

## Somalia: Moving the Federalism Agenda Forward<sup>1</sup>

Nearly 30 years after the collapse of the Siad Barre regime, Somalia has made considerable progress in defining a new relationship between the federal government and the member states. But key agreements on the allocation of functions and revenues between the two tiers of government have yet to materialize. This paper considers three options: (i) maintaining the status quo; (ii) shifting most revenue raising powers to the federal government while assigning responsibility for major functions to the states and financing those functions through intergovernmental transfers; and (iii) concentrate both revenue-raising powers and expenditure responsibilities at the federal level. This paper endorses the second option, as it responds to the desire of states to maintain substantial autonomy, while establishing a federal government that can provide security against external threats, ensure a basic level of public services available to all Somalis regardless of where they live; and facilitate the free movement of people and goods throughout the country.

This paper makes five recommendations:

- 1) Prioritize agreement on the distribution of functional assignments between the federal and state levels, focusing on the largest cost-drivers;
- 2) Ensure the federal member states have the resources available to implement functions assigned to them through implementing a large-scale transfer which could be financed by the centralized collection and administration of taxes from international trade, the assignment of direct taxes, and eventually a more equitable transfer of revenues from natural resources;
- 3) Avoid complicated formulae for the allocation of inter-governmental transfers;
- 4) Build on the institutional mechanisms in place to allocate resources to the federal and state levels, considering the possible role of an intergovernmental finance commission; and
- 5) Continue working towards small wins to build trust.

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## 1. Introduction

1. **Somalia is emerging from decades of conflict, with the signing of the Provisional Constitution in 2012 paving the way toward a political settlement.** Whereas the Provisional Constitution defines the boundaries of Somalia based on the country's former (pre-1991) frontiers, the 'government' effectively consists of five member states,<sup>2</sup> a federal government, and the self-declared Republic of Somaliland. Since the onset of the civil war in 1991, the member states and Somaliland have been largely autonomous. The authority of the federal government is largely confined to the city of Mogadishu. The agreement of the Provisional Constitution marked substantial progress. However, key issues related to the distribution of functional assignments and the sharing of resources still need to be agreed upon.

2. **Somalia continues to develop its own form of federalism in response to its unique history, culture, and socio-economic needs. The objectives of this paper on moving the federalism agenda forward are to:** (i) explain federalism and its relevance to the Somali context; (ii) provide a stocktaking exercise of where Somalia is in its journey toward fiscal federalism, with the objective of informing multiple audiences of the current status and gaps remaining with reference to international examples; and (iii) present some forward looking options to inform the policy dialogue and stimulate wider debate among the various stakeholders in Somalia.<sup>3</sup>

## 2. Federalism and its Application to Somalia

3. **Federalism is conventionally defined as a structure of governance in which two or more governments share sovereignty over the same territory.**<sup>4</sup> In this context, the federal government's mandate extends over the entire national territory and the subnational governments' mandates extend over the individual parts of it. Some countries in fragile and conflict-affected settings have adopted federal structures to accommodate regional political interests within a single political entity.<sup>5</sup>

4. **There are 25 officially designated federal countries in the world, accounting for 40 percent of the world's population.**<sup>6</sup> Many federations have large populations (Brazil, India, Nigeria and the United States), but some may be small, such as Bosnia and Herzegovina (with a population of 3.5 million). Federal structures arise from a variety of different historical circumstances. However, for purposes of this chapter, federal structures are considered as having three key characteristics: a guarantee of political autonomy for first-tier subnational governments (states); explicit limitations on the powers and functions of the federal government; and provisions to ensure that first-tier subnational governments have the resources required to perform the functions assigned to them.

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<sup>2</sup> The member states of Somalia are Galmudug, Jubbaland, Puntland, Hirshabelle, and Southwest Somalia. For administrative purposes, the member states are divided into districts. The city of Mogadishu itself is governed by the Benaadir Regional Administration, which is responsible for education, health, and urban services within the city. The current mayor was appointed by the President of Somalia, following the death of his predecessor.

<sup>3</sup> This paper was finalized in March 2020. At the time of this writing, discussions were ongoing to finalize the Provisional Constitution, as well as to enhance the implementation of customs reforms. Versions of this paper have benefitted from consultations with the Finance Ministers of the Federal Member States (FMS), the Directors of Revenues from the Federal Government of Somalia (FGS) and FMS, and development partners.

<sup>4</sup> G. Anderson, "Federalism: An Introduction," Oxford University Press, 2008

<sup>5</sup> J. Frank, E. Bergman, and F. Vaillancourt, "Intergovernmental Fiscal Relations in Fragile and Conflict Situations." (Unpublished, World Bank, 2015).

<sup>6</sup> G. Anderson, "Federalism: An Introduction," Oxford University Press, 2008

5. **Regarding political autonomy, each member state has an independently elected government, with a parliament and an executive chosen by the citizens of each state.**<sup>7</sup> Many non-federal countries have multiple tiers of territorial administration, including some with elected parliaments, but would not necessarily be considered federal under this definition.<sup>8</sup>

6. **In a federal structure, the constitution limits the functional responsibilities of the federal government.** Typically, federal functional responsibilities are limited to national security, foreign affairs, the regulation of the monetary and banking systems, and certain modes of transportation. The assignment of functional responsibilities to states can take two forms. Some constitutions simply authorize states to perform any function that is not assigned to the federal government. Others list the functional responsibilities of state governments, with varying degrees of generality. Typically, federal constitutions only outline the aspects of the relationship between the federal government and the states

***Box 1: Functional Assignments in Federal Constitutions: Selected Country Examples***

The Nigerian Constitution defines a limited list of federal functions, including defense, foreign affairs, regulation of the monetary and banking systems, certain modes of transportation (national trunk roads, interstate waterways) the post office, and the exploitation of mineral resources, including oil. These functions are listed in an Annex to the Constitution called the ‘exclusive list.’ Regarding the states, the Constitution reserves the “power to make laws for the peace, order and good government of the state or any part thereof with respect to any matter not included in the exclusive list.”

In Brazil, similarly, the Constitution grants the federal government the exclusive power over national defense, foreign affairs and the monetary and banking systems, as well as the national transport and telecommunications systems and the social security system. It grants the states ‘all powers not forbidden to them by the Constitution’. This includes internal security. One single state, Sao Paulo, has half as many personnel under arms as the entire federal army, navy and air force.

The Ethiopian Constitution assigns the federal government exclusive responsibility for foreign affairs and national defense, along with the regulation of the monetary and banking systems and certain modes of transportation. All powers not expressly allocated to the federal government alone, or concurrently to the federal government and the states, are reserved to the states. However, the Constitution provides for federal oversight of functions that would otherwise be entirely left to the states, authorizing the federal government to formulate and implement the country’s policies, strategies and plans with respect to overall economic, social and development matters and to ‘establish and implement’ national standards and basic policy criteria for public health, education, science.’ It also provides a framework for the relationship between the federal security forces and those of the states.

The federal government in Ethiopia is given the authority to establish and administer the national defense and public security forces. At the same time, the Constitution permits states to establish and administer state police forces of their own, charging the states with maintaining public order and peace within their respective territories. Federal security forces may intervene in individual states under the following circumstance: “The federal government shall deploy, at the request of a state administration, Federal defense forces to arrest a deteriorating security situation within the requesting State when its authorities are unable to control it.”

*Source:* Author’s compilation from various federal constitutions

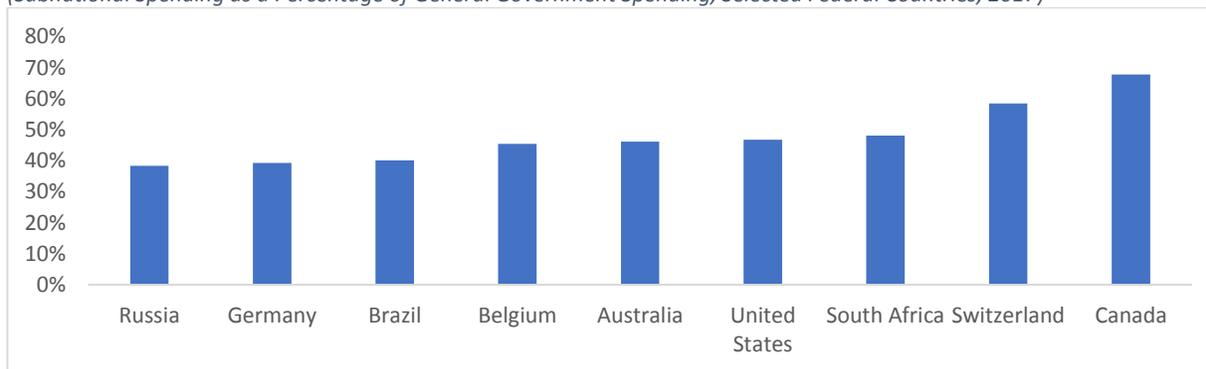
<sup>7</sup> In line with Somali parlance, individual members of the federation will be referred to as states in this chapter. The terms that are used to refer to this tier of government vary among federations.

<sup>8</sup> China, for example, has three tiers of subnational administration—provinces, prefectures and counties/cities. Together these account for 85 percent of total public expenditures. However, the power to appoint officials and make policy rests with the vertically integrated Communist party. Thus, China would not be considered federal under this definition.

that are intended to be permanent, leaving details that may be frequently revised to ordinary legislation. See Box 1 for specific examples from selected federations.

7. **Importantly, the delimitation of federal powers in federal constitutions does not imply that a federal government can have no role whatsoever in functions that are not explicitly assigned to it.** Federal governments typically regulate the functions performed by states. In fact, federal constitutions do not prevent a federal government from expanding its role into new fields. For instance, Figure 1 shows that state and local governments typically account for only 40 to 60 percent of total public spending in the federal countries for which internationally comparable data is available. This is partly due to central government spending on social insurance—a function that was not contemplated when most of their respective constitutions were first drafted.

