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Raising Sufficient Domestic Revenue to Overcome Dependency on External Budgetary Support for Somalia

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Contents

1. Introduction

Domestic revenue is the single most important source of financing for any country's development. Through domestic revenue mobilization, Somalia – a country that is slowly emerging from decades of chaos – can accelerate economic recovery by raising and spending its own funds for essential services such as education and health, as well as energy and infrastructure development. These are all critical to ending extreme poverty and promoting inclusive growth.

In 2012, Somalia transitioned to a federal governance model and conducted its first post-transition presidential election. Hassan Sheikh Mohamud, a former civil society member, won the presidency. Over the next decade, the country saw significant reconstruction efforts aimed at rebuilding the state economic institutions and undertook economic reform programs aided by international development partners including the World Bank Group (WBG) and International Monetary Fund (IMF).

> *In 2020, Somalia reached Decision Point for HIPC debt relief and arrears clearance from International Financial Institutions (IFIs) giving it access to new financial resources from donors – both direct budget support and projects. It is expected that the country will secure complete debt relief by the 13th December 2023*

This economic reform program has dramatically improved the country's domestic revenue generation which increased to $229.6 million in 2021 from $84.3 million in 2014.[1] As a result, the international community, and in particular the WBG and IMF, have viewed Somalia as a success story as it has met the conditions of external debt clearance under the Heavily Indebted Poor Country (HIPC) initiative. During the last decade, the country's GDP averaged three percent annually. In 2020, Somalia reached Decision Point for HIPC debt relief and arrears clearance from International Financial Institutions (IFIs) giving it access to new financial resources from donors – both direct budget support and projects.[2] It is expected that the country will secure complete debt relief by the 13th December 2023.

These successes have masked challenges such as never-ending political tensions, security threats posed by al-Shabaab, Covid-19, as well as climatic-related shocks such as recurrent droughts. Poverty and unemployment, especially among youth, remain stubbornly high, and inequalities and food insecurity persist. Overcoming these challenges require sufficient fiscal space that is underpinned by robust domestic resource mobilization.

Somalia depends heavily on external grants and has not yet managed to raise enough domestic revenues to deliver public services. Donor grants constituted about 73 percent of the federal government budget in 2023, the majority of which is allocated to the security sector and administrative fees[3].

1. Ministry of Finance data.
2. IMF, March 2020. Somalia: Enhanced Heavily Indebted Poor Countries (HIPC) Initiative – Decision Point. https://www.imf.org/en/Publications/CR/Issues/2020/03/26/Somalia-Enhanced-Heavily-Indebted-Poor-Countries-HIPC-Initiative-Decision-Point-Document-49290
3. Budget appropriation act, 2023. Federal Government of Somalia.

> *Despite reforms aimed at improving revenue collection, Somalia's domestic revenues are still very low, accounting for only 3.1 percent of GDP which is among the lowest in the world*

Despite reforms aimed at improving revenue collection, Somalia's domestic revenues are still very low, accounting for only 3.1 percent of GDP which is among the lowest in the world.[4] This low rate of tax collection puts economic development at risk, as the country cannot finance essential services like health and education, critical infrastructure such as roads and electricity, or other public services.

The extreme dependence on external support underscores the importance of strengthening domestic revenue mobilization, which needs to be accompanied by an efficient tax policy and management. Generating domestic revenue through expanding the tax base is essential for Somalia to finance its development. Uncertainty about the availability of donor grants after Somalia reaches debt relief completion under the HIPC process at the end of 2023 is another reason to mobilize sufficient domestic resources.

In this context, understanding the issues that are impeding the raising of domestic revenue to overcome external donor dependency is crucial to bolstering government tax revenues and channeling them into the development priorities of the country.

This brief will examine how much tax the federal government and member states collect; the domestic revenue reforms that the government has already undertaken; the taxes it has yet to introduce; the critical gaps in strengthening domestic revenue mobilization; and how Somalia can mobilize sufficient domestic revenue to overcome aid dependency and finance its development priorities.

It begins by setting the context and assessing the country's fiscal performance by analyzing how domestic revenue mobilization will be key to averting long-term donor dependency and fully taking responsibility for financing Somalia's reconstruction effort and inclusive growth.

The brief then looks at the broader domestic revenue generation and tax collection mechanisms among the different levels of government – federal, state, and local. It goes on to explore challenges that inhibit raising sufficient domestic revenue and provides policymakers with recommendations to strengthen domestic revenue mobilization.

