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Revenue Sharing as a Basis for a Sustainable Federal System in Somalia

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Abstract

Taxes from international trade account for the largest share of Somalia's domestic revenue. However, not all subnational administrations have access to ports where customs revenues are collected, creating a considerable fiscal disparity among different subnational units. This paper argues that revenue sharing from international taxes is an important step towards a cohesive and sustainable federal system in Somalia. It further presents options for revenue sharing arrangements through fiscal equalization between the Federal Government of Somalia and the Federal Member States that may strengthen the federal system and allow for more equitable access to domestic revenue.

Keywords

Somalia, fiscal federalism, revenue sharing, equalization, intergovernmental coordination, fiscal sustainability, trust-building

Disclaimer

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A) Introduction

Somalia is a relatively new federation that emerged in 2012 after twenty years of civil war. Article 1 of the 2012 Provisional Constitution declared Somalia 'a federal, sovereign, and democratic republic founded on inclusive representation of the people, a multiparty system and social justice'. The Mogadishu-based administration declared itself the Federal Government of Somalia (FGS) and called for regional governments across Somalia to form subnational governments. Puntland State of Somalia had already been established by then, while four other states – Jubbaland (formed in 2013), Southwest State (2014), Galmudug (2015), and Hirshabelle (2016) – formed Federal Member States (FMS) between 2012 and 2016. The self-declared Republic of Somaliland chose not to align itself with the federation.

Ten years after the Provisional Constitution was agreed upon, Somalia is yet to fully define its federal structure. While the Provisional Constitution identifies four functions that are exclusively within the powers and responsibilities of the federal government – foreign affairs, national defense, citizenship and immigration, and monetary policy – it does not provide for a clear division of resources, nor does it define functional assignments for key state functions. Revenue generation capacities across Somalia are varied. The FGS, Puntland, and Jubbaland generate larger portions of revenue from international taxation, while the non-port states of Galmudug, Hirshabelle, and Southwest heavily depend on fiscal transfers from the federal government. This creates large fiscal imbalances and contributes to already existing political tensions between the federal and sub-national governments and among sub-national governments. Coupled with extreme levels of poverty, low resilience to external shocks, and a continued threat from the militia-based opposition, known as Al-Shabaab, fiscal disparities further exacerbate Somalia's patterns of fragility.

This essay argues that fiscal equalization through revenue sharing from international taxation is a critical step toward a cohesive and sustainable federal system in the Somalia context. To substantiate this thesis, the first section of this essay introduces a theoretical framework on the role of resource re-distribution and fiscal equalization in building a strong federal system, and the next section applies this theoretical framework to the political and economic context of Somalia. The following section presents options for revenue sharing in Somalia, while the final section concludes.

B) Revenue Sharing as a Success Factor of Federalism

There are about twenty-five federal countries in the world today that arose from a variety of historical circumstances. Some of them are federations that were formed centuries ago, and some are relatively young federations created at the outset of the 21st century (Nepal, Somalia).

What makes successful federal structures? Burgess (2012) provides an excellent review of academic literature[1] on the conditions for success and failure in federalism, which derives seven conditions of success: (1) a desire for a federal union by its constituents with a dual loyalty of citizens to their own state/nation and a common attachment to the federation as whole; (2) a formal

[1]This includes the review of Wheare K.C (1963) *Federal Government*, London; Riker W.H. (1964) *Federalism: Origin, Operation Significance*, Boston; Franck T.M. (1968) *Why Federations Fail: An Inquiry into the Requisites for Successful Federalism*, London; and Hicks U. (1979) *Federalism: Failure and Success,* London.

written constitution that incorporates an institutional design, decision-making process, and consociational procedures suitable to create or sustain a national or a multinational (plurinational) federation together with appropriate guarantees to preserve the identity of the constituent units; (3) the existence of liberal democracy; (4) the existence of political elites with the capacity to govern and to work together; (5) the existence of a political party system that has the structural capacity to bind the federation together, while simultaneously accommodating the social diversities expressed as sub-national parties in the federal policy; (6) the existence of a viable system of fiscal federalism that can address the most important economic challenges of resource allocation and redistribution in order to furnish the basis of adjustment and adaptation to change and development; (7) the need to keep alive 'the federal spirit' in the sense of sustaining a commitment to the federal idea as a value – even a moral value – in and of itself.

