REALIGNING SOMALI'S FISCAL STRATEGY

Policy brief: February 2024

KEY MESSAGES

- The Revenue Assignment Agreement displays ambiguities and inconsistencies that require attention for standardization and proper classification of tax categories.
- Clarity is needed regarding tax policy roles and collection responsibilities to ensure effective management and enforcement.
- Revenue allocation appears disconnected from the functional assignment agreement. Local governments and municipalities are granted significant powers, more than the state government in some instance, but lack a designated tax authority, thus undermining their ability to provide services effectively.
- Inconsistencies exist in the application of tax collection, raising questions about assigning both tax policy and revenue collection to a single jurisdiction.
- Inclusive and technical consultation is lacking, rendering agreements more of apolitical manifestos than practical action points.
- The National Consultative Council's decision on functional responsibility and revenue assignment lacks coherence. This may lead to imbalanced funding for public services.
- The power allocation agreement represents a significant move towards decentralized service delivery and aligns with constitutional proposals however, challenges persist that require attention such as power duplication and control discrepancies.
- Successful implementation of agreements requires addressing challenges like the lack of unanimous endorsement from all Federal Member States (FMSs), limited engagement during deliberation, and ensuring technical capabilities alongside political agreements.

Introduction

Somalia's governance structure has undergone significant changes over the years. Following independence in 1960, the country was ruled under a unitary system, largely by the Soviet Union-affiliated military regime. However, in January 1991, the state system collapsed entirely, plunging the country into a devastating civil war, clan conflicts, ideological clashes, and natural disasters, resulting into widespread death, displacement, and loss of livelihood for millions. Since 2000, Somalia has been gradually transitioning towards a federalized model, driven by the need to address historical grievances related to centralized power and unfair resource distribution. The aim has been to improve service accessibility, devolve power to regional and municipal levels, and enhance local governance.

The National Consultative Council (NCC), established in early 2014, emerged as a vital platform for negotiations among Somalia's top political leaders. It convenes representatives from the Federal Government of Somalia (FGS), Federal Member States (FMS), and Benadir Regional Administration (BRA). Its members, including the president, prime minister, and deputy prime minister of the federal government, along with presidents of five federal member states and the governor of Benadir, now include the deputy prime minister to represent Somaliland.

Since the adoption of the provisional constitution in 2012, the National Consultative Council (NCC) has convened numerous sessions, initially focusing on security concerns. However, a notable shift occurred in 2022 and 2023, when discussions expanded to encompass functional and revenue assignment. During these sessions, stakeholders achieved significant agreements regarding the allocation of powers and revenue responsibilities between the federal government and sub-national units. These agreements delineated revenue powers into three distinct categories: those exclusively under federal jurisdiction, those reserved for state governments, and concurrent powers shared by both levels of government.

While there have been some successes, challenges remain, particularly concerning the preservation of national unity. Under the new framework, Somalia is divided into five federal member states (Puntland, Galmudug, Jubbaland, Southwest, and Hirshabelle), alongside Somaliland, which unilaterally declared independence. The Banadir Regional Administration, although participating in the NCC and IGFF forums, awaits constitutional status as the national capital hosting the federal government and functioning as a devolved administration. Since the re-election of Somali President Hassan Sheikh Mohamud in mid-May 2022, the National Consultative Council (NCC) has intensified its meeting frequencies, addressing critical issues such as the National Security Architecture (NSA), the judiciary model, political system reforms, election model, and the national fiscal arrangement. Despite some progress, challenges remain, notably with Puntland withdrawing from the platform. This background creates the need for a comprehensive policy that provides for the division and management of finances, tax collection and financial administration for each level of government in Somalia.

This policy brief assesses the agreements made in the National Consultative Council (NCC) and proposes recommendations and suggestions aimed at ensuring the successful implementation of both revenue and functional fiscal agreements. It critically analyzes the content, identifies potential challenges, and proposes policy considerations.

BACKGROUND OF THE STUDY

An overview of the fiscal issues in Somalia

The 2012 Provisional Constitution of Somalia lacks clear delineation of revenue collection and administration powers between the federal government and member states governments, and thereby necessitating negotiations and agreements between the different government levels. The constitution emphasizes allocating revenue responsibilities to the most effective level of government, considering expenditure assignments, service costs, and funding sources. However, challenges continue to persist due to legal, political, institutional, and security factors. In adherence to the Subsidiary Rule, the Provisional Constitution states that service implementation responsibilities should be allocated to the most competent and accessible level of government relative to the citizens in need. Except for specific areas like currency, citizenship, immigration, and foreign affairs, all other roles and duties are open to negotiation between the Federal Government of Somalia (FGS) and the subordinate entities.