This brief draws mainly on secondary data from the last 10 years, as well as a review of government documents and reports produced by local and international organizations. Researchers also conducted interviews with officials at the Ministry of Finance and fiscal policy experts to supplement the brief.

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4. World Bank report, 2022. Somalia Economic Update: Investing in Social Protection to Boost Resilience for Economic Growth. https://documents1.worldbank.org/curated/en/099645010242215445/pdf/P17502402429f50e708a6408e3872dbb193.pdf

2. Somalia's domestic revenue

Overall domestic revenue, although increasing, is insufficient to achieve peace, provide essential services for the Somali people and bring the country back to its economic development trajectory

Despite efforts by the Federal Government of Somalia (FGS) over the past decade, Somalia suffers from lingering domestic shortfalls and an extremely low tax/GDP ratio. Overall domestic revenue, although increasing, is insufficient to achieve peace, provide essential services for the Somali people and bring the country back to its economic development trajectory.

Somalia's government revenue is divided into three major components: taxes, non-tax revenue and grants provided by international development partners. A diverse revenue stream is crucial for the government to finance its operations as well as invest in critical services for the people and fuel development. Though it generates taxes on international trade, Somalia relies heavily on grants which constitute about 70 percent of the FGS's annual budget.

Table 1:Actual domestic revenue performance, 2018-2022
(in millions of dollars)

Description	2018	2019	2020	2021	2022
Domestic revenue	**180.2**	**229.7**	**211.2**	**229.4**	**263.1**
Income tax	8.6	11.7	16.2	15.8	18.7
Taxes on goods and services	30.0	36.0	32.3	38.0	47.0
Taxes on international trade	100.3	107.0	91.1	108.9	116.6
Non-tax revenue	41.3	75.0	71.7	66.8	80.9

Source: Ministry of Finance, FGS

Total domestic revenues, which includes income taxes, taxes on goods and services, taxes on international trade, and non-tax revenue, rose from $180.2 million in 2019 to $263.1 million in 2022

As Table 1 shows, the FGS's domestic revenue has increased significantly over the past five years. Total domestic revenues, which includes income taxes, taxes on goods and services, taxes on international trade, and non-tax revenue, rose from $180.2 million in 2019 to $263.1 million in 2022. This growth was primarily driven by the increase in tax revenue from both international trade and taxes on goods and services, while non-tax revenue also saw a double-digit increase.

Despite constituting a relatively small proportion of the total tax revenue, income taxes also grew over the period. The FGS collects taxes in Mogadishu, the capital city, while member states and local governments are responsible for taxation in other regions.

These figures highlight a positive trend in domestic revenue generation for the FGS. The increase in tax revenue from international trade and taxes on goods and services indicates potential economic growth and increased commercial activities. The rise in non-tax revenue further suggests the government's efforts to diversify its income sources are improving. Growth in income tax collection indicates potential improvements in tax compliance.

Table 2: Domestic revenue as a percentage of GDP, 2018-2022

	Domestic revenue	Income and corporate taxes	Taxes on goods and services	Other taxes	Non-tax revenue	Taxes on international trade
2018	3.9	0.2	0.5	0.2	0.9	2.1
2019	3.5	0.2	0.4	0.2	1.2	1.6
2020	3.1	0.2	0.3	0.2	1	1.3
2021	3	0.2	0.3	0.2	0.9	1.4
2022	3.1	0.2	0.4	0.2	0.9	1.4