**Figure 1: In Federal Countries, Subnational Governments Play a Large Role in Public Spending**  
(Subnational Spending as a Percentage of General Government Spending, Selected Federal Countries, 2017)



Source: International Monetary Fund

8. **To ensure that states have the resources to perform the functions assigned to them, federal constitutions typically assign certain taxing powers to them.** In assigning taxes Federal constitutions typically make a distinction between taxes that have a localized incidence and those that do not. Taxes that do not have localized incidence include taxes on international trade and transactions, value-added taxes and corporate income taxes. These taxes do not have localized incidence because their burden falls not on the firm or person that pays the tax, but rather on people who buy the firm’s products, or those who work for the firm or own it. Those people may not live in the jurisdiction where the tax is collected. Allowing a state to impose a corporate income tax, for example, would generate substantial revenues for the jurisdiction where corporations are headquartered, while the burden of those taxes would ultimately fall on employees, consumers, or stockholders throughout the country. For this reason, states and their subordinate local governments are typically assigned only taxes that have localized incidence such as retail sales and property taxes. States are also permitted to impose personal income taxes, although this power may be shared with the federal government. Box 2 illustrates selected country examples.

9. **Federal constitutions often also call for a system of fiscal transfers from the central government to the states.** These take a variety of forms. Some are discretionary, that is, states can use the transfers for any (legal) purpose they wish. Countries also provide transfers earmarked for specific purposes. These are intended to encourage states to spend more on certain functions than would otherwise be the case. Governments often provide earmarked funding for education, for example, to ensure that states devote sufficient funding to this function. Central supervision is required to ensure that states spend these funds as directed.

### ***Box 2: Revenue Assignment: Selected Country Examples***

The process of assigning revenues to subnational governments and designing intergovernmental transfers is highly political, where different federal systems have their own idiosyncrasies.

In Ethiopia, states are granted exclusive power to impose taxes on farmers and individual traders, rental incomes, transport services within their respective territories and the incomes of their own employees. However, the states are largely reliant on central government transfers. The main federal transfer is an unconditional grant, which is distributed among the states according to a complex assessment of the revenue potential and specific expenditure needs of each state.

In Nigeria, state governments are permitted to impose personal income taxes, as well as various minor taxes on entertainment, hotels, and so on. However, the principal sources of state revenues (except in Lagos state) are transfers—including shares of the value-added tax (VAT) and shares of oil revenues which form part of a so-called federation account. The VAT is administered by the central government, which retains 15 percent of the proceeds. States and local governments receive 40 percent and 30 percent, respectively. Of the total assigned to states and local governments, 40 percent is distributed in equal amounts per state, 30 percent is distributed on the basis of population, and 20 percent on the basis of origin. The Nigerian Constitution prohibits one state from taxing citizens of another state.

In Brazil, the federal constitution authorizes states to impose a VAT, as well as taxes on property transactions. Local governments are authorized to impose taxes on property. To supplement state revenues, the Brazilian Constitution requires the federal government to distribute 21.5 percent of the revenues from the federal income and industrial products to the states. Funds are distributed on the basis of population and per capita income, with poorer states receiving a proportionately larger share. Another 24 percent of revenues from those two taxes are distributed directly to local governments.

The Canadian Constitution restricts provinces to taxes that are considered 'direct,' a term which has been subject to much debate. At present, 'direct taxes' include the personal income tax, the corporate income tax, and the harmonized retail sales tax. These taxes are administered by the federal government (except in Quebec) and are shared between the two tiers. Each province's share is based on the amount collected in the province, which in turn reflects the size of its tax base and the tax rate it chooses to impose. The provinces also benefit from several central government transfer programs, including a large equalization program which supplements the revenues of the poorer provinces.

*Source:* Author's compilation from various federal constitutions

#### **10. Whereas every federal country is unique, the federal model appears well suited to Somalia.**

The key characteristics of federalism (state-level political autonomy, significant functional responsibilities and allocation of revenue raising powers) respond well to the desire of states to maintain substantial autonomy, while establishing a viable federal government for the territory as a whole. As such, federalism can aim to prevent military conflict among states; ensure a basic level of public services available to all Somalis regardless of where they live; and facilitate the free movement of people and goods throughout the country.

#### **11. The details of any such federal arrangement will need to be worked out among the relevant parties in Somalia, who have various interpretation of federalism, and its potential benefits.**

Some parties may prefer a more centralized approach, holding on to the legacy of the Siad Barre regime. Other parties may prefer a loose confederation of largely independent states, reflecting in certain states how governance arrangements evolved during the period of state collapse. Others may prefer something in

between. What is critical is that the relevant parties arrive at an agreement on key components of a federal structure that they are willing to buy into and stick with.

### 3. The Status of Somalia in its Journey toward Federalism

#### A. Drafting the Constitution

12. **The process of reconstituting a central government in the territory of the former republic is underway.** It began in 2000 when the Djibouti Peace Conference established a Transitional National Government (TNG) and a power-sharing arrangement based on a so-called 4.5 formula. Under this formula, Somalia's four main clan families each received an equal stake in political representation, and the other 'minority' clans together shared a 0.5 stake. In 2004, the Nairobi Conference led to the creation of a Transitional Federal Government (TFG). In the same year, the president of Puntland was elected President of the TFG. Before the voting, the 25 Presidential candidates signed a declaration, pledging to support the elected president and demobilize their respective militias. However, the demobilizations never occurred.

13. **It was not until August 2012 that a new Constitution was provisionally adopted by a National Constituent Assembly (NCA) comprising 825 members representing various parts of Somali society.** The Constitution has several key provisions. First, it declares that the territory of the federal republic corresponds to the boundaries of the former republic as defined in the 1960 Constitution (thus including Somaliland). Second, it defines the political structure of the federal government. It consists of a federal Parliament comprised of an upper house of no more than 54 members, with an equal number of representatives for each region (based on the 18 regions that existed in Somalia before 1991) and a lower house consisting of 275 members 'representing all communities of the federal republic in a balanced manner.' Together the two houses are to elect a president, who among other duties, serves as commander in chief of the armed forces, approves legislation drafted by the federal parliament, and appoints a prime minister. The prime minister, in turn, serves as the head of the federal government, and appoints and dismisses members of the Council of Ministers.

14. **The Provisional Constitution defines the structure of the state but leaves the division of responsibilities for several major functions undefined.** The state is to consist of two levels: the federal government and the federal member state (FMS) levels.<sup>9</sup> The Provisional Constitution goes part way toward assigning functions to each of the two levels. It identifies four functions that are exclusive to the federal government: foreign affairs, national defense, citizenship and immigration and monetary policy. It also states explicitly that the 'Federal Government shall guarantee the peace and ... national security of the Republic through its security services, including the armed forces and the police force.' At the same time, it acknowledges that the FMSs may have their own police forces, stating that the 'police forces established by the FMS have the mandate to protect lives and property and preserve peace and security locally, alone or in cooperation with the federal police force.'<sup>10</sup> However, the Provisional Constitution does not define the functional responsibilities for a wide range of other functions such as education, health, and transport, stating that 'power (shall be) given to the level of government where it is likely to be most effectively exercised.'<sup>11</sup>

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<sup>9</sup> Notably, the Provisional Constitution does not define a third tier of government at the regional level nor the Benaadir Regional Administration.

<sup>10</sup> As described below, this issue was subsequently addressed in the (2017) political agreement regarding the national security architecture.

<sup>11</sup> In addition, the Provisional Constitution states that the federal government and the FMS shall conduct regular meetings to discuss (among other things) water resources, agriculture, animal husbandry, health, education, and foreign affairs.

15. **Likewise, the Provisional Constitution does not provide for a division of resources or a system of intergovernmental transfers, stating only that the distribution of resources is to be ‘fair’, and that responsibility for the raising of revenues shall be given to the level of government ‘where it is likely to be most effectively exercised’.** It states that ‘the allocation of natural resources shall be negotiated and agreed upon between the Federal Government and the FMS.’ Also, ‘in the spirit of intergovernmental cooperation, the federal government shall consult the FMS on negotiations relating to foreign aid and commits the Federal Parliament to enact a ‘framework for financial management’. The framework is to define the procedures and timetable that FMSs are to use in preparing their annual budgets.

16. **The 2012 Provisional Constitution therefore leaves some key elements of the federal structure undefined, and is in the process of being reviewed.** Unlike the constitutions of other federations, it does not constrain the functions of the federal government or define the revenues of the states. As the Constitution was intended to be provisional, procedures are defined for making amendments and adopting a final version. Schedules C and D of the Constitution include the specific list of issues to be addressed through amendments.<sup>12</sup> The task of drafting these amendments was assigned to an Independent Constitutional Review and Implementation Commission (ICRIC), overseen by a high-level Provisional Constitutional Review and Implementation Oversight Committee (OC). At the time of writing (March 2020), the constitutional review process is currently underway, spearheaded by the United Nations. As part of the Mutual Accountability Framework, agreed at the 2019 Somalia Partnership Forum, a commitment was made to adopt a reviewed Federal Constitution by June 2020. Pending adoption of such a permanent constitution, further legal procedures may be followed to allow the Provisional Constitution to continue.<sup>13</sup> In the case of Puntland, the Constitution of Puntland was adopted before the Provisional Constitution, and so Puntland is allowed to function on the basis of its own State Constitution until such time that the Provisional Constitution and the Puntland State Constitution are harmonized.

## B. Current Situation<sup>14</sup>

17. **In the meantime, the federal government and the member states continue to operate as quasi-autonomous jurisdictions.** Although the Provisional Constitution grants the federal government exclusive power over foreign affairs and immigration, as well as monetary policy, for example, some states have taken these powers into their own hands.<sup>15</sup> Each member state supports itself from its own tax revenues, supplemented by small ad hoc transfers from the federal government and direct foreign aid.

18. **The expenditures of the federal government and the member states are dominated by two functions: administration and security.** Figure 2 shows the functional breakdown of their respective expenditures based on the Appropriation Acts for 2018. As indicated, roughly half the spending of both the federal and member state governments was allocated to administration, a category that (for the FGS) includes the operations of Parliament and the Ministries of Finance and Interior. At the federal level, 40 percent of spending was allocated to security. Among the member states, that proportion varied from 21 percent (Galmudug) to 43 percent (Jubbaland.)

