected revenues (World Bank 2017). The Revenue Department (established in its current form in 2016) operates within the Ministry of Finance. It is further divided into the Inland Revenue Department, with approximately 230 employees, and the Customs Department, with approximately 100 employees (World Bank 2017). Enforcement activities are carried out by a Fiscal Police within the Police Force (E&Y 2017). The Inland Revenue Department is divided along tax categories (for direct taxes, indirect taxes and non-tax revenues). It is a structure from which most revenue authorities in the region have diverged because it is no longer considered to be best practice.<sup>36</sup>

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<sup>36</sup> A Large and Medium Taxpayer Office was nonetheless created in 2018 (IMF 2019).

**There is no clear separation of activities between headquarter functions and operational functions, nor is there a specific tax policy unit to carry-out broader analysis and policy development work.** Support functions, such as human resources, finance and procurement are shared with other organs of the Ministry of Finance, which also hinders the efficiency of the Revenue Department. The Department is responsible for the 16 districts of Mogadishu, but it operates in only half of them (8) because of security issues. Also, there is office space and equipment in only 2 of these districts (E&Y 2017). Furthermore, the Revenue Department suffers from a human resource gap, both in terms of formal education and job-specific professional training. Only around 20 percent of staff have a university degree, over half did not study beyond a secondary education, and 10 percent completed only their primary education (E&Y 2017). No employees in the Inland Revenue Department or in Customs have undergone formal training.

**The second main source of administrative weakness is the lack of equipment, automation and information systems, as well as the absence of clearly defined processes.** The work environment is challenging due to the lack of office space, computers, information and communications technology (ICT), as well as a means of local transportation. Whether it be for domestic taxes or for customs, processes are almost entirely manual. The taxpayer registry and the tax database in the Inland Department are on paper, thereby making it subject to mistakes and loss or manipulation of information. As such, the task of producing reliable tax statistics becomes very challenging. Tax payments are made directly to tax agents, including outside of the office. In the customs area, agents are technically not supposed to directly handle cash payments, although the policy is not always fully enforced. All processes in customs are also manual: each shipment is examined physically, and there is a high level of face-to-face interactions between traders and customs agents. The latter are weakly monitored and controlled (IMF 2017). Somalia has not yet adopted the international Harmonized Commodity Description and Coding System. Furthermore, the administration does not have the capacity to reduce informal trade flows entering from non-official border posts.

**These administrative weaknesses result in a situation in which some essential functions of an effective tax administration are simply not undertaken. As such, significant discretionary power is given to tax collectors/customs officers (such as revenue collecting agents in Ministries, Departments or Agencies in the FMS).** Business taxation relies mainly on negotiations between firms and the administration. Tax liabilities are determined through a bargaining process, and only weakly depend on the official tax base — instead of being assessed in line with the existing legislation. Disputes rarely arise since everything is negotiated, nor does the administration conduct any tax audits (E&Y 2017). These factors further aggravate the asymmetry between the administration's capacity and the weight of a small number of large private companies from specific sectors — notably telecommunications and financial institutions, including banking and remittance operations. Companies usually make 'voluntary donations' to the tax administration. In this context, it is possible that a culture of secrecy remains quite prevalent in the tax administration (Rift Valley 2019).

## 5. Policy Recommendations

**Policy recommendations are presented in the following order:** First, recommendations are presented on tax policy issues, then on tax administration with a focus on human resources issues and finally on revenue sharing principles between the FGS and the FMS.

**An important lesson from international experience of tax capacity building in fragile states is the need to sequence reforms** by distinguishing measures that can be achieved in the short-term from improvements that should be planned for the medium and longer term (IMF 2017). This sequencing allows policymakers to adjust their objectives to contexts in which administrative capacity is initially low but increases as the reforms are being launched. Moreover, in the short-term, customs reforms are critical to generating revenues.

**When designing tax reforms, it is crucial to highlight that some relatively easy paths to increasing revenues in fragile and conflict situations may seem appealing, but they may prevent a sustainable fiscal/social contract from emerging.** As an example, governments ideally aim to raise revenues in a short period of time, but not at the cost of confronting powerful vested interests (Moore and others 2018). This can translate into accepting a bargain with the largest taxpayers — such as the largest private sector actors. This could create inequities if smaller taxpayers face inflexible tax obligations which may be perceived as relatively too high, thereby undermining the legitimacy of taxation for larger segments of the population<sup>37</sup>. Thus, the question of taxation legitimacy, which is often overlooked, is of critical importance for sustainable taxation in Somalia<sup>38</sup>.