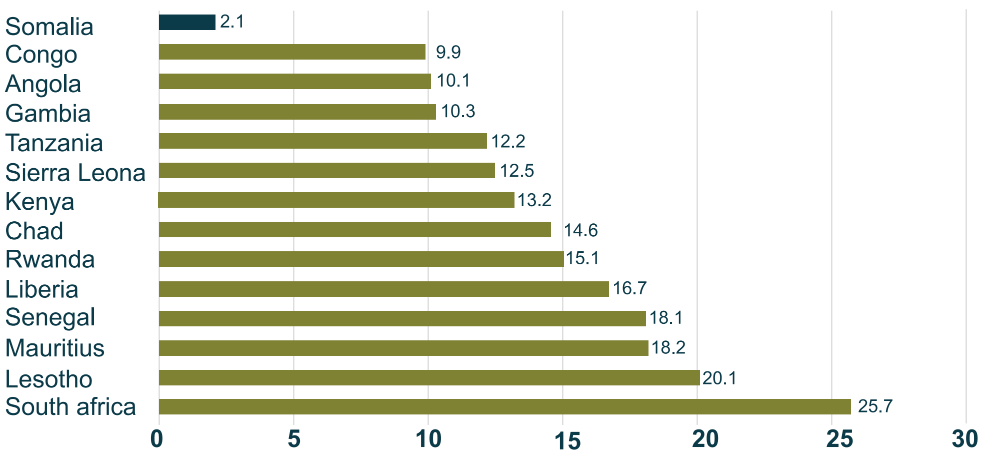
Source: World Bank Data

Based on Table 2, the data reveals that, for the period between 2018 and 2022, the proportion of consolidated domestic revenue as a percentage of GDP for the FGS remained stagnant at three percent. Conversely, taxes on trade decreased from 2.1 percent in 2018 to 1.4 percent in 2022. The ratio of taxes on goods and services consistently remained below one percent.

> *The stagnant trend in consolidated domestic revenue for the FGS at three percent suggests a lack of growth and ability by the government to generate revenue*

These trends indicate that the country is facing a persistent challenge in tax collection, with the revenue generated remaining low. The stagnant trend in consolidated domestic revenue for the FGS at three percent suggests a lack of growth and ability by the government to generate revenue. The decline in taxes on trade and the consistently low ratio of taxes on goods and services further highlights the difficulties in revenue collection.

Figure 1: Tax revenue, 2021



Source: World Bank Data

Tax revenue mobilization in Somalia is well below all the selected countries, many of which are yet to achieve the minimum threshold of tax revenue to meet development goals and ignite inclusive growth

Figure 1 illustrates Somalia's tax collection efforts against selected Sub-Saharan African countries, including those in fragile and conflict-affected settings, as well as against neighboring countries. Tax revenue mobilization in Somalia is well below all the selected countries, many of which are yet to achieve the minimum threshold of tax revenue to meet development goals and ignite inclusive growth. Somalia's tax-to-GDP ratio in 2021 was 2.1 percent, scoring the lowest of its continental peers including Sierra Leone (12.5), Kenya (13.2), Chad (14.4), and Liberia (16.7). For more advanced countries such as South Africa, Lesotho, Mauritius, and Senegal, tax revenue exceeded the 15 percent of tax-to-GDP required to fund public goods and services and foster growth.

Tax revenue exhibits varying characters in different economies, influenced by country-specific factors stemming from socio-economic and political conditions. African countries face challenges with large hard-to-tax sectors like small businesses, small-scale farming, and a significant informal sector. This is compounded by corruption and mismanagement of public funds. In countries like Somalia, weak enforcement capacity and the absence of tax arrangements between the FGS and FMS are hamstrung by a lack of tax compliance, further impeding the raising of sufficient domestic revenue.

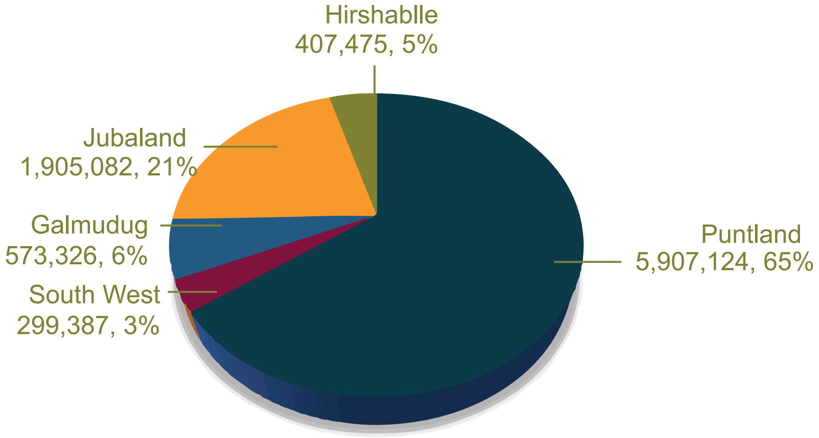
Sub-national revenue patterns

Although there is no agreed assignment of who levies what tax between central and states, sub-national authorities collect tax in a similar way to the federal government. According to a recent report by the official accountant general, revenue collection differs substantially between federal member states. Puntland generates the largest tax revenue among the states, at about $5.9 million in April 2023. Southwest generated the smallest tax revenue at $300,000 in April 2023. Jubaland also levied around $2 million over the same period.[5]

Puntland and Jubaland heavily rely on taxing trade at Kismayo and Bosaso ports to generate a significant portion of their tax revenues. Galmudug, Hirshabelle, and Southwest do not have properly functioning seaports and collect less taxes as a result.