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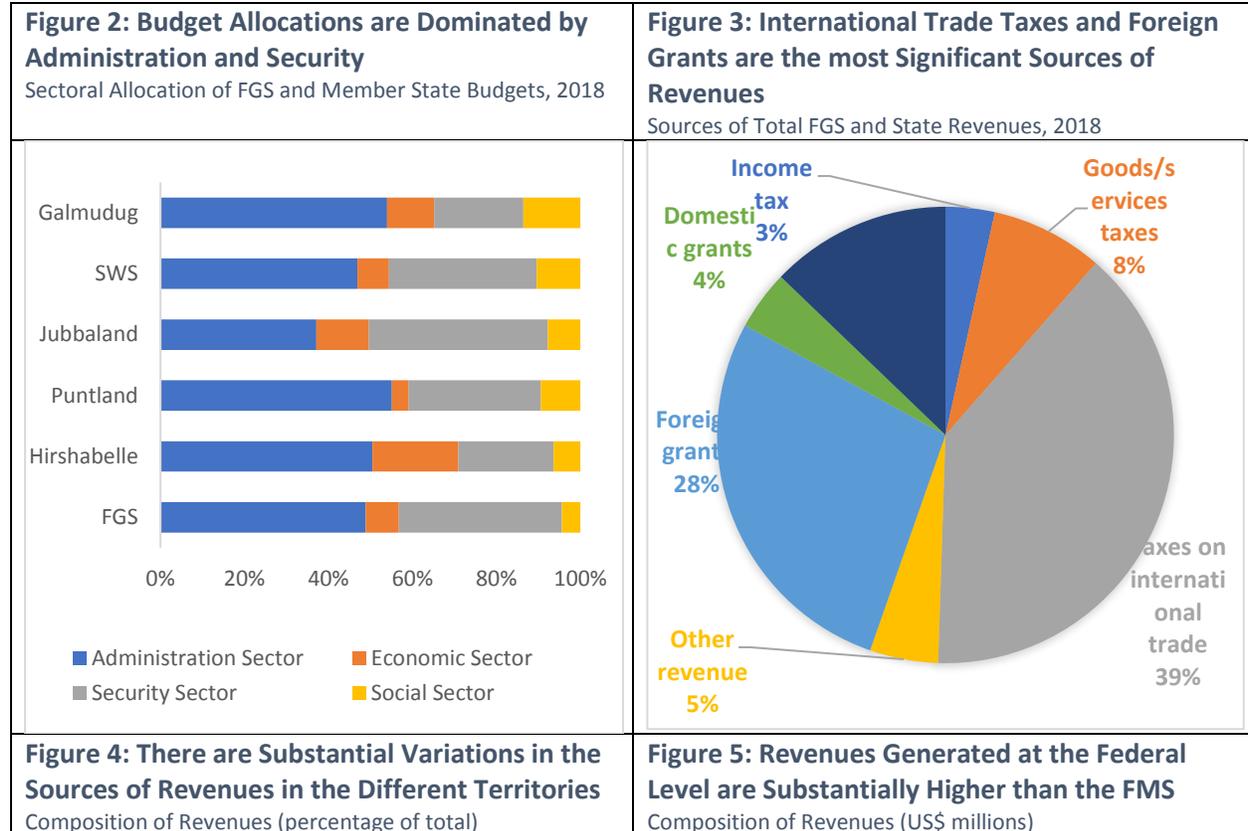
<sup>12</sup> These include the electoral system, the boundaries of the member states, the structure and functions of the federal police and their relationship with the police forces of the FMS.

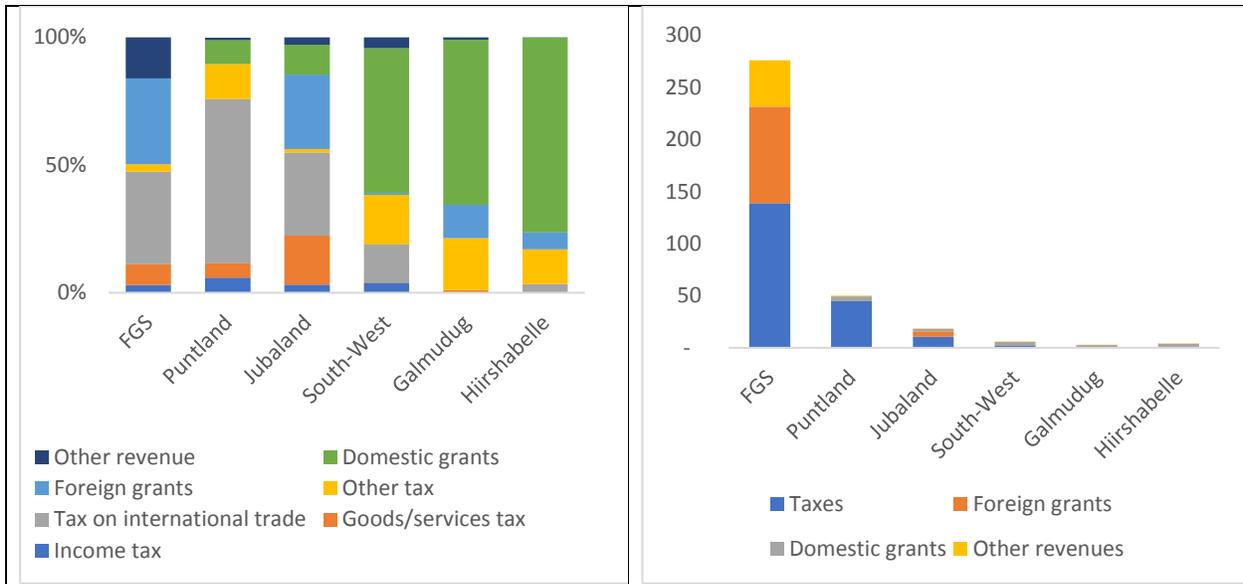
<sup>13</sup> Law No. 20 had previously been adopted to defer the constitutional review process from the 9th to the 10th parliament and postpone the referendum on the Provisional Constitution when this was no longer feasible in 2016. The extended term of the Provisional Constitution comes to an end in November 2020.

<sup>14</sup> A statistical appendix provides information on government accounts.

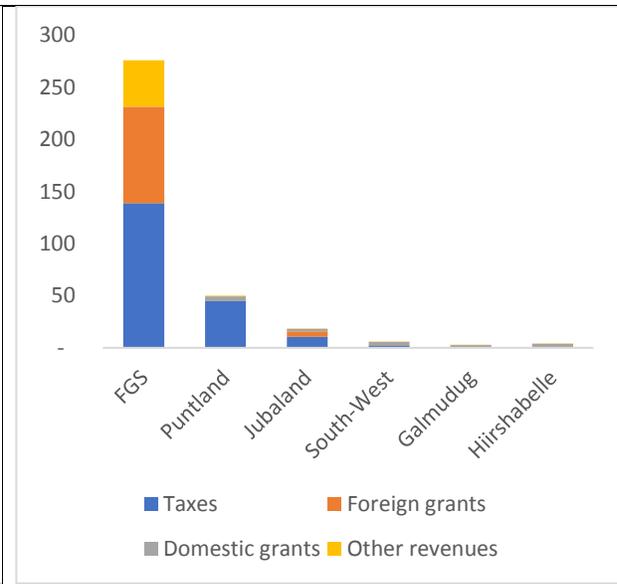
<sup>15</sup> For example, it was only in 2017 that a Memorandum of Understanding was signed between the FGS and Puntland for the Central Bank of Puntland to stop printing money.

19. **Very little spending is devoted to economic activities, which include transportation, public utilities, and support for agriculture, as well as social services, such as education, health and social protection (Figure 2).** The FGS devoted eight and four percent of its budget to economic activities and social services, respectively. State allocations to economic activities ranged from four percent (Puntland) to 21 percent (Hirshabelle). State spending on social services ranged from six percent (Hirshabelle) to 14 percent (Galmudug). The low level of state spending on economic activities and social services is particularly striking when expressed in per capita absolute terms. In Galmudug, for example, allocations for economic activities totaled US\$ 0.13 per capita, and allocations for social services totaled US\$ 0.15 per capita.

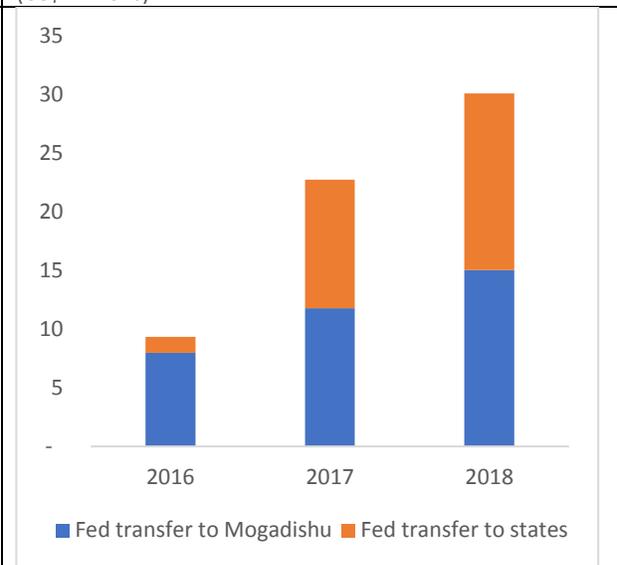
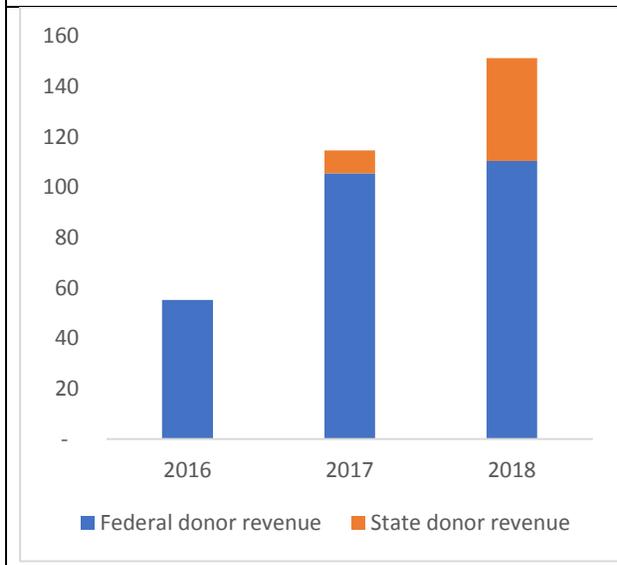




**Figure 6: Donors Grants are a Growing Source of Revenues at the Federal and State Levels**  
Trends in Donor Support (US\$ millions)



**Figure 7: Transfers from the Federal Government to the States are Increasing**  
Trends in Federal Transfers to Mogadishu and the States (US\$ millions)



Source: Abyrint Monitoring Agent (2018); FGS, and FMS Budgets (2018)

20. **The federal government and the five member states are largely dependent on two sources of revenue: taxes on international trade and foreign aid (Figure 3).** Taxes on international trade accounted for roughly 40 percent of total revenues in 2018 and official development assistance (ODA) accounted for nearly 30 percent. The federal government collects the highest share of revenues from international trade taxes (at 72 percent) and is the largest recipient of ODA (at 94 percent).<sup>16</sup>

21. **Each member state collects and retains its own taxes, along with various fees.** The federal government also collects taxes and fees, but only within the Benaadir Regional Administration (BRA). By

<sup>16</sup> Information on revenues collected by Somaliland is included in the module on Domestic Resource Mobilization

and large, both federal and FMS taxes fall on the same bases. International trade taxes account for the vast majority of own-sources revenues at the federal level, as well as in Puntland and Jubaland (**Figure 4**). For the remaining states which do not generate taxes from customs-related activities, own-source revenues are almost nonexistent (**Figure 5**). Indeed, tax revenues in Galmudug, Hirshabelle and Southwest are all less than US\$ 0.05 per capita.