Article 54 states that “the allocation of powers and resources shall be negotiated and agreed upon by the Federal Government and the Federal Member States.” (Article 50(f)) also provides that ‘revenue-raising responsibilities should be given to the level of government that can exercise that responsibility most effectively.” These aspects remain unresolved, pending the ongoing constitutional review process.

METHODOLOGY

The methodology included a thorough literature review, primary data collection on taxation laws and practices, current jurisdictional responsibilities, and interviews with experts, finance ministry officials, and political economists. Empirical analysis centered on intergovernmental fiscal arrangements. We interviewed 19 experts including politicians, finance experts, officials from the finance miniseries, and political economists.

Fiscal federalism status

Since 2015, significant financial and economic reforms have been going on, including establishing a financial management system, re-engaging with international financial and economic institutions, and restructuring national financial governance. These reform efforts involved heterogeneous and parallel work across different layers of government, with different efforts, systems, policies, and technical assistance implemented in different jurisdictions. Harmonization efforts began through forums such as the Finance Ministers' Fiscal Forum and the Intergovernmental Fiscal Federalism Technical Committee, resulting in key agreements. These platforms have managed to harmonize syntax and created the adoption of a temporary grant-sharing formula (60/40) between the FGS and FMS.

The grant sharing formula is tied to reform parameters such as revenue collection enhancement, budget management accountability, and regulatory compliance. Although tariff harmonization remains incomplete, Somalia achieved significant milestones, including debt relief of $4.5 billion under the HIPC Initiative. Agreements were also reached on revenue sharing from fishing licenses, income tax harmonization and natural resource revenue between the FGS and FMSs that was facilitated by the NCC rather than through formal fiscal federalism forums. It's worth noting that parallel efforts on fiscal federalism occur at the ministerial level. For example, the Ministry of Interior, Federal Affairs, and Reconciliation, in collaboration with state-level ministries, have been actively engaging on the subject over time. They have published papers exploring options for responsibility allocation and revenue assignment between the different levels of government in Somalia. Somalia's accession to the East African Community in 2023 presents opportunities for trade integration but also presents procedural challenges.

Currently, Somalia's national revenue system is fragmented, with each authority imposing taxes independently and with significant regulatory frameworks remaining unharmonized. The country heavily relies on taxes from international trade and donor grants for revenue. This fragmented approach leads to inefficiencies and confusion. To advance fiscal federalism, there is a need for a procedural transition towards synchronized revenue allocation and functional responsibility. Improving capabilities and investing in institutional capacity building programs are also crucial steps in the process. Owing to the lack of a fully defined federal structure, there exist no distinct boundaries or constraints delineating the functions of each governmental tier. This lack of clarity allows any level of government to assume tasks as they see fit, resulting in a considerable overlap of responsibilities. For instance, state governments might undertake duties earmarked for the federal government, and vice versa. Moreover, each Federal Member State (FMS) independently operates its security forces, administers services, and engages in diplomatic affairs without central government sanction.