5. Consolidation Report, April 2023. Office of the Accountant General.

Figure 2: Sub-national tax revenue, April 2023



To address the underlying factors contributing to this situation and achieve a more sustainable and robust tax collection system, Somalia must implement strategies to enhance tax compliance, improve tax administration, and explore alternative revenue sources. Efforts to stimulate economic growth and promote investment may also contribute to increased tax revenues.

3. Cross-country lessons for domestic revenue generation[6]

Box 1:

There are examples Somalia could draw from to improve its tax collection from across the globe, particularly in Rwanda, Georgia, the Gambia, and Liberia.

Rwanda: After the genocide that ravaged the country's economic and social structures, Rwanda embarked on various tax reform packages. They included the establishment of the Revenue Authority, the introduction of value-added taxes (VAT) to replace sales taxes, and a new tax law in 2005 which introduced a four percent annual turnover tax and eliminated many tax exemptions. The Rwandan government also overhauled its tax collection procedures, improved staff capacity and information management, and conducted massive public education and stakeholder engagement to build a new fiscal contract with its citizens. Between 2010 and 2015, Rwanda introduced electronic registration, filing and payment systems; automated tax and customs operations; adopted a single duty tariff for facilitating international trade; and increased tax rates on imported construction goods and excise duty on airtime of mobile phones to 10 percent from five percent. These tax reform initiatives boosted tax-to-GDP by 3.5 percent.

6. Jorge Martinez-Vazquez, 2022. Successful Tax Reforms in the Recent International Experience: Lessons in Political Economy the Nuts and Bolts of Increasing Country Tax Revenue Effort. https://www.adb.org/sites/default/files/institutional-document/782851/ado2022bp-tax-reforms-experience-lessons.pdf

Georgia: Prior to 2004, Georgia had poor tax collection mechanisms and pervasive corruption. However, after the new government came to power, radical yet phased tax reforms were initiated to raise domestic revenue and improve tax collection to meet national expenditure demands. The first phase started with a zero tolerance approach to corruption and the arrest of prominent public figures. All unnecessary and ineffective intervention from the government into businesses was removed, reducing the VAT rate from 20 percent to 17 percent, and bringing tax and customs agencies under the Ministry of Finance. Phase two focused on simplifying the tax code and expanding the tax base by reducing the number of tax categories. Corporate income tax was set at a flat rate of 15 percent down from 20 percent. Personal income tax was set at a flat rate of 20 percent – equal treatment for all taxpayers. Phase three introduced an electronic system for taxpayer registration, filing, and payment, which improved compliance and mitigated tax evasion risks, as well as customs infrastructure development. Finally, the fourth phase involved refining the new tax code based on global practices and the further enhancement of tax IT system to lessen costs associated with compliance. As a result, tax-to-GDP surged from 7.6 percent to 23.2 percent.

Liberia: Liberia initiated landmark tax reform in 2003 by introducing turnover taxes or import values including goods and services, excise and customs tariffs, all guided by simple tax legislation. This broadened Liberia's tax base and raised significant domestic revenue. It also automated its tax collection administration by implementing an e-filing system to make it easier to pay and decrease the opportunities for corruption. As a result of these reforms, Liberia's tax-to-GDP dramatically increased from less than 10 percent in 2003 to 25 percent in 2010.