**22. Apart from taxes, the federal government derives a substantial proportion of its revenues from foreign grants.** These grants include funding from the European Development Fund, focused on state building, food security and education, as well as the World Bank Recurrent Cost and Reform Financing project. In 2018, the federal government derived about one-third of its revenue from such sources. Starting in 2018, direct donor assistance to individual states also reached a significant level (**Figure 6**). Although donor funding has increased rapidly over the past three years, future levels are unpredictable. In addition, other non-tax revenues are important sources of revenues, such as port fees, tuna licensing fees and potentially revenues from the oil sector, in the form of royalty and profit oil.

**23. The federal government, for its part, makes transfers to the Mogadishu local government and the member states.**<sup>17</sup> Approximately half of such transfers went to Mogadishu in 2017 and 2018. With few exceptions (**Figure 7**)<sup>18</sup>, the available evidence suggests that there is no rule or formula that determines the amount allocated to each jurisdiction. Instead, the amount is determined through negotiations on a case-by-case basis.

### C. Recent Developments

**24. Since the Provisional Constitution was adopted, some progress has been made on the political front as well as on specific issues.** In the last three years, in particular, there have been several meetings signaling an intention to continue dialogue. These include meetings in London, UK (May 2017), Baidoa, Somalia (June 2018), Kampala, Uganda (November 2019), Kismayo, Somalia (December 2019), and another meeting is planned for this year in Baidoa, Somalia (March 2020).

**25. On the political front, elections for the lower house of Parliament were successfully held in 2016 using a multi-stage process,** starting with the selection of traditional elders from each of the main clans. The new parliament and government convened with the leadership in 2017, promising to finalize the process before the 2020 elections. To this end, the National Security Council, comprised of the leaders of the federal government and the federal member states, met several times in 2017 and 2018, culminating in a meeting in Baidoa in June 2018.<sup>19</sup> They reached a political agreement in principle on an electoral model based on proportional representation and a closed party list system. Nevertheless, the situation remains fluid and a broader political agreement still needs to be reached.

**26. There has been some progress in defining the respective functions of the federal and state governments,** particularly for the security and education sectors.

**(i) Security.** The 2017 (London) agreement on Somalia's national security architecture represented a first step in defining the respective responsibilities of the federal and state governments. The agreement calls for a Somali National Army (SNA) and a Somali police force, divided into Federal and State Police forces. The existing regional forces are to become part of the SNA or the State

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<sup>17</sup> Domestic grants to states are financed from the federal budget.

<sup>18</sup> The Benaadir regional administration receives 15 percent of its revenues from the Mogadishu port. In 2019, the member states received revenues from tuna licensing and petroleum surface rental arrears in accordance with the fisheries and petroleum revenue-sharing agreements agreed between the FGS and the FMS in 2019 and 2018, respectively.

<sup>19</sup> "Report of the Secretary-General on Somalia, see: <https://reliefweb.int/report/somalia/report-secretary-general-somalia-s2018800>.

Police. The SNA is charged with safeguarding and defending national interests. While the agreement limits the size of the federal army to 18,000 personnel and places an aggregate ceiling on the number of personnel in the police force (32,000), it does not specify how numbers should be divided between the federal and member state levels. The respective responsibilities of the federal and state levels are also not defined, where the state (FMS) level forces are expected to ensure security within the FMS solely or with the support of the Somalia National Army (SNA).<sup>20</sup> Under the London agreement, the federal government would be responsible for the salaries and support requirements of the SNA. The member states would be responsible for the salaries and support requirements of the state-level police. Internationally mobilized resources (donor support) for the security sector would be ‘equitably distributed across the Federal and FMS level’. However, since the London Agreement does not specify the extent of federal involvement in the internal security of each state, the financial implications of the agreement are unclear.

**(ii) Education.** Some progress has been made in defining the respective functional responsibilities of the federal and member state governments.<sup>21</sup> In August 2019, the federal Ministry of Education, Culture and Higher Education (MoECHE) and representatives of the education ministries of the five member states signed a memorandum of understanding (MOU). The MOU calls for the federal ministry to develop national education policies and standards in collaboration with the states. The states are required to finance education at the state level, establish and manage the schools, and manage school personnel.<sup>22</sup> At this time, only Puntland provides some form of public education. Instead, education has been provided by a multitude of institutions ranging from non-governmental organizations (NGOs), religious groups, the United Nations Children's Fund (UNICEF) and governments at various levels, including the federal, state and local authorities, as well as the private sector.

**27. An interim agreement on the division of functions and assignment of revenues was reached in November 2019 in Kampala, which while marking a step forward, leaves several issues unresolved.**<sup>23</sup> Consistent with the Provisional Constitution, the agreement calls for the federal government’s exclusive responsibilities to include national defense, foreign affairs, citizenship/immigration, and monetary policy. However, key functions such as education and internal security (police) are allocated concurrently to the federal government, the member states, as well as (undefined) regional governments, leaving the specific division of responsibilities in these sectors undefined. With respect to revenues, the agreement calls for 60 percent of ‘shared revenues’ to be allocated to the federal government, with the remaining 40 percent to be transferred to the states to finance development projects. But it does not provide any explanation for the particular (60:40) split. Nor does it define ‘shared revenues’ or provide any guidance on the allocation of the states’ share among individual states. The agreement calls for the recurrent expenditures of states to be financed from ‘own revenues without defining the term. Paradoxically, the agreement also calls for a system of equalization transfers—although it does not explain how this will be financed or

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<sup>20</sup> The agreement also established a complex management structure for the security forces, in which a National Security Council (NSC) including the federal president and the presidents of each member state would handle ‘policy and security matters.’ The regional security councils would enforce implementation. The regional security councils would be chaired by FMS presidents and would include SNA sector commanders and state-level security departments.

<sup>21</sup> “Somalia Economic Update: Building Education to Boost Human Capital.” (World Bank, 2019).

<sup>22</sup> Under the MOU, the MoECHE is responsible for facilitating international financing for education at both the federal and state levels. The MOU (Article 13) also calls for the federal and state ministries to ‘develop guidelines for the determination of state shares in education grants’ — although this is the only reference in the document to federal financing for education.

<sup>23</sup> These expenditures guidelines were developed by the FGS and the FMS following an intergovernmental meeting in Kampala, Uganda in November 2019. The development of the guidelines was supported by the International Monetary Fund’s Staff Monitored Program IV.

distributed. Therefore, while this agreement marks a step forward in advancing the dialogue, many of the provisions will require further clarification and agreement.

28. **Several important steps have been taken to improve specific tax legislation and administration.** The Revenue Administration Law, enacted in October 2019, 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>24</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>25</sup> Additional legislation governing customs taxes has been approved by Parliament and (as of March 1, 2020) awaits the President’s signature.

29. **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.** Revenues from taxes and fees were equal to 10.3 percent of gross domestic product (GDP) in 2018 (including the federal government, the five member states and Somaliland. This figure compares unfavorably to revenue performance in neighboring countries, such as in Kenya (18 percent) and Ethiopia (14 percent).<sup>26</sup>

30. **There are multiple challenges to raising revenues in Somalia, including tax competition amongst ports.** Revenues from taxes on international trade are impeded by competition among ports, which encourages member states to reduce the customs duties at their ports in order to divert trade from Mogadishu. The result is a lose-lose situation, in which both the federal government and the member states impose rates that are lower than would otherwise be the case. Federal personal income taxes are levied only on government and selected private sector employees.

31. **The quality of tax administration is also extremely weak.**<sup>27</sup> The federal inland revenue department is short of qualified staff and equipment. As such, it is reliant on manual, rather than electronic, processes. As a result, significant discretionary power is given to tax collectors. Several actions can be undertaken to increase tax revenues.<sup>28</sup> On the policy front, the rate of customs taxes can be increased, and the coverage of the personal income tax can be extended to include wage and business income for all employees (public and private), with more attention to service sectors such as telecommunications and financial services. On the administrative front, better trained staff should be recruited, and processes should be automated, such as the electronic sharing of customs documentation. However, the current structure in Somalia implies that these types of reforms are likely to benefit jurisdictions which have major ports. By the same token, broadening the coverage of the personal income

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<sup>24</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>25</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.

<sup>26</sup> As noted in the Public Expenditure Review’s Domestic Resource Mobilization (DRM) module, citizens also pay informal taxes in the form of clan or religious contributions or payments extorted by Al-Shabaab.

<sup>27</sup> This paragraph refers to taxation at the federal level, that is, by the Benaadir Regional Administration and the inland revenue service. Information about the tax policies and administrative practices of the FMS is not available.

<sup>28</sup> These actions are drawn from the DRM module of the Public Expenditure Review (PER).

tax will largely benefit the federal government, as the majority of government employment, as well as formal employment in services, is concentrated in the capital. Such an eventuality underscores the importance of revenue-sharing mechanisms that seek to support poorer jurisdictions.