FINDINGS

Some Aspects of the NCC Agreements

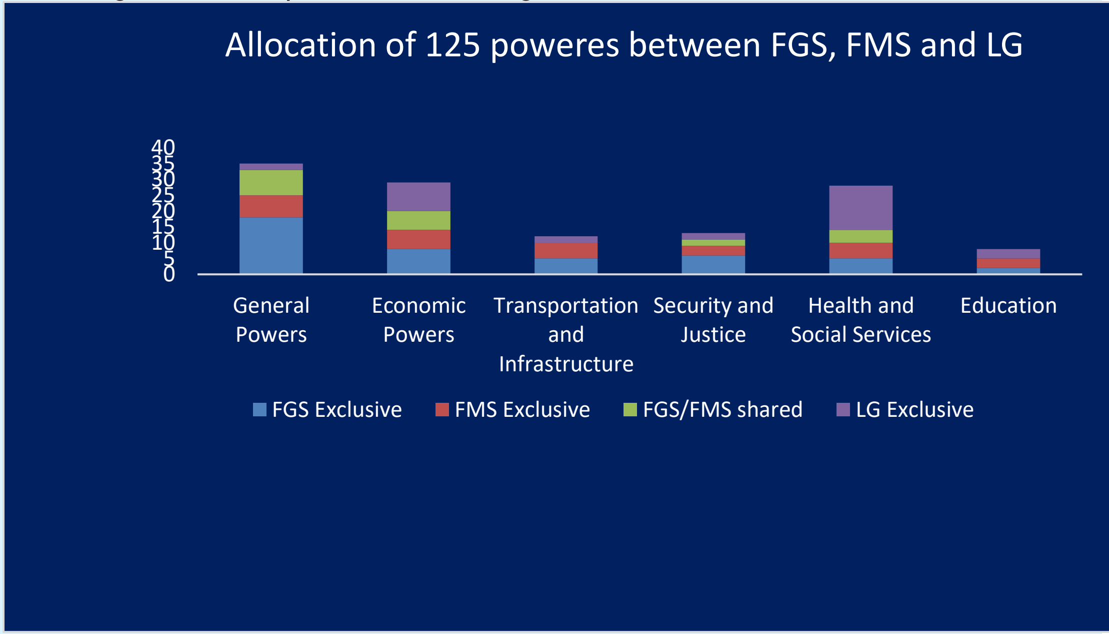
The decisions made by the National Consultative Council (NCC) regarding functional responsibility and revenue assignment have been observed to be both a good beginning but disjointed and overlooking the critical interplay between the two levels of government together with lack of proper consultation between the two levels. This approach deviates from the principle of "funds follow functions," which underscores aligning financial resources with assigned responsibilities. Consequently, the agreements fail to adequately link funding with the provision of public services, potentially resulting in imbalances where some activities lack sufficient funding while others receive an excessive amount. Moreover, the absence of unanimous endorsement from all Federal Member States (FMSs) may hinder the implementation of the agreements, leaving dissenting states unaffected. Furthermore, the implementation of these agreements requires not only political agreements but technical capabilities, wider acceptance, and stability.

THE POWER ALLOCATION AGREEMENT.

According to the agreement detailing power allocation, powers will be categorized into federal exclusive, state exclusive, concurrent/shared, and local government exclusive powers. The Federal Government of Somalia (FGS) will have 44 exclusive powers (compared to the current 4 in the Provisional Federal Constitution), while Federal Member States (FMSs) will have 29 exclusive powers. Additionally, 20 powers will be shared between the FGS and FMS, with 32 powers exclusive to local governments. The agreement also outlines powers exclusive to the legislative bodies of federal, state, and local governments.

Despite some challenges, the rationale of the power allocation agreement has notable strengths. It aligns closely with proposals from constitutional review bodies, lending it both legal and political legitimacy. Particularly significant is the allocation of exclusive powers to local governments, marking a significant advancement in decentralized service delivery.

Furthermore, the agreement fosters collaboration between the Federal Government of Somalia (FGS) and Federal Member States (FMSs), ensuring a balanced distribution of executive powers. However, certain challenges persist. These include ambiguity regarding duplicated powers, limited engagement with relevant institutions during deliberations, and discrepancies in the control of ports and airports. Addressing these issues is imperative for ensuring effective implementation and governance in Somalia.



Revenue assignment

The Revenue Assignment Agreement serves as a regulatory framework outlining the division of taxation responsibilities between the Federal Government of Somalia (FGS) and the Federal Member States (FMSs). Under this agreement, the FGS is mandated to regulate and collect various taxes and fees, including but not limited to international/custom duties, excise duties, license fees on telecommunication and financial institutions, stamp duty at the federal level, road tax on highways and intra-state roads, capital gains tax, revenue from natural resources, grants, and loans. Additionally, any other taxes or fees provided by law enacted by the federal parliament fall under the purview of the FGS.

On the other hand, certain taxes are shared between the FGS and FMSs, including sales tax, rental income tax, personal income tax, corporate income tax, and tax on professional fees. However, there are taxes and fees exclusively regulated and collected by the FMSs, such as property tax, state-level stamp duties, turnover tax, local market fees, local agricultural product taxes and fees, local road tax, driver license fees, plate number, and logbook registration fees.

Furthermore, the agreement emphasizes the pooling of revenue sources, which includes natural resource revenue, port fees, and international grants, among others, to ensure equitable distribution and allocation of financial resources between the FGS and FMSs. Numerous systemic and practical challenges impede the agreements on revenue collection in Somalia, spanning legal, political, institutional, and security domains.