**In fragile states where taxation legitimacy is usually very weak<sup>39</sup>, fairness, transparency and a clear link between tax and service provision are critical. In order to increase tax adherence, the use of resources is of critical importance.** Authorities need to convince citizens that the government does not misappropriate public funds and that it will use them for service provision. The use of such funds should be more transparent in terms of revenue collection. However, it should also be more participative and transparent in the use of taxes. In addition, transparency regarding budgetary and revenue exemptions should be a priority for authorities in Somalia.

**Many citizens —especially those in fragile states — perceive tax issues as technical, complex and lacking in fairness. Yet, it is vital for the legitimacy of the tax system to secure a broad-based citizen engagement around taxation and fairness issues.** In numerous fragile states, consumers, who are generally poor, are disproportionately affected by taxes on the consumption of consumer goods, food products, import duties and so on. However, the elite is usually less affected due to low effective tax collection for direct taxes, such as personal income taxes. Civil society organizations, including business associations, can help broaden the debate and bring a new focus to the discussion of fairness and pro-poor taxation regarding tax policy (Fjeldstad 2018). Somalia faces the same problem and should carefully review its tariff structure, notably for import duties — and especially for direct taxation. Moreover, representatives of the private sector are asking for an appeals board, better

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<sup>37</sup> Gottlieb (2018) shows that in Senegal, informing microeconomic actors about an existing reform which shifted some of the tax burden from small taxpayers to medium and large firms, and simplified processes for micro firms, led to stronger support for the government, as well as a higher propensity to vote for the incumbent.

<sup>38</sup> Militia, like Al Shabab, rely on very strong enforcement mechanisms and therefore do not have to improve their legitimacy.

<sup>39</sup> It is usually even more difficult when taxation is spread between the FGS, the FMS and local authorities, not to mention communities or militias.

engagement by tax authorities, and, more broadly, adherence to the rule of law. All of these issues appear essential to improving tax legitimacy in Somalia.

#### A. Tax Policy<sup>40</sup>

**Beyond revenue-sharing issues, several reforms should be gradually undertaken to expand the tax base for corporate and personal income taxes, as well as increased tax rates for trade taxes.**

**In terms of general recommendations, over the short-term, the tax structure should remain simple, transparent and minimize disputes because of the weak systems currently in place<sup>41</sup>.** Tax officers in many fragile states have discretion over important decisions, such as tax liability assessments, the selection of audits and litigation. Many administrative procedures should be transparent because business people usually report over-assessment of tax liabilities followed by ‘negotiations’ with the tax officer(s), which ultimately erodes the tax base. Somalia is representative of such a case (Rift Valley 2019).

**More specifically related to Somalia, the focus should be on extending the personal income tax to all employees, including more attention to service sectors such as the telecommunications companies, financial institutions and/or restaurants and hotels for corporate taxes (World Bank 2017).** In parallel, the equivalent rate of import duties in Somalia is low (around 4 percent) and could be revised upwards (provided the adjustment is done in the three main ports). Some excise taxes could also possibly be introduced on petroleum products, tobacco or motor vehicles.

**Multiple taxation is usually common in FCVs; however, Somalia seems to be an extreme case. Authorities from the FGS/FMS (and possibly from local governments) are encouraged to clarify revenue collection and administration levels for the most important tax instruments. In this regard, the Revenue administration law should be complemented by secondary legislation (or in the Constitution) to clarify tax collection and administration between the various levels of authorities.**

**Somalia has also traditionally relied on a small number of taxes and will probably continue to do so as long as enforcement capacity remains weak. For the country, it will be critical to further simplify taxes by streamlining them with dozens of ‘small taxes with low yields’, harmonizing rates whenever possible starting with trade taxes, and eliminating double taxation between the FGS/FMS.** Most of these measures do not generate large revenues, but they can be detrimental to economic activities and should be removed. A presumptive tax for small businesses should probably be introduced like in many developing countries with a large informal sector.

**Moreover, as mentioned in Kalyandu et al. (2020), exemptions on corporate income tax or on customs duties or sales taxes on imported goods should be more transparent and with no discretionary power left to the Minister of Finance.** A well-defined, transparent and collegial process should be put in place to limit exemptions and a negative impact on the competitive environment.

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<sup>40</sup> This section is focusing on short-mid-term horizon. Tax policy reforms are the main objective of the recent paper published by Kalyandu et al. (2020) where measures are presented in details.

<sup>41</sup> Although it is difficult to make them work in fragile states, tax appeal boards and tax tribunals are important mechanisms for securing taxpayers’ rights, as well as in establishing fair and transparent procedures to addressing tax disputes (Fjeldstad and others 2018).