32. **Although revenues from natural resources are not large at the present time, there is some prospect that such revenues (particularly from petroleum) could become important in the future.** How these revenues should be shared among the jurisdictions that comprise Somalia is controversial. The Provisional Constitution evades this issue, stating only that ‘the allocation of the natural resources of the Federal Republic of Somalia shall be negotiated by, and agreed upon, by the Federal Government and the Federal Member States in accordance with this Constitution.’ At the aforementioned Baidoa National Security Council meeting in June 2018, an agreement was reached between the FGS and FMS regarding the division of oil and other mineral revenues between the federal government, producer FMS, producer districts and non-producer FMS.<sup>29</sup>

33. **The revenue-sharing arrangements vary depending on whether the source of oil is on-shore or off-shore, as well as according to the source of revenue** (see Table 1.) In the case of offshore oil, for example, the federal government would receive 55 percent of the government’s share of profits from oil, with 25 percent going to the FMS adjacent to where the oil was extracted offshore, ten percent to the *district* adjacent to where the oil was extracted offshore, and the remaining ten percent being shared between all other non-producer FMS (that is, two percent to each non-producing FMS<sup>30</sup>). Revenue shares from on-shore oil extraction would differ with a greater share of the profit going to the producing FMS and districts, as would shares for rents, signing bonuses, and so on. Amendments to the 2008 Petroleum Act recently passed by the House of the People require petroleum revenues to be shared in line with the Baidoa Agreement.<sup>31</sup> An analysis based on indicative oil finds in various on-shore and off-shore locations across Somalia indicates that this proposed division of resources would create substantial horizontal inequities between the different FMS, with a petroleum-producing FMS (including producing districts) receiving between 10 and 17 times more revenue than a non-producing FMS — although, in some cases, the oil may be offshore. Importantly, disparities of this magnitude, coupled with potential challenges in identifying which FMS and Districts should be deemed the producing entities in the case of off-shore production, could serve as a basis for further conflict.

Table 1: Proposed Distribution of Oil Revenues among Governmental Tiers (%)				
Details	FGS	P*. FMS	P*.District	NP FMS
Investment Fund				
Offshore	55	25	10	10
Onshore	30	30	20	20
Royalties	40	40	10	10
Signing Bonus	40	60		
Surface Rents	30	50	20	10

<sup>29</sup> Technical Committee for Facilitation of Negotiations on Federal Affairs. *Ownership, Administration and Sharing of Revenues from Natural Resources of the Country (petroleum and minerals)*. (Government of Somalia, undated). The Baidoa agreement is also included in the Petroleum Legislation which was enacted in the first quarter of 2020.

<sup>30</sup> The Benaadir Regional Administration is included with the FMS in the petroleum revenue-sharing arrangements.

<sup>31</sup> Financial Governance Committee. “Financial Governance Report.” (Government of Somalia, July 2019). The report adds: “Given that the revenue shares set out in the Baidoa Agreement have far-reaching implications for vertical (between FGS and FMS) and horizontal (among FMS) revenue distribution and equity, as well as fiscal sustainability, it is important that space remains for the Agreement to be revisited in future.”

License fees	50	50		
Production Bonuses	30	50	10	10
Corporate Income Taxes	100			
Export Taxes	60	40		
Capital gains	50	30	20	
Seismic Data	50	50		
Capacity Building	50	50		
Local Community	?%	30	70	

*Source: Baidoa agreement. Note: FGS= Federal Government of Somalia; FMS= Federal Member States; NP=non-producer; P= producer.*

34. **The recent fisheries agreement represents a more promising revenue-sharing case.** The agreement established a satellite-based system to monitor foreign vessels fishing in Somalian territorial waters (Box 3). This technically difficult task is assigned to the federal government. The federal government charges these vessels a licensing fee, which is then shared among the federal government and the member states on the basis of a formula. While some states receive more than others, the differences among states are relatively small.

*Box 3: The Fisheries Agreement*

In February 2018, the federal government and the five member states signed an agreement governing the issuance of fishing licenses for the exploitation of tuna and tuna-like species beyond 24 nautical miles from Somalia's coast, that is, outside of the zone reserved for Somali fishers. Under the agreement, vessels are monitored by a team from the Federal Ministry of Fisheries and Marine Resources through a satellite-based vessel monitoring system. Revenues from the issuance of such licenses are shared among the federal government and the member states on the basis of a formula. A total of US\$1,045,000 in license fees was collected in the first year. The table below shows the revenue-sharing formula that took effect in March 2019.

FGS/RAs	Revenue-sharing (%)
Federal Govt	29
Puntland	18
Jubbaland	13
Southwest	13
Galmudug	13
Hirshabelle	14
<b>Total</b>	<b>100%</b>

Due to uncertainties over government revenue potential in the fisheries industry, the agreement was made for a period of 18 months. It is expected that the terms of the agreement will be extended before it expires.

Source: Agreement on the Management of Fisheries and Revenue Sharing

## 4. Options and Recommendations

35. **At present, the former Somalia functions, in most respects, as seven separate political jurisdictions:** the ‘federal government’ whose authority is largely confined to Mogadishu, the five member states, and Somaliland. Despite 20 years of effort, the various regional interests have not managed to reach definitive agreements regarding the division of expenditure responsibilities between the federal and FMS governments, the assignment of revenues between them, and/or the design (if any) of a fiscal transfer system. Indeed, goods imported from one FMS are taxed in another FMS as part of revenue-generating activities.

36. **Looking ahead, different governance options can be envisioned.** Theoretically, the former Somalia could be permanently divided into seven independent countries, linked to each other only through a customs union along the lines of the European Economic Community from 1957 to 2009. Or it could become a defensive pact along the lines of the North Atlantic Treaty Organization (NATO). Both types of options are inconsistent with Somalia’s efforts to reconstitute the nation-state. At the opposite extreme, Somalia could be reconstituted as a unitary state. This option is inconsistent with demands for some degree of regional autonomy. This chapter therefore rejects both extremes and instead focuses on intermediate, federal solutions that combine varying degrees of federal and state power.

37. **The governance options presented below presume that the immediate, overriding objective of any solution is the prevention of further military conflict.** A second objective is the creation of a stable structure of government that can provide internal security and a minimum of government services on a reasonably efficient basis. Given the extreme poverty of some member states, this latter objective would imply the provision of such services either directly by a central government or through a system of transfers from the federal government to the poorest member states. Another objective is freer trade to facilitate the free movement of people and goods throughout the country, which would help to raise incomes and enhance economic growth.

38. **When considering the options, it is important to recognize that the context in Somalia is still evolving.** Firstly, the overall size of the resource envelope is likely to increase over the short-to-medium term. Reforms to tax policy and tax administration are expected to result in enhanced revenues from customs duties and personal income taxes. Somalia’s reengagement with the international community facilitated through debt relief as part of the Heavily Indebted Poor Countries (HIPC) initiative is most likely to result in higher budgetary grants.<sup>32</sup> The potential exploitation of natural resources, particularly oil, would also increase revenues. Secondly, the increase in these revenues means that the capacity of the public sector (in the FGS, FMS and Somaliland) to increase expenditures on national priorities — such as education, health and transport infrastructure — will increase.

39. **In the short term, though, any reform scenario should begin by addressing two pressing issues.** The first is the division of responsibility for financing and managing internal security. As noted, both the federal government and the states perform this function, which appears to consume most of their respective budgets. No rational progress on the assignment of revenues between the two tiers can be made until the division of responsibilities for financing this function can be determined. There are many ways to resolve this issue. In theory, the federal government could be granted sole responsibility for defense against both external and internal threats. However, the terms of the 2017 London Agreement

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<sup>32</sup> In March 2020, Somalia qualified for the Heavily Indebted Poor Countries (HIPC) initiative Decision Point, facilitating reengagement between Somalia and International Financial Institutions

suggest that a more substantial role for the states would be more acceptable. As such, Somalia might consider the experiences of Brazil and Ethiopia.

40. **Another issue concerns the administration and allocation of tax revenues from international trade.** While states that derive most of their revenues from taxes on international trade taxes would want to retain them, there is a strong case for assigning this revenue source solely to the federal government. First, it would allow Somalia to implement a common tariff policy, avoiding a race to the bottom whereby each member state (despite federal legislation to the contrary) is free to offer lower rates to attract trade.<sup>33</sup> Second, it would remove the random element of geography from the determination of each state's tax revenues, where access to ports, airports, or a border with a foreign trading partner generates taxes from international trade. Those that do not have such advantages cannot impose such taxes. Centralizing customs duties would provide the federal government with the wherewithal to provide financial support to *all* the member states, including those that have virtually no customs tax base. Third, centralizing taxes on international trade would eliminate the ability of some states to tax the residents of others, since this is a type of indirect tax.<sup>34</sup> To avoid tax exporting, states should only be assigned taxes with localized incidence. Fourth, as Somalia is party to or is planning to enter into bilateral, regional and multilateral trade agreements, a prerequisite is to have a single, national tariff schedule.

## A. Option One: No Reform

41. **If no progress is made on these governance issues, then Somalia would be left in its current situation, in which each jurisdiction finances whatever functions it can afford from its own revenues.** In the short term, the federal government's principal function (other than 'administration') would continue to be limited to national security, which would be financed with taxes collected in the Benaadir District as well as donor support.<sup>35</sup> Similarly, outside of Mogadishu, the individual member states would spend most of their budgets on internal security, and would be reliant on their own tax bases, donor support, and a trickle of grants from the federal government. Over the longer term, as the yield of domestic taxes increases, the member states could increase spending on non-security-related functions including education, transport and health. The states with stronger tax bases would expand spending in these sectors relatively quickly; however, those without such tax bases would fall further behind. The federal government, for its part, could increase spending on these functions, either in Mogadishu and/or in the member states.

42. **The current status option has several drawbacks.** First, it does not resolve the ambiguities in the division of functions between the federal government and the member states. Second, it does not resolve the problems associated with what is, *de facto*, a decentralized tax on international trade. However, most importantly, in leaving each jurisdiction to fend for itself, it would leave several states with very limited resources. As shown in Figure 6, Galmudug, Hirshabelle and Southwest have virtually no tax revenues of their own. Because these jurisdictions lack major ports, their revenues from taxes on international trade will continue to be minimal, even as the national economy grows. Furthermore,

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<sup>33</sup> Although the October 2019 Revenue Administration Law states that customs taxes will be based on federal law, it does not explicitly require the rates to be harmonized among the member states. It should also be noted that the adoption of a national tariff schedule is a HIPC Completion Point trigger

<sup>34</sup> With indirect taxes the ultimate incidence of such taxes falls not on importers, but on the final consumers. Those consumers may not live in the jurisdiction where the tax is collected. Goods imported through the port of Mogadishu, for example, may be sold to customers in Galmudug — in effect forcing consumers in Galmudug to subsidize the taxpayers in the capital.