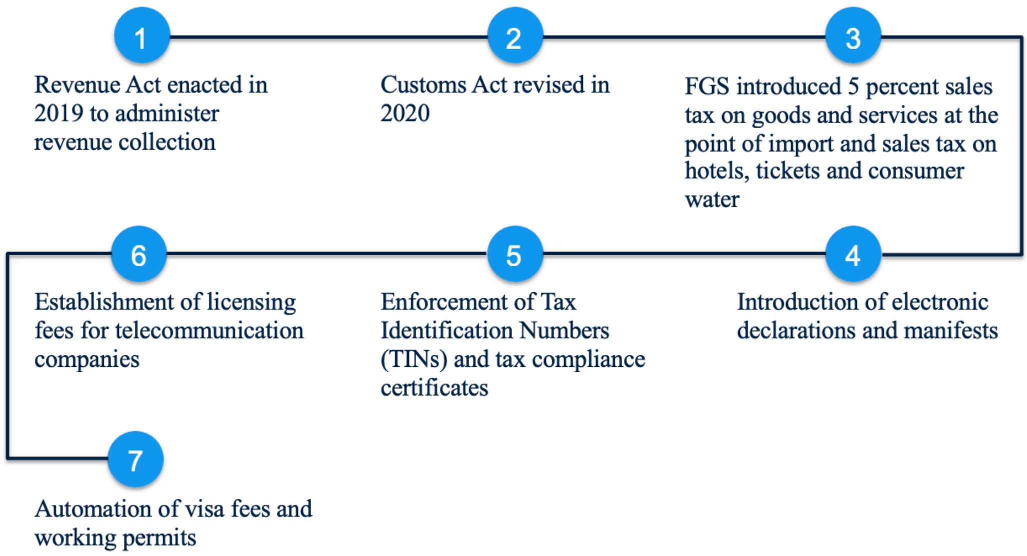
The Gambia: This tiny country struggled after the financial crises of 2008. External debt skyrocketed, leading to increased pressures on inflation, interest rates and exchange rates. The authorities had no option but to reform tax policies to increase domestic revenue and overcome the overreliance on external resources. Reform packages launched in 2013 focused on indirect taxes and the enhancement of the tax administration. The government introduced VAT to replace sales tax at a rate of 15 percent for all import supplies and 18 percent for telecommunication services. It imposed an excise tax on tobacco products, increasing the rate on cigarettes by 25 percent. Fuel subsidies were eliminated to increase fuel tax revenue. The revenue authority enhanced its administrative capacity by improving compliance and its audit system, as well as upgrading its IT system. As a result, tax-to-GDP rose from 13 percent to 17.5 percent, according to the IMF.

Drawing from the above successful tax policy reforms, there is no one-size-fits-all approach when formulating tax policies to maximize revenue generation. For instance, Rwanda implemented tax reforms with a primary emphasis on increasing various tax rates, whereas Georgia opted for simplifying its tax system by reducing the number of tax rates and eliminating double taxation.

While Somalia is in urgent need of maximizing tax revenue to finance its development imperatives, authorities must strike a balance between increasing tax rates and ensuring efficiency in tax collection. This is crucial to prevent an excessive burden on taxpayers and to avoid any adverse impact on Somalia's economy.

4. Recent revenue reforms in Somalia

Figure 3



5. Challenges in raising domestic revenue

Dysfunctional economic conditions impede the government from generating maximum revenue. Somalia's economy is characterized by hard-to-tax informal sectors.[7] For instance, small and informal enterprises or subsistence farming business activities provide ample opportunity for tax non-compliance due to the lack of information on revenues. The share of informal employment or self-employment remains one of the largest in the world.[8] The prominence of the informal sector stems from the income generation or employment opportunities it offers to the unemployed, in particular. As a result, the amount of income, property and capital gains tax generated from informal businesses is limited as their tax category is the lowest (see table).

7. AFDB, 2018. Somalia Country Note. https://www.afdb.org/fileadmin/uploads/afdb/Documents/Generic-Documents/country_notes/Somalia_country_note.pdf
8. Karamba,R. Wendy, 2021. Improving Access to Jobs for the Poor and Vulnerable in Somalia (English). Washington, D.C. : World Bank Group. https://documents.worldbank.org/en/publication/documents-reports/documentdetail/540261609935995160/improving-access-to-jobs-for-the-poor-and-vulnerable-in-somalia

> *The vast informal economy which encompasses workers and companies operating beyond the purview of legal and administrative systems presents a significant barrier to expanding the tax base and collecting direct taxes, and gives rise to various economic challenges*

The vast informal economy which encompasses workers and companies operating beyond the purview of legal and administrative systems presents a significant barrier to expanding the tax base and collecting direct taxes, and gives rise to various economic challenges. Not only does it result in a failure to collect taxes, but informal firms are also less productive, and lack labor and social protection programs for workers. A concrete effort should be made to register informal businesses into the tax net. Doing so will help the government to expand its tax base and generate a new revenue window.

Another critical issue is the absence of harmonized fiscal governance, particularly the lack of clear revenue collection assignments.[9] Currently, different levels of government – the FGS, the FMS, and some localities – impose taxes and levies. This fragmentation emanates from the lack of clarity in the provisional constitution which does not explicitly lay out the tax powers for each tier of the government. Article 50(f)[10] says, "the responsibility for raising revenue shall be given to the level of government where it is likely to be most effectively exercised." This has important implications: collecting taxes in the context of widespread multiple taxation systems is challenging and enables businesses to avoid or evade taxes, leading to significant revenue loss.