**Compliance with simpler procedures and self-assessment should be encouraged (World Bank 2017).**

Business licenses should be improved, possibly leading to improved revenues. Also, customs duties rates could be further increased to better reflect the COMESA tariff structure (and could be harmonized across points of entry) (Cantens 2018). In this mid-term perspective based on strengthened capacity and knowledge, customs could use the transactional value for customs transactions (but not in a short-term horizon).

## B. Tax Administration

**The monitoring of tax collector behaviors and impacts is equally important to better control bad behaviors and corruption**<sup>42</sup>. Although corruption in tax agencies is difficult to measure with accuracy, especially in Somalia, there are some indirect measures that tend to show that corruption is probably important. For instance, the automation of revenue collection points through the financial management information system may help generate some evidence. As an example, in Puntland, after the automation of airport visa fees, collections increased by about 70 percent in one month. Confirmation would be required; however, it shows that corruption among tax collectors remains probably quite high.

**Somalia's tax administration should strive to recruit higher skilled staff and invest in training. In the meantime, the administration should also automatize processes.** The FGS should benefit from a full automation of processes, developing seamless information sharing between the various ports of entry in Somalian territory. The import clearance process should also be simplified with supporting documents sent electronically.

**As a successful example of increased revenues over the medium term, Afghanistan was able to increase its revenue collection in recent years.** The most salient measures included the following: strong leadership with focused attention; the firing of 40 corrupt or inefficient senior staff; tight monitoring of revenue collection by the Ministry of Finance; and revised technical systems and processes (World Bank 2017).

**Somalia faces a human factor constraint due to the formal lack of training and a poor incentive framework; this issue will have to be tackled over several years. One possible approach could be to follow the lessons of some successful support initiatives to customs reform in Madagascar (from 2015 and in Cameroon in the early 2010s)**<sup>43</sup>. The World Bank Group-supported customs reforms had led to significantly increased revenues, a reduction in clearance time in the main port, and improved fraud detection. These results were achieved by: (i) undertaking data-driven diagnostics in key areas identified with customs management (including in human resource [HR] issues); (ii) designing operational tools/procedures to increase performance (including staff) through inclusive policy dialogue with customs at the managerial and technical levels, as well as among users (private sector) based on these diagnostics; (iii) assessing the impact of those piloted solutions; and (iv) adapting/changing pilot solutions where necessary. A similar approach, tailored to local purposes,

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<sup>42</sup> This has been relatively successful in customs with individual performance contracts, such as in Cameroon or Madagascar (Raballand and others 2017).

<sup>43</sup> For more information on the approach, see Raballand and others (2017). For a rather similar approach in Cameroon, see Raballand and others (2013).



should be undertaken for the main Somalia port of Mogadishu, and shared with the Bosaso and Kismayo ports.

**Finally, it will be crucial for Somalia authorities to monitor progress of tax reforms.** In this regard, it will be important for them to monitor on a regular basis average applied tariff rates in the three ports regarding customs duties. Moreover, the expansion of number of taxpayers and average revenue for the main instruments, such as corporate or income tax will have to be monitored. Some taxpayer education will have to be organized and taxpayer surveys should be undertaken to have feedback from taxpayers.

### C. Potential Strategies for Setting Revenue Sharing<sup>44</sup> between the FGS and the FMS<sup>45</sup>

**Highlighting the main theoretical principles of revenue sharing for all tax and non-tax revenues is key.** A large spectrum of autonomy can be left (or not) to local authorities regarding the tax rate or tax base (Ebel 2017). International experiences point to very diverse solutions. For the future of Somalia, a number of important principles will need to be taken into account (World Bank 2015) as follows:

- Revenue sharing is a dynamic process grounded in cooperative intergovernmental relations.
- Intergovernmental financing arrangements work best when considered comprehensively.<sup>46</sup>
- Fiscal arrangements should support a strong and unified economic space and deter the disintegration of the economic space with taxes between the FMS.
- Equity lies at the heart of intergovernmental fiscal arrangements, which means that if the revenue-raising capacity of individual states is uneven, some form of fiscal equalization will be needed<sup>47</sup>.
- Who administers taxes is a separate question from who controls the revenues. It implies that taxes can either be collected by: (i) national agencies on behalf of subnational governments (such as in Canada<sup>48</sup>, Germany or Uganda); (ii) separate tax administrations; or (iii) subnational governments collecting national taxes for the central government.
- There are three main arguments for national taxation. First, the FGS plays a major role in stabilizing the economy; as such, it requires funding. Second, the FGS should play a major role in equalizing revenues across the FMS. It will be even more important when oil revenues flow because natural resources are unevenly distributed spatially, which would require even more equalization between the FGS and the FMS. Third, revenue collection costs are said to be higher in a decentralized system because the capacity to fight evasion or fraud may be lower.