<sup>35</sup> In addition, it would presumably be responsible for the conduct of foreign relations, the issuance of passports, and the various central bank functions including: the issuance of currency and regulation of the banking sector. On the revenue side, it could continue to collect taxes on telecommunications and overflights.

because most growth in the formal economy will presumably occur in Mogadishu and larger cities of Puntland and Jubbaland, revenues from the personal income taxes (PIT) or other domestic taxes will be limited in the other member states as well.

43. **A much preferable option would be to fundamentally restructure the relationship between the federal government and the member states.** This would entail centralizing the tax on international trade, clearly delimiting the respective responsibilities of the federal and state governments. It would also involve organizing a system of transfers to ensure that all member states have the wherewithal to provide the functions assigned to them. Two functional decentralization options bear consideration.

## B. Option Two: Functional Federation

44. **Under the functional federation approach, the majority of public sector functions would be assigned to the states.** This would include responsibility for internal security, primary and secondary education, primary health care and intra-state transportation. (The individual states, for their part, could delegate some of these functions to their respective local governments.) The federal government's functions would be limited to national defense, along with foreign affairs, international and interstate transport (for example, international airports, highways and railroads), monetary and fiscal policy, and the regulation of the banking system. If such an approach was followed in Somali, the permanent Constitution would resemble those of many other federations including Brazil, Ethiopia, and Nigeria.

45. **There are multiple fiscal implications of option 2:** With the majority of functions assigned to the state level (and the Mogadishu local government) and the absence of strong tax bases in the three poorer member states, option 2 would require a large-scale transfer system. Centralized revenues from taxes on international trade could be used to finance a transfer system, supplemented with resources from grants. Over the longer term, there could be additional revenues from federal corporate income tax or a production-based value-added tax (VAT). In the short term, any attempt to centralize taxes from international trade would reduce the revenues generated by the states that have ports. Experience with similar reforms in other countries suggests that, at the outset, the transfer will have to compensate them for this loss. For example, in the first year, the transfer to each state might be equal to the amount of revenues generated from taxes on international trade in the year prior to the reform. While such an approach would not reduce disparities, an equalization formula could be introduced over time. A hold-harmless provision could be specified, such that the amount of the transfer would always be at least equal to the amount the state collected in the year prior to the reform.

46. **There are innumerable ways to implement a large-scale transfer system.** The most complex and ambitious form of an equalization transfer is one that attempts to fill the gap between the expenditure needs of each jurisdiction, based on the costs of particular service standards, as well as the ability of each jurisdiction to finance those needs from its own tax bases. Although this approach is used in several former members of the Soviet bloc (as well as Ethiopia), it has several drawbacks. First, it is extremely difficult to calculate expenditure needs, as the costs of meeting service standards for individual functions varies across jurisdictions. Moreover, the costs of meeting any uniform set of national standards is likely to far exceed the available resources, requiring some arbitrary form of rationing. Certainly in Somalia, where the quality and quantity of public services (education, primary health care, roads) has deteriorated so badly, the cost of meeting uniform standards will far exceed the available resources for years to come. Second, it is difficult to calculate the ability of individual states to generate their own revenues. Some states have strong tax bases; others have weak ones. Moreover, the yields of any particular tax are affected by the quality of its administration and the rates at which it is imposed. Therefore, allocating more equalization transfers to states with low tax revenues, in effect, punishes states with strong economies and discourages states from improving the quality of their tax

administration. Some countries address this problem by allocating transfers on the basis of *potential* revenue, which is also difficult to determine. Formulas that rely on actual revenues in previous years encourage strategic behavior: states have an incentive to limit local tax revenues in order to increase the amount of transfers they receive. For these reasons, formulas for distributing discretionary transfers are often much less ambitious.

47. **A more practical alternative would be to allocate transfers on the basis of more generic indicators of need — making no attempt to calculate the revenues (potential or otherwise) of individual member states.** In its simplest form, for example, transfers could simply be allocated on the basis of population using the most recent census data. The total amount of the transfer could be based on a fixed percentage of federal tax revenues. In this respect, it would resemble the transfer systems of Brazil and Nigeria, as described at the beginning of this chapter. If significant oil deposits are discovered in a particular member state, the transfer formula would have to be modified. Alternatively, the Baidoa Agreement would have to be changed. It is very possible that revenues from oil could outstrip other sources of revenues used for the equalization transfer (See Box 4).

#### *Box 4: Oil Revenues and Equalization Transfers*

When and if significant oil deposits are discovered in Somalia or its territorial waters, the design of the equalization transfer system will have to take this into account. As noted, the Baidoa Agreement calls for half of the profits from onshore discoveries—and 35 percent of profits from offshore discoveries—to be allocated to the producer states and districts. Such windfalls could dramatically widen disparities in the per capita revenues of the member states.

There are two ways to address this issue. One is to take state oil revenues into account in the formula that is used to distribute the equalization transfer, that is, to reduce equalization transfers to states with high levels of revenues from oil. However, a better—and more common — approach would be to change the Baidoa Agreement itself. This would entail reducing the share of revenues allocated to producer states, and increasing the share allocated to the FGS. The FGS could then use this increase in revenues to increase the level of equalization transfers to all member states.

International practices in the sharing of revenues from natural resources include:

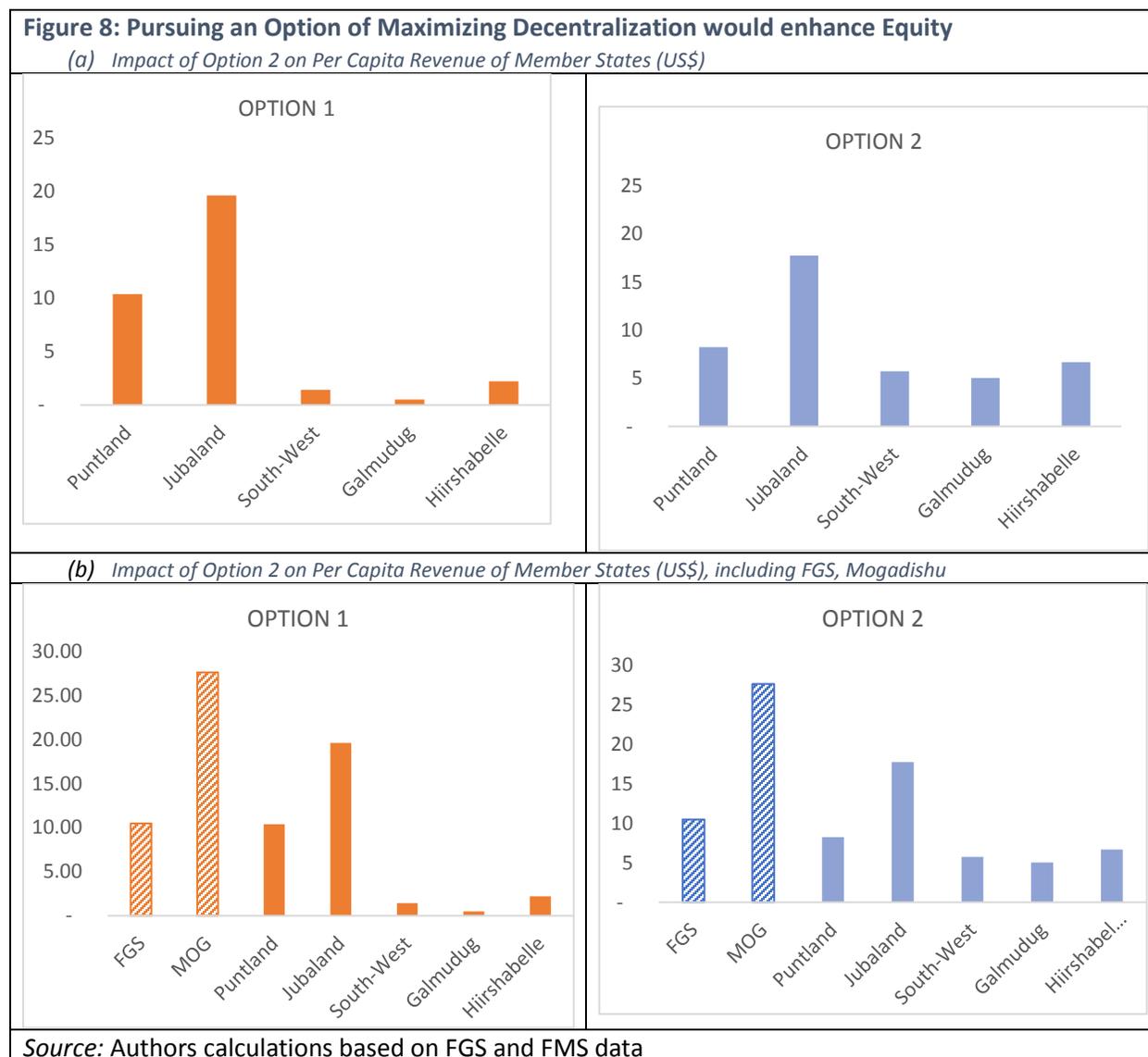
- Centralized collection of revenues. The central government then retains part of the revenues and distributes the rest to subnational governments on the basis of a formula. (In a few cases, including Canada and the United States, natural resource taxes are collected directly by the states in which the natural resources are located. However, this approach is not recommended in the case of Somalia.)
- Some countries (such as Chile and Norway) pool revenues from natural resources with all other central government revenues and distribute them to subnational governments as part of a general intergovernmental transfer system.
- Other countries (such as Brazil, Ghana, Indonesia, and Nigeria) use a separate formula for distributing natural resource revenues among subnational governments. To varying degrees, they allocate the subnational share on a derivation basis, that is, on the basis of where the natural resources are located.
- The proportion of revenues shared on the basis of derivation varies, but it is generally far lower than indicated in the Baidoa Agreement. In Ghana, for example, only 4.95 percent of oil revenues are distributed on a derivation basis. In Uganda, the figure is 6 percent, in Indonesia, 9.3 percent, and in Nigeria, 13 percent. (In Brazil, however, the figure is 30 percent.) The remainder is retained by the federal government and is allocated to both producer and non-producer states on the basis of population or other factors.

*Source:* Natural Resource Revenue Sharing (UNDP, 2016) and authors

48. **Figure 8 illustrates the fiscal implications of Options 1 and 2.** The Figure labelled Option 1 illustrates the per capita revenues of each state under the existing system (based on data for 2018). The Figure labeled Option 2 illustrates the implications of a very simple version of the changes described above: specifically, each state would lose its customs revenues, which would instead be collected by the federal government and deposited in an equalization fund. In addition, the federal government would contribute half of its customs taxes to the fund. The amount in the fund would then be distributed to each state on the basis of its population. As shown, this would still leave substantial disparities in the per capita

revenues of the various states because of the existing variations in domestic revenues. However, it would provide a lifeline to the three poorer states.