Fiscal federalism, listed as one of the seven factors above, and specifically assigning revenue collection and spending functions, is an important element of any federal structure. The absence of a clearly defined fiscal federalism framework leads to fiscal imbalances, which in Hicks' (1978) and Wheare's (1963) view are the greatest threat to the overall stability of a federation (Burgess, 2012: 230-231). Insufficient financial resources at both federal and constituent unit levels lead to political discontent and economic inability to operate at full potential efficiency (Hicks, 1979 as quoted in Burgess, 2012: 235).

Revenue sharing agreements that are common in most federal countries along with other fiscal federalism instruments such as intergovernmental transfers and grants, may play a key role in overcoming imbalances in the access to resources. At the same time, tax-sharing agreements can be highly politicized. Tax sharing is often considered as providing a balance between granting fiscal autonomy and keeping the overall fiscal framework stable (Blochliger and King, 2006). The power to define the share varies considerably across countries, from arrangements where subnational governments are in full control over their share to arrangements where the share is unilaterally set and modified by the central government. Often, the distribution formula is enshrined in the constitution.

However, there is a concern that the increasing financial dependence of the constituent units upon their respective federal governments – and the overwhelming centralization that it implies for public policy – undermines the 'federality' of federations. In other words, over-dependence by constituent units on the federal (central) government may eventually lead to a 'centralization' of power and the drive for a 'unitary' government, which may face opposition from the constituents and create political tensions. Riker (1964) saw the need for centralization that will allow the federal government to exploit the advantages of a large base for taxes and armies as a condition for success. But he stressed the importance of maintaining guarantees to the constituent units to protect them from the union transforming into a unitary state (Riker as quoted in Burgess 2012: 233).

Striking the right balance between 'subsidiarity' and 'solidarity' is a choice that emerging federations, like Somalia, need to make. The subsidiarity principle refers to bringing decision-making and service delivery to the lowest level of administration or as close to the citizens as possible. The solidarity principle is about centralizing certain functions for the benefit of all constituents and redistributing resources for internalizing local or regional spillovers, which may consequently enhance national wealth (Jochimsen, 2018). At the same time, Arban (2017) argues that if federalism is conceived as a resilient scheme for a division of powers to reconcile unity and diversity, solidarity is an intrinsic trait of federalism where constituents collaborate for the ultimate benefit of the federation.

Fiscal equalization is a critical element of federal solidarity. It plays an important role in rectifying structural inequalities by correcting for economic conditions beyond the control of the local government to mitigate differences in service quality between regions (OECD, 2013). At the same time, fiscal equalization should be applied with caution to avoid constituents' dependence on the transfers from the central government and incentivize local revenue generation.

The discussion of success factors of federalism, concepts of subsidiarity and solidarity, autonomy versus centralization, and fiscal equalization are highly relevant to Somalia as it defines its own form of federalism. The next section discusses how the theoretical framework outlined above can be applied in the context of Somalia.

C) Revenue Sharing in Somalia: Context and Challenges

First, what would success or failure of federalism mean in the context of Somalia?

Somalia is a young federation that is still at risk of being torn apart. The biggest persistent risk is a takeover of large parts of the country by Al-Shabaab and the repeat of the Afghanistan 2021 scenario. The secession of the Puntland State of Somalia, the oldest and most developed federal state, following the example of Somaliland, is a potential scenario that may unfold if its leadership is not satisfied with the central government's role as a guarantor of national security, or with the balance of power between the FGS and Puntland. Highly politicized clan structures and low trust levels of sub-national governments in the FGS are further factors intervening with the federal structure and hampering constructive dialogue. The historical memory of a strong and better-off capital-city Mogadishu and weak and worse-off regions further nurtures distrust and fuels regional leaders' and citizens' determination in their resistance to any kind of centralization.