**Somalia presents some important characteristics for future revenue-sharing mechanisms:**

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<sup>44</sup> Revenue-sharing agreements usually allocate own-source revenues to one level of government (the FGS or the FMS) or revenues are shared. These are usually based on a formula.

<sup>45</sup> The inter-governmental fiscal module provides more detailed recommendations in this regard.

<sup>46</sup> Resources can be allocated in two ways: by assigning tax bases to different levels of government or by transferring funds from one level of government to another. Therefore, both aspects need to be considered when designing revenue-sharing mechanisms.

<sup>47</sup> Transfers are then called 'receipts' (Ebel 2017).

<sup>48</sup> Canada is described as a 'loose federal system', which could be of some relevance for Somalia (Ebel 2017). Canada is defined as the most fiscally decentralized member country of the Organisation for Economic Co-operation and Development (OECD).

- *Tax competition is high between the FGS and the FMS, which creates a potential 'balkanization' of Somalia's economic space. Corporations could be taxed multiple times using various rates. Puntland (and to a lesser extent Jubbaland) have had preexisting rights and perform (de facto) most functions of an independent state, including raising revenues. These are usually considered to be a national function, such as trade taxes<sup>49</sup>.*
- *Taxation at the federal level remains difficult due to the poor public perception of federal institutions (Menkhaus 2014). The FGS has difficulties in taxing outside the capital and the Benadir province.*
- *There are large imbalances in revenue potential and current collection between the FGS/Puntland and Jubbaland and the other FMS.*

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<sup>49</sup> In almost all countries of the world, customs duties and trade taxes more broadly are considered as national taxes — especially as trade policy is a central government competency. For instance, Yemen had had difficulties in assigning revenues and expenditures between the federal government and local governments. It was decided that customs would remain a national institution and trade taxes would be administered by a national customs administration.

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## Annex 1. Potential Strategies for Adequately Sharing Future Oil Revenues

**If revenue collection from oil production would flow in 5-10 years and exports remain relatively modest, they will fundamentally change the revenue picture in Somalia; as such, they should then be part of the overall design of revenue-sharing arrangements.** The absence of tax bargaining in oil-rich states is considered to be one of the possible channels of the “resource curse” (Eubank 2012; Ross 2012). In oil-rich countries, it has been demonstrated empirically that accountability vis-à-vis the citizenry is even lower than in non-resource rich oil countries (with all other things being equal) (Devarajan and others 2011). This situation could possibly create growing tensions between the FGS and the FMS, as well as tensions between the FMS. Therefore, any revenue-sharing agreement would need to consider the future oil revenues.

The FGC has consistently raised this issue as part of the current Constitutional redrafting process. Some provisions in this regard can help mitigate any increasing inequality in the future. This could be done by either requiring natural resource revenue agreements to be time-limited, while also introducing an equalization mechanism that stands above the individual agreements. Alternatively, it could be done by doing away with the sectoral revenue-sharing agreements altogether, and then introducing a single revenue-sharing mechanism for all revenues, including natural resources.

**Regarding oil revenue sharing, a recommended approach should follow these principles:**

- Ensure that petroleum revenues are managed sustainably;
- Compensate oil-producing areas for the environmental impact of extraction;
- Ensure that resources are allocated between levels of government in line with functional responsibilities; and
- Ensure that resource allocations between authorities at the same level are guided by an agreed definition of equity.

**In the current context, the Baidoa revenue-sharing agreement (signed in 2018 and now included in the 2019 Petroleum Act) delivers a skewed horizontal revenue distribution between the FMS, with an oil-producing FMS, and the producing district within it, potentially receiving anywhere between 10 to 14 times more revenue than a non-producing FMS — thereby exacerbating inequality between districts/the FMS.** Vertical distribution between the FGS and the oil producing FMS/district is also potentially problematic.

**Importantly, the PFM act (enacted in December 2019) addresses the issue of fiscal sustainability, and revenue sharing between FGS and FMS such as:**

- The Minister shall establish fiscal rules to determine the portion of natural resource revenues that should be saved rather than spent in any given financial year.
- The fiscal rules shall be agreed between the Federal Government and the Federal Member States.

- The investment policy shall include a requirement that investments under this section shall be undertaken in a manner that does not jeopardize the macroeconomic stability of Somalia.
- All planned large-scale infrastructure investments funded by natural resource revenue savings will be agreed between the Federal Government and the Federal Member States.