49. **It is difficult to disentangle the federal revenues that finance federal services to Somalia as a whole from those that benefit only the residents of Mogadishu.** Thus, the figures do not show an amount for the federal government. The potential impact of the two options for the federal government can nevertheless be illustrated using somewhat arbitrary assumptions. Figure 8b illustrates the fiscal implication of the two options. It is based on the assumption that 75 percent of federal expenditures are devoted to services that benefit Somalia as a whole and the remaining 25 percent on services that benefit residents of Mogadishu. (The per capita figure for the federal government is based on Somalia’s total population, whereas the figure for Mogadishu is based only on the population of the city).



50. **The question remains whether transfers be earmarked.** In the short term, the answer is probably not. Although it might be tempting to require transfers to be spent on activities that the federal government considers ‘priorities’, the obstacles to doing so are formidable. At present the quality of data

on budget execution is limited. As of end-2019, the states have only begun to report spending by economic category. Only two states report spending by department. None report spending by function. Also, none of the reports are audited. Under these circumstances, earmarking requirements would be easily evaded. Efforts are ongoing to improve the quality of fiscal reporting. For the present, however, it would be best to allow each state, and the Mogadishu local government, to spend their equalization transfers according to their own priorities.

51. **Over time, as the federal government’s ability to enforce earmarking improves, Somalia could consider sectoral earmarking, particularly for the education and health sectors.** There is a strong case for federal involvement in the financing of both services: a healthy and educated work force benefits all Somalis. Also, there is some concern that some states may underfund this function. Both services are particularly critical to improving the living standards of the poor. (Federal support for education and health should be kept separate from the equalization transfer, however, as the two forms of transfers pursue different objectives.) To ensure a minimum level of spending in each state (and in Mogadishu), the federal government has several options. One is to simply pay the largest component of spending in each of the sectors. In the case of education, this would consist of teachers’ salaries. Such an arrangement could take the form of an earmarked transfer to each state government, calculated on the basis of the number of federally-authorized teaching positions and a federally-dictated salary structure.

52. **Alternatively, the federal government could calculate the education sector transfer based on enrollment, transferring a fixed amount per pupil to each state based on the number of pupils attending classes.** In the case of health, the transfers could cover both the salaries of health care workers and basic medicines and supplies. Again, the distribution of such funding could be based on authorized inputs (for example, the number of authorized health care workers) or on an indicator of demand (for example, the number of registered patients).

53. **Either of these transfer approaches to the social sectors would require close supervision by the federal government, since they contain perverse incentives.** Under the first option, states would have an incentive to pressure the federal government to authorize more staff than they need. Under the second option, states would have an incentive to overstate enrollment (in the case of schools) or registered patients (in the case of health care). In this context, any attempt to establish earmarked transfers should be held off until the federal government has the administrative capacity to limit such behavior.<sup>36</sup>

54. **Possible tax sources for the states:** In theory, even with the federal government monopolizing customs taxes, states (and the Mogadishu local government) would have a wide range of options. These would include personal and corporate income taxes, broad-based taxes on goods and services (for example, a VAT or a retail sales tax), taxes on the sale of specific goods and services), and various forms of property taxation. However, the range of options is in fact more limited for two reasons.

55. **The range of taxation options for states is limited as a matter of principle.** As noted, residents in one state should not be permitted to tax the residents of another. Several of the taxes cited above do not have localized incidence, borne by the taxpayer in the jurisdictions where the tax is collected, but is shifted elsewhere. The incidence of a corporate income tax, for example, may be shifted backward onto stockholders or labor — or forward onto consumers living in other jurisdictions. The incidence of a VAT,

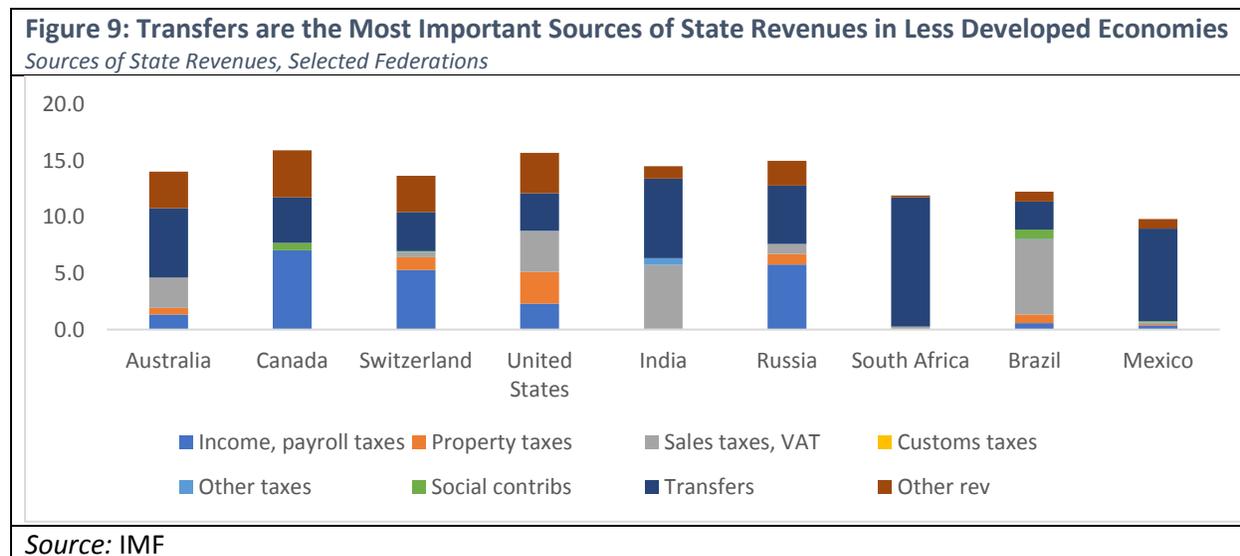
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<sup>36</sup> A recent World Bank report, *Education Programmatic Technical Assistance: Education in Federal Systems – Lessons from Selected Countries for Somalia* (2019) surveyed the organization and financing of education in three federal countries (Bosnia Herzegovina, Pakistan, and South Africa) with the aim of drawing lessons for Somalia. In all three countries, education is largely provided by the intermediate tier of government: the provinces (Pakistan and South Africa) and the ‘entities’ (Bosnia). To varying degrees, these units of government are financed by transfers from the federal government. However, in all three cases, the transfers are not earmarked for education. The recipient governments are instead free to use the funds at their own discretion.

similarly, may be shifted across state lines. For this reason, the list of candidate state taxes should be limited to those that are localized: the personal income tax, retail sales taxes, taxes on retail sales of specific products, and property taxes.

56. **The range of taxation options for states is also limited for purely practical reasons.** Some taxes are more cost-effective to administer than others. Taxes are inexpensive to administer when they can be imposed on a large volume of taxable activity flowing through a small number of collection points. In Somalia, few direct taxes meet this criterion. However, some do—to an extent. One is the personal income tax. The PIT can be difficult to administer in an economy where most incomes are generated from farming or small-scale trading and manufacturing. However, personal income taxes can be cost effective where they are imposed through withholding, that is, by requiring employers to deduct the amounts due from their employees’ paychecks. For the present, the number of such employers is likely to be limited to the federal and state governments and large ‘formal’ firms such as banks as well as non-governmental organizations. States could nevertheless be assigned this tax. It should be noted, though, that this would not preclude the federal government from imposing a tax on the same base. In Canada and the United States, for example, both the federal and state governments impose a personal income tax.

57. **The other option is a retail sales tax.** Like the PIT, the retail sales tax can be difficult to administer in an economy where most retailing is done by small-scale traders. In such cases, the volume of transactions per taxpayer is small and record keeping is typically poor. Nevertheless, the growth of large-scale retail suggests that this could be an important source of state revenue in the future.



58. **For the foreseeable future, states would be largely financed from federal transfers under Option 2.** This would be consistent with other federations, particularly those with less developed economies. Figure 10 shows the sources of state revenues in a sample of federal countries.<sup>37</sup> As shown, states in Mexico and South Africa derive virtually all their revenues from transfers. Even in more developed countries, transfers are a primary source of state revenues, accounting for 34 percent of state revenues in Russia, 26 percent in Canada and Switzerland, and 21 percent in the United States.

<sup>37</sup> Data is from International Monetary Fund (IMF) Government Finance Statistics website and is limited by the number of countries reporting relevant data.

## C. Option Three: Centralization of Major Functions

59. **Another option would entail having the federal government assume direct responsibility for a wider range of services.** In addition to national security, this might include education, health care, and transport infrastructure. The federal government, for example, could assume direct responsibility for primary and secondary education, recruiting and managing teachers and paying their salaries. This is a common approach in unitary countries (such as France) where the responsibilities of local governments are limited to operating and maintaining school buildings. As in Option 1, this would require most taxing power to be concentrated at the federal level. However, unlike Option 1, this would not require a major system of intergovernmental transfers. Instead, spending on centralized services would be financed directly by the federal budget. In choosing between the options, states would have to decide whether they would prefer to give up management responsibility for these functions in return for escaping the burden of paying for them.

## 5. Summary and Recommendations

60. **Nearly 30 years after the collapse of the Siad Barre government, the regional interests governing separate parts of Somalia have yet to devise a workable governance arrangement for the country as a whole.** Although there has been progress in the form of the 2012 Constitution and certain agreements on specific issues, critical decisions about the role of the federal government vis-a-vis the states have yet to be reached.

61. **A federal approach, consisting of (1) a central government whose powers and resources are deliberately constrained and (2) member states, with a wider mandate and guaranteed access to federal funding, would appear to be a promising way of gaining the benefits of a national government while also accommodating regional demands for autonomy.**

62. **The federal approach would require a definition of the functions and resources of each of the two tiers of government.** In the short term, this involves two issues. The first is the division of responsibility for security. At present, while the federal government is nominally responsible for national security, the member states also maintain their own armed forces. Under the terms of the 2017 London Agreement, the federal government would be responsible for national defense, but both tiers would play a role in maintaining internal security. In working out the details of such an arrangement, Somalia could consider the examples of Brazil and Ethiopia.