Fiscal federalism, including resource-sharing mechanisms and revenue mobilization, has been the subject of significant discussion among federal and state leaders in recent years. Under the National Consultative Conference (NCC), the FGS and FMS except Puntland, agreed on a tax schedule that defines the responsibility of collecting different types of tax collection for each tier of the government. This landmark agreement calls for broader consensus – bringing Puntland and other political stakeholders on board – before it is translated into constitutional terms. Settling on revenue powers under a federalized fiscal government is critical in raising Somalia's domestic revenue.

The weak fiscal contract is a major barrier to raising domestic revenue. Based on Levi's 1988 theory "Of Rule and Revenue", fiscal contracts entail a reciprocal relationship between the state and its citizens, which facilitates compliance from taxpayers in fulfilling their tax commitments in return for responsive public goods and services.[11] Tax collection and government spending for the well-being of citizens should reinforce each other. For Somalia, the fiscal contract has been far from perfect, as different tax regimes are unable to provide public goods and services to the people.

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9. HIPS, 2022. Somalia's External Debt Relief: Pursuing Economic Reforms Beyond HIPC Initiative. https://heritageinstitute.org/somalias-external-debt-relief-pursuing-economic-reforms-beyond-hipc-initiative/publications/
10. Provisional Constitution of the Federal Republic of Somalia.
11. Levi, M. (1988). Of rule and revenue. Univ of California Press.

Many Somalis view paying taxes to the government as facilitating corruption and allowing officials to misuse public funds. Neither the federal government nor the sub-national regimes spend money on essential services, suggesting they do not act as agents of taxpayers, selling services in return for revenue. This absence of tax morale and compliance calls for commitment to social dialogue with stakeholders and citizens to help secure social support for voluntary tax collection. However, this dialogue would not be enough unless it is embedded with providing services for citizens.

> *While the government has recently vowed to curb the mismanagement of public funds – a number of prominent officials were arrested for embezzlement of domestic revenue13 and others are on the run*

Widespread corruption among tax administrators is the single most important obstacle to strengthening domestic revenue collection. Corruption manifests itself in various forms in the domestic revenue landscape. First, officials use public funds to enrich themselves and associates instead of on public goods and services. Second, tax collectors often take bribes from businesses and taxpayers in exchange for tax evasion.[12] This is particularly pervasive in inland revenue generation, where the lack of a systematized mechanism makes it harder to identify tax avoidance. While the government has recently vowed to curb the mismanagement of public funds – a number of prominent officials were arrested for embezzlement of domestic revenue[13] and others are on the run – comprehensive anti-corruption laws and strong institutions as well as education and enforcement strategies are also needed.

An unbalanced and narrow revenue base is also a crucial issue impeding the raising of domestic revenue. According to a recent World Bank report, the applied trade tariff rate for Somalia is seven percent, while the majority of Sub-Saharan African countries apply an average tariff rate of 12.2 percent.[14] Corporate and personal income taxes have yet to be fully extended across different spectra of the sectors – private sector and international organizations, although FGS included in the tax net in 2017.[15] Enforcing personal income taxes to such sectors is one of the major challenges for Somalia, which also has fiscal deficits along with significant development challenges.

Somalia grapples with weak administrative capacity in its tax collection, although the FGS and some FMS have made commendable reforms in the area of revenue administration, anchored by the establishment of a Financial Management Information System (FMIS). Poor tax administration stems from inadequate infrastructure for tax collection including lack of technology. Both customs and inland revenue collection is predominantly manual and paper-based. This outdated administrative practice is susceptible to tax evasion and fraud.

12. HIPS interview, 2023
13. Hiiraan, June 2023. High-ranking Somali officials arrested in pivotal step towards national anti-corruption efforts. https://www.hiiraan.com/news4/2023/Jun/191715/high_ranking_somali_official_arrested_in_pivotal_step_towards_national_anti_corruption_efforts.aspx
14. World Bank Report, 2021. Domestic Revenue Mobilization for Somalia. https://documents1.worldbank.org/curated/en/121391596804622057/pdf/Domestic-Resource-Mobilization-in-Somalia.pdf
15. Ibid.

> *Lack of qualified staff also hinders efforts to increase domestic revenue as most employees do not have the required knowledge and skills.*

As cross-country experiences in Box 1 show, successful tax reform hinges on leapfrogging ICT to improve compliance and combat tax fraud, boosting tax revenue. Lack of qualified staff also hinders efforts to increase domestic revenue as most employees do not have the required knowledge and skills. Skills gaps include IT specialists, accountants, tax specialists, lawyers and inspectors.[16] Motivated by political and clan affiliations, the public sector lacks meritocracy and employs people who lack technical knowhow in revenue administration. Resolving these human resources issues require a multifaceted approach that encompass merit-based recruitment processes, capacity building programs and better wages for revenue collection staff.