In this context, success of federalism in Somalia would mean several things. First, it would imply that the federal government and all member states reach agreements on the political settlement and finalize the Constitution which would clearly define the power and resource sharing structure with appropriate guarantees to preserve the FMS' autonomy. Second, success would mean increased trust levels by member states' leadership and ordinary citizens in the federal system. A third indicator of a longer-term success would be the achievement of comparable levels of development and equal access to public services in all member states.

On the contrary, a failure would mean the declaration of independence by any member state, the take-over of central or regional power by Al-Shabaab due to the inability of the federal government to ensure the country's security, or extreme inequalities in key socio-economic development indicators across the regions.

Next, it is important to understand the factors that could contribute to the success of Somalia's federalism project as defined above. All seven success factors summarized by Burgess and discussed in the first section apply to the Somali context. However, the focus of this essay is the fiscal federalism aspect, and specifically the revenue sharing angle, as a prerequisite for a cohesive and sustainable federal system in Somalia.

As discussed above, 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' (Article 50-e), and that 'the responsibility for the raising of revenues shall be given to the level of government where it is likely to be most effectively exercised' (Article 50-f). The Constitution further states that 'the allocation of natural resources shall be negotiated and agreed upon between the Federal Government and the Federal Member States' (Article 44). Similarly, functional assignments in education, health, transport and other important state functions are not clearly defined. Article 50-b of the Provisional Constitution states that 'power is given to the level of government where it is likely to be most effectively exercised'.

The Somalia Revenue Act, enacted in December 2019, has notable implications for taxation at the federal and state level. The law states that laws governing major taxes should be made at the federal level and gives the FGS' Ministry of Finance the responsibility for the administration and implementation of such laws. The FGS and the member states are yet to agree on revenue assignment functions through an intergovernmental dialogue and consensus building. The basis for intergovernmental transfers is currently ad hoc, resulting in a lack of predictability and transparency on how resources are shared.

A series of policy discussions with policymakers, think tanks, and practitioners organized in March 2022 as part of a Political Dialogue Platform in Somalia demonstrated that there is a consensus that the powers of the FGS and the regional governments should be different. The federal government should continue to be responsible for national issues, such as foreign relations, monetary policy, citizenship and immigration, and national defense as defined in Article 54 of the Provisional Constitution. The FMS should take on the delivery of services such as health and education. There is also broad agreement on the need for resource-sharing and fiscal transfers – from the FGS to the FMS – to address the inequality of resources between the different states (Rift Valley, 2022).

Somalia's tax revenue has always been very low even before independence. After 1960, the tax revenue was less than 10 percent of GDP (Raballand et al, 2021). In the fiscal year 2020, tax collection was 4.4 percent of GDP compared to the average of 18.6 percent in the Sub-Saharan African region from 2015 to 2019 (World Bank, 2021). The main revenue source for Somalia continues to be international trade, mainly from operational ports. Regions with operational ports, such as the FGS, Puntland, Jubbaland, and Somaliland, receive more than 60 percent of their tax revenue from international trade. Regions that do not have operational ports, such as Galmudug, Hirshabelle, and Southwest, rely on intergovernmental transfers from the FGS because currently they have limited options for raising domestic revenues. The FGS, Puntland, and to some extent Jubbaland, raise 10 to 40 times more revenues than Hirshabelle, Galmudug, and Southwest.

Each FMS administration collects and retains its revenues. Tax competition between operational ports and between administrations and local militias is strong, leading to multiple taxations. Individuals transporting goods incur significant costs, such as road user taxes on vehicles tonnage. These are collected by different administrations and local militias controlling trading routes along key roads. In turn, this multiple tax burden is transferred to the consumers, ultimately affecting economic growth.

As international taxation is the key revenue source for Somalia, establishing the 'rules of the game' for customs tariff rates, collection, and redistribution is imperative for the country's medium to long-term socio-economic development. Resource sharing agreements can create conditions for equitable development and support trust-building between the federal and state governments in line with the solidarity principle.