63. **Another immediate issue concerns tax revenues from international trade.** There are strong arguments for giving the federal government exclusive power to impose customs taxes. In the short term, states that are reliant on customs taxes would have to be compensated. This could be accomplished through a federal transfer, funded in part from the federal government's newly-expanded customs revenues. Such a compensation transfer should be considered temporary, however.

64. **Over time, as revenues from customs taxes and domestic taxes increase, along with possible revenues from oil, the ability of the public sector to expand spending on non-security related functions will increase.** These functions would include education, transportation, and health care. This will again require a definition of the respective responsibilities of the federal and state government in these sectors. One option is to assign responsibility for managing these functions to the state level, but assign responsibility for financing them to the federal level.

65. **To this end, the federal government could establish a transfer aimed at ensuring that even the poorest states have the wherewithal to provide a minimum level of the services for which they are responsible.** This could be phased in as the compensation element of the transfer is phased out. In

designing such a transfers, elaborate formulas should be avoided. There is a strong case for allocating transfers to the states solely on the basis of population, at least until such time as the federal government is able to accurately monitor the functional allocation of state expenditures. Even afterward, attempts to fine-tune distribution formulas to reflect supposed variations in unit costs or revenue potentials should be avoided.

66. **In this connection, there is a case for re-visiting the Baidoa Agreement regarding the distribution of revenues from the exploitation of oil and other mineral resources.** Consideration could be given to reducing the share of oil and gas revenues allocated on the basis of derivation and increasing the proportion that is used to reduce disparities in the per capita revenues of the members states.

67. **In order to supplement federal transfers and fund discretionary expenditures, individual states should be authorized to impose direct taxes.** Given the informal nature of state economies, the options for raising significant revenues through such taxes are limited. However, there are two promising candidates: the personal income tax, which would be largely imposed through withholding from the employees of governmental organizations and large enterprises, and a retail sales tax.

68. **Some of the agreements on these issues should be enshrined in the revised Constitution; others in ordinary law.** Apart from establishing the structure of the state (the organization of Parliament, the role of the head of state, the federal election system), a federal constitution typically provides the broad outlines of the relationship between the central government and the states. These provisions are intended to be permanent—or at least difficult to change. To this end, the rules for amending a constitution typically establish a much higher threshold than is the case for ordinary legislation. Somalia's 2012 Constitution is typical. It requires a two-thirds majority in both houses of Parliament to amend the constitution. Ordinary legislation requires only a majority vote in both houses and the signature of the president.

69. **Regarding the relationship between the federal government and the member states, the constitution should include only those provisions that are *not* intended to be frequently revised.** This would include, for example, a broad definition of the functional responsibilities of each of the two tiers, recognizing that ordinary legislation may permit the federal government to regulate functions nominally assigned to the states. By the same token, the constitution should define the respective tax instruments assigned to the federal and state governments, while leaving the details governing tax rates and tax administration to ordinary law.

70. **In principle, the same rule applies to transfers and the division of oil revenues, that is, the constitution should outline the broad principles and leave the details to ordinary legislation.** Thus, the constitution might say that 'the federal government will make equalization transfers with the aim of reducing disparities in per capita revenues among the states' and 'oil revenues shall be centrally collected and shared among the federal government, the producer states and the non-producer states'. Details would be left to ordinary legislation.

71. **But the distribution of centrally collected revenues — whether ordinary taxes or oil revenues — can be very controversial. Leaving the details to ordinary legislation runs the risk of provoking disputes among the member states in every legislative session.** To prevent this, some countries enshrine their transfer distribution formulas in their constitutions. (As described in Box 2, Brazil is one such case.) In these cases, the transfer formula can still be revised, but only by amending the constitution. Other countries allow changes in the distribution formula, but only at periodic intervals. India's transfer formula, for example, can only be changed every five years (See Box 4.) Some countries attempt to de-politicize

the process of revising the distribution formula by assigning the task to a fiscal commission staffed by technical experts. Box 6 describes two such examples. However, it has to be recognized that these finance commissions only operate in an advisory capacity. Ultimately, the decisions concerning the distribution of transfers and natural resource revenues must be incorporated in legislation (or presidential decrees, as in India). Therefore, they require a political consensus. Given current uncertainties over the scale and location of possible oil recoveries, Somalia should probably refrain from enshrining a distribution formula in the constitution at the present time, and instead leave this to ordinary legislation.

*Box 5: Intergovernmental Finance Commissions: India and South Africa*

Several federal model countries employ constitutionally-mandated finance commissions to recommend changes in the distribution of intergovernmental transfers to subnational governments. The Indian Constitution (Article 280), for example, requires the President to appoint a finance commission at five-year intervals to perform this function. As specified in the Finance Commission Act (1951), the Chairman of the Commission is to be 'selected from among persons who have had experience in public affairs.' The four other members are selected from among persons who 'are (or are qualified to be) appointed as judges of a High Court; have special knowledge of the finances and accounts of Government; have had wide experience in financial matters and in administration; or have special knowledge of economics'. The Chairman of the most recent (15th) Finance Commission is a former member of parliament. None of the other members are or have been politicians. The Commission conducts extensive hearings before making its recommendations. Its recommendations are implemented by an order of the President. Although the Commission's recommendations are not binding on the government, there is a strong precedent for following them.

South Africa's Constitution (Section 220), similarly, establishes a Financial and Fiscal Commission (FFC) which is charged with making recommendations to the Parliament regarding the distribution of revenues collected by the federal government. South Africa's 1996 Constitution initially provided for each province to appoint a representative to the Commission, who would serve along with a chair and deputy chair appointed by the president, two representatives of local governments and nine appointed members. This proved to be unwieldy. The Constitution was amended in 2001, replacing the nine provincial representatives with three members selected from a composite list of provincial nominees. (The Minister of Finance collects nominations from the provincial governors (premiers) who must endeavor to reach a consensus.) Unlike the Indian Finance Commission, the South African Commission operates on an ongoing basis. At least ten months before the start of each financial year, the Commission must submit its recommendations for that year to both houses of Parliament and the Minister of Finance. The Minister then required to take these recommendations into account before introducing a division of the revenue bill into the national assembly.

Sources: South Africa: <https://ffc.co.za/docs/publications/brochure.htm>,

India: <https://fincomindia.nic.in/>

72. **Since the Djibouti Peace Conference twenty years ago, there have been many attempts to reach agreement on the terms of a federal structure for Somalia.** Many of these have started off ambitiously and have ended inconclusively. The 2012 Provisional Constitution did so deliberately, leaving most issues of revenue and expenditure assignment to be determined at a later date. However, as noted, the same could be said of subsequent agreements, including the 2017 London Agreement on security and the more recent memorandum of understanding on education, the Kampala Agreement on the division

of functions, and the 2019 Revenue Administration Law. The Fisheries Agreement by contrast, does include a specific formula for dividing revenues among the federal government and the member states.

73. **Efforts to reach agreement about the fundamental parameters of the federal structure should certainly continue.** However, there is also a case for pursuing more modest targets, where rapid, concrete results that clearly benefit the participants can be achieved. Modest objectives might be applied to the pressing issues of security and taxation. In the former case, within the framework of the London Agreement, the federal government might agree to maintain a specified level of its own military personnel in a member state — in return for that state transferring most of its security forces to the SNA. In the latter case, the federal government might agree to a hold-harmless provision for any state that allows the federal government to administer and collect its customs revenue. Such measures will not create a federal Somalia. But they can build trust among the federal government and the members states, which could be the basis for more comprehensive agreements later on.

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## Statistical Appendix

<b>Table 1. Federal Government Operations 2018 - 2019</b>					
<b>General government finances (millions of dollars)</b>			<b>2018</b>	<b>2019</b>	
<b>Revenue and grants</b>			<b>270.2</b>	<b>338.3</b>	
<i>Tax revenue</i>			<b>138.9</b>	<b>154.8</b>	
Taxes on income, profits, and capital gains			8.6	11.7	
Taxes on goods and services			22.1	25.0	
Taxes on international trade and transactions			100.3	107.0	
Other taxes			7.9	11.1	
Other revenue			44.5	74.9	
<i>Grants</i>			<b>86.8</b>	<b>108.6</b>	
From foreign governments			23.5	36.4	
From international organizations			63.3	72.2	
<b>Total expenditure</b>			<b>267.8</b>	<b>314.5</b>	
Compensation of employees			143.1	162.3	
Use of goods and services			80.6	92.7	
Consumption of fixed capital			9.9	14.1	
Interest and other charges			0	0	
Subsidies			0	0	
Transfer to sub-national governments & Banadir Region			30.1	43.5	
Other expenses				0.4	
Contingency			4.1	0.7	
<b>Table 2. Federal Member States Operations, 2019</b>					
	<b>Galmudug</b>	<b>Hirshabelle</b>	<b>Jubbaland</b>	<b>South West State</b>	<b>Puntland</b>
<b>Revenue and grants</b>	<b>6,476,734</b>	<b>5,984,825</b>	<b>38,431,463</b>	<b>21,335,204</b>	<b>62,932,062</b>
Tax revenue	3,098,620	1,455,024	20,876,272	4,737,286	62,433,562
Taxes on income, profits, and capital			425,119	305,223	176,093
Taxes on payroll and workforce		273	1,080,260	804,415	3,884,080
Taxes on goods and services	2,132,221	800,805	9,616,220	1,716,210	5,655,099
Taxes on international trade	499	653,946	9,644,551	1,250,727	36,523,075
Other taxes	896,950		110,122	329,661	
Other Revenue	68,950		452,322	331,050	16,195,215
Grants	3,378,114	4,529,800	17,102,867	16,597,918	498,500
From international organizations	2,359,034		11,748,887	4,288,742	
From other general government units	1,019,080	4,529,800	5,353,980	12,309,176	498,500
<b>Total expenditures</b>	<b>6,275,170</b>	<b>5,940,994</b>	<b>38,977,184</b>	<b>21,395,273</b>	<b>61,743,441</b>
Compensation of employees	5,672,591	3,610,910	30,197,842	14,559,175	28,245,775
Use of goods and services	352,870	1,006,281	7,465,693	2,022,147	15,824,357
Consumption of fixed capital	93,073	832,300	798,719	4,320,906	1,047,509
Other Expenses		491,503	331,959	441,045	7,262,694
To other General Government Units	161,634		182,971	52,000	9,363,106

Source: Federal Government of Somalia and preliminary reports from the Federal Member States