Challenges with the current arrangements

The Revenue Assignment Agreement exhibits numerous ambiguities and inconsistencies that require attention. One notable issue is the lack of standardized classification of tax categories, that has led to confusion among stakeholders. Additionally, there are instances of redundant allocations where the same revenue source is assigned multiple times. Another significant concern is the lack of clarity regarding tax policy roles and collection responsibilities. While some jurisdictions are tasked with both imposing and collecting taxes, others are advised to separate these functions. This inconsistency hampers effective revenue management and enforcement. Another significant concern is that the allocation of revenue seems to be disconnected from the functional assignment agreement. For example, local governments and municipalities are granted a substantial number of powers, more than the state government in some instance, but lack a designated tax authority, undermining their ability to provide the services. Additionally, while the rationale behind tax collection is articulated clearly in the agreement, it is not consistently applied. For instance, corporate tax, which significantly contributes to national revenue, is designated as a shared tax despite its nationwide impact, suggesting the need for centralized mandate. Further, assigning both tax policy and revenue collection to a single jurisdiction may not adhere to standard practices and practical considerations in many instances. Finally, the lack of inclusive and technical consultation, makes the agreements mostly be a political manifesto rather than practical action point.

FGS EXCLUSIVE SOURCE	FMS EXCLUSIVE SOURCE	SHARE/POOL SOURCE
Tax on international trade /custom duties.	Property tax	Sales tax
Excise duties.	State level stamp duties	rental income tax
License fees on telecommunication and financial institutions	Turnover tax	Personal income tax
stamp duty (federal level)	Local market fees	Corporate income tax
road tax on highways and intra-state roads.	Local Agricultural product taxes and fees.	Tax on professional fees
Any other tax or fees provided by law enacted federal parliament.	Local road tax	Natural resource revenue
Capital gains	Driver licenses fees	Port fees
All revenue from natural resources	Plate number and logbook registration fees.	International grants
Grants and loans	tax or fee provided by law of regional parliament	

Conclusions

To ensure the successful implementation of the proposed agreement by the National Consultative Council (NCC) and effectively tackle the challenges related to transferring customs responsibilities to the designated jurisdiction, several suggestions could be considered:

1. Establishment of the Revenue Authority and Allocation Commission (RA and AC):The federal government should establish a Revenue Authority and Allocation Commission (RA and AC) as an independent body responsible for overseeing the collection of revenue, including customs duties.
2. Compensation guarantees: In exchange for discontinuing import duty collections, the Federal Government should provide assurances and fiscal incentives to the Federal Member States (FMS) governments.
3. Capacity building for Federal Member States: While financial compensation is important, it is crucial for the federal government to prioritize capacity building and revenue reforms within the member states. Enhancing FMSs' capacity to generate their own revenue ensures their financial competence to deliver public services, boost morale, and advance fiscal federalism. Implementing Treasury Single Accounts (TSAs) and automated financial systems can streamline revenue collection and ensure transparency. Additionally, providing training and resources for FMSs to manage their finances effectively is essential for sustainable governance.

Recommendations

To promote fiscal federalism and equitable resource distribution in Somalia, several steps should be taken to address challenges and implement the current agreements effectively. These measures collectively contribute to advancing fiscal federalism and promoting equitable resource distribution in Somalia.

Firstly, the federal leadership should prioritize addressing Puntland's concerns and ensuring its president's participation in the upcoming NCC meetings to prevent setbacks. Conversely, Puntland should articulate its objections to the agreed-upon arrangements, fostering open dialogue within the NCC framework. Secondly, the NCC should broaden participation in discussions on contentious issues, ensuring involvement from relevant government institutions and civil society actors. These stakeholders should contribute to agreements, as contentious points are not exclusive to the NCC's purview. While the NCC holds political authority, inclusive engagement enhances the credibility of its decisions. Open public discourse led by think Tanks can enhance participation and accommodating different viewpoints and thereby granting the procedural inclusivity and public acceptance of the outcome.

Thirdly, Formalizing agreements from the National Consultative Council (NCC) into the constitution would ensure legal validity and thereby providing streamlined and legalized decision-making. tracing, and advocacy. Fourthly, gradual Implementation of fiscal responsibility sharing agreement, can provide space for lessons, reduced frictions, and align with institutional capacity to accommodate emerging issues. For instance, introducing standardized road tax collection arrangements for vehicles traveling between FMSs as trial and error.

Fifth, establishing an independent Revenue Authority and Revenue Allocation Committee, with representatives from federal and state governments, would improve revenue administration and allocation. Seventh, conducting a population census agreed upon by all relevant authorities would facilitate fair resource allocation between the Federal Government of Somalia (FGS) and FMSs, considering factors like landmass and poverty levels. Eighthly, enhancing capacity-building is vital for improving financial management and planning capabilities across government levels. Training and technical assistance can empower officials to make informed decisions and manage resources effectively.

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