6. Implication for fiscal sustainability of external budget support

Somalia has a history of relying on foreign assistance in the form of grants, borrowing, technical support as well as investment projects. In the decade after independence, Somalia became the highest aid recipient in Africa, receiving economic assistance of $90 per capita.[17] Project investment support represented the majority of the economic assistance to Somalia during that time. Somalia continues to rely on external financing from traditional and non-traditional donors through bilateral and multilateral support. In the early 1980s, Somalia was part of the IMF and World Bank's Structural Adjustment Program for third-world countries to support macroeconomic stabilization in the form of loans. However, after the government collapsed in 1991, foreign development assistance was diminished, but humanitarian intervention continued on a significant scale as the country entered into a civil war compounded by drought-induced food crises.

> *Current government expenditure is unproductive as it is mainly spent on recurrent items such as security and public sector wages, with little attention given to capital expenditure*

Having made notable economic reforms, Somalia started to receive budgetary support from numerous international partners, including Turkey, Saudi Arabia, the World Bank, and the European Union. On-budget support (comprising grants and projects) has dramatically increased from $26.9 million in 2015 to $695 million in 2021, according to Ministry of Finance data.[18] Budget support through projects and grants constitutes around 73 percent of the total annual budget of the federal government. In addition, current government expenditure is unproductive as it is mainly spent on recurrent items such as security and public sector wages, with little attention given to capital expenditure.[19] This raises serious concerns about the fiscal sustainability of the country – especially after Somalia reaches the Completion Point of debt relief – when the current grant support window will change to concessional loans.[20]

16. HIPS interview, 2023.
17. Laitin, D. D., & Samatar, S. S. (1984). Somalia and the world economy. Review of African Political Economy, 11(30), 58-72.
18. Budget Appropriation Act. Ministry of Finance, Federal Government of Somalia.
19. HIPS, 2022. Somalia's External Debt Relief: Pursuing Economic Reforms Beyond HIPC Initiative. https://heritageinstitute.org/somalias-external-debt-relief-pursuing-economic-reforms-beyond-hipc-initiative/publications/
20. Ibid.

> *Although external grants undoubtedly contributed to the ongoing state-building process, especially funds spent on security and critical public services such as education and health, they have resulted in subsequent Somali governments making little effort to raise domestic resource mobilization*

Although external grants undoubtedly contributed to the ongoing state-building process, especially funds spent on security and critical public services such as education and health, they have resulted in subsequent Somali governments making little effort to raise domestic resource mobilization. Economic scholars have extensively covered the negative consequences of aid dependency, arguing that massive reliance on external support puts a country into a weak or what they call a "rentier state." Given the exogenous and volatile nature of external aid, any decline could severely impact fiscal instability.[21] Excessively fast external aid flows have serious macroeconomic consequences, especially if they are accompanied by an unsustainable fiscal deficit. The political decisions of donors, which can be hard to predict, could result in a decline in foreign aid. This was particularly evident during the 2022 elections when the vast majority of donors suspended budget support due to political tensions emanating from the delayed electoral process. This led to severe fiscal pressures.

Countries that rely significantly on donor support have little incentive to concentrate on tax policies and boost domestic revenue.[22] Donor support gives governments less reason to attain a fiscal contract with citizens, undermining state accountability. The poor accountability of donor-driven budgetary support can be observed in Ghana where the increase in donor financing compelled the government to satisfy donors instead of citizens.[23]

On the fiscal outlook front, Somalia is anticipated to continue relying on external support, with the fiscal deficit projected to reach 1.2 percent of GDP in 2024 and further widen by 1.4 percent in 2025.[24] Domestic revenue is expected to persist at around 3 percent of GDP, while external grants are forecasted to decline from 4.4 percent to 2.0 percent of GDP.[25]

Given this analysis, it becomes evident that Somalia's fiscal performance will likely be unsustainable in the short to medium term and beyond. In the outlook scenario of low domestic revenue and decreasing external grants in the post-HIPC era, the country may resort to funding its budget through concessional borrowing. This calls for a prudent fiscal framework supported by budget and expenditure rules, as well as a debt management strategy.

The implementation of expenditure rules or budget rules will assist the government in rationalizing its spending and eliminating unproductive expenses, particularly considering that the current budgetary process is predominantly focused on recurrent costs. Developing and implementing a debt management strategy is equally crucial for establishing a robust medium-term fiscal framework. This should be accompanied by strong institutions, transparency, and accountability mechanisms to clearly outline who will borrow what and for what purpose.

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21. Moss, T. J., & Subramanian, A. (2005). After the Big Push? Fiscal and institutional implications of large aid increases. Center for Global Development working paper, (71).
22. Kaldor, N. (1963). Taxation for economic development. The Journal of Modern African Studies, 1(1), 7-23.
23. Tony Killick, 2005. The politics of Ghana's Budgetary System. https://cdn.odi.org/media/documents/1963.pdf
24. Federal Government of Somalia, IMF, and World Bank staff estimates.
25. Ibid.

7. The Way Forward

A formula for inclusive fiscal federalism with a clear legal framework for revenue collection must be found. While significant progress has been made in reforming the policy and legal framework for revenue mobilization, the country has not added the functional assignments of tax collection in different tiers of the government to the constitution. The proposed revenue-sharing agreement by the National Consultative Conference (NCC) is a good start but there are calls for a clearer and stronger consensus (Puntland is not part of the agreement) among all the political entities before its constitutionalized. It is also imperative to establish legal and policy frameworks that are up-to-date and relevant to the current federal nature of the country. Somalia still uses outdated tax codes that do not reflect the current realities of the economy.

Somalia's revenue base must be expanded. Both federal and regional governments must make concerted efforts to collect sufficient domestic revenue to fund the national development agenda. The following tax reform measures could be considered to expand the country's tax base:

i) Introducing entirely new taxes, such as VAT, to replace the current sales taxes. VAT has been found to be a strong and efficient revenue booster across countries in Sub-Saharan Africa and could be a way to increasing domestic revenue mobilization;

ii) Adopting customs duties rates comparable to the Common Market for Eastern and Southwest Africa (COMESA) country average of 12.2 percent. Somalia collects a seven percent average tariff rate. Raising tariff rates to the regional peers' average level could yield higher revenue for the government;

iii) Focusing on the low-hanging fruits of gradually increasing excise taxes on luxury goods and tobacco products. This could be effective as tax authorities can quickly raise revenue without significant alternations to the current tax system. The government could also consider introducing a new excise duty for telecommunication, for example, on airtime or mobile money transfers.

iv) Registering 300,000 [why this number] new businesses and small enterprises to bring them into the tax net. The economic informality of the country presents a challenge to effective tax mobilization as unregistered businesses and individuals evade taxes. Proper collection of corporate and personal income tax in untaxed sectors is also critical in order to equitably increase the collection of income taxes.

Strengthen tax administration to effectively and efficiently mobilize domestic revenue. Professionalization of the tax administration creating strong institutions is at the heart of tax reforms. Three key revenue administration reforms are needed: i) establish a dedicated revenue entity with the autonomy to administer tax collection and revenue management. This is currently managed under the Ministry of Finance. At the institutional level, this would separate the revenue body from political interference and ensure efficient and effective management; ii) automate tax processes including online filing and payment. Strengthening Somalia's domestic revenue hinges on digitalizing the tax system and leveraging the power of information and data to curb corruption and fraud and improve tax compliance; iii) getting qualified staff working in the revenue administration is critical. Developing the capacity of revenue administration staff will help with efficiency and also help to combat tax fraud and disincentivize corruption.

Fundamental political commitment from all levels of government is needed. Without strong political leadership from the federal, state and local administrations, it will be difficult to realize tax policy reform. Tax reform efforts and domestic revenue mobilization should involve joint action by the federal and state governments; local councils; parliament; the judiciary; the police; and enforcement agencies.

A fiscal contract is critical to tax collection and revenue generation. Somalis believe taxation is a form of extortion by the government. One way to achieve fiscal contract, and tax compliance, is by launching a comprehensive dialogue with taxpayers, businesspeople, civil society and other key stakeholders. Government must also allocate resources to essential services such as education and health to ensure voluntary compliance. Experience from other countries shows that continuous engagement and dialogue with stakeholders helps to strengthen domestic revenue mobilization.

Finally, the government should wage an all-out war on corruption in revenue mobilization – and in general. While the federal government recently launched aggressive measures such as arresting prominent civil servants and bringing embezzlement cases to court, the authorities should put in place an anti-corruption legal framework that sets out a foundation for combating corruption.

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