Establishing a common customs tariff and administering international taxation by the FGS could have been considered a long-term option due to potential gains from the economies of scale. However, revenue-generating member states are not ready to give up their customs revenue. It will be important to ensure guarantees for the revenue-generating member states that they would benefit from the resource sharing arrangement as much as non-port member states, as well as maintain autonomy on decisions related to the administration of customs in line with the subsidiarity principle.

Finally, through establishing interlinkages and interdependence, revenue sharing has the potential for enhancing horizontal cooperation as well as preparing the ground for sharing revenue from future potential revenue sources in the extractive industry.

D) Options for Revenue Sharing in Somalia

This essay makes a proposal for a possible way forward in trade-related tax revenue sharing. It is based on a policy note by Nurshaikhova, Raballand, Jama (forthcoming). The proposal is founded on four key principles: equalization, absorption capacity, fiscal sustainability, and intergovernmental consensus.

1) ***Equalization***. Given large imbalances in revenue potential and current collection between the FGS, Puntland, and Jubbaland on one side and the remaining member states on the other, fiscal equalization is critical for sustained growth and equal access to public services by residents of different member states. Disparities in the access to and quality of public services may eventually lead to uncontrolled inter-FMS migration, putting additional service delivery pressures on better-off regions.

2) ***Absorption capacity***. Annual revenues and budget expenditures of non-port member states are considerably lower than that of the FGS, Puntland, and Jubbaland. FMS budget deficits range from US$9 million to US$11 million or 4 to 40 times non-port FMS domestic revenue. The compensation of employees ranges from 46 to 73 percent of budgetary expenditures. More than 70 percent of non-port member states' budget expenditures are covered by FGS transfers including grants. Therefore, the absorption capacity of non-port member states is much lower and should be carefully considered in any revenue-sharing formula. Furthermore, since revenue equalization may potentially reduce tax and development efforts, especially in poorer regions (OECD, 2007), it is essential to strike the right balance to enable positive incentives.

3) ***Fiscal sustainability***. Fiscal equalization can jeopardize budget stability, especially if transfers are open-ended. Moreover, high annual transfer fluctuations and frequent formula adjustments can complicate budget planning. To cope with budget drift, some countries have set equalization transfers as a fixed percentage of total tax revenue and introduced ceiling and floor provisions to dampen fluctuations (OECD, 2007). Therefore, the fiscal equalization formula should be embedded in a general fiscal framework that ensures stability and fiscal discipline.

4) ***Intergovernmental consensus***. Any decision on the revenue sharing approach and equalization formula should be the result of open intergovernmental dialogue and consensus.

As an initial step towards revenue equalization, Somalia could start from a simple and modest approach, where the bulk of customs revenue remains at the sub-national level and only a small proportion is assigned for redistribution. In this scenario, the FGS, Puntland, and Jubbaland would be contributing up to 20 percent of their customs revenue to an "equalization fund" to be created at the FGS level. The funds would be redistributed to all entities (including Benadir Regional Administration or BRA[2]) based on a fixed share reflecting respective absorption capacity and revenue share contribution.

The "equalization fund" created at the federal level would at the same time serve as a trust-building instrument. The FGS' Ministry of Finance may be selected as a fund manager. The funds could be deposited in a designated account at the Central Bank of Somalia. Member states may agree on establishing an oversight committee over the equalization fund management to strengthen trust, accountability, and transparency.

The "equalization fund" should be managed through the budget process. Additional fund administration and management details may be worked out and agreed upon by the federal and sub-national governments. These would include details on the frequency of contributions to the equalization fund (monthly, quarterly, or annually), the periodicity of transfers from FGS to FMS (quarterly, semi-annually, or annually), and forecasting of equalization fund revenues for the next budget period.

The formula could be adjusted regularly, based on how revenue and absorption capacity evolve. An intergovernmental committee may need to be established to monitor a set number of criteria to assess the formula's efficiency and recommend revisions. While flexibility is an important feature of the formula, frequent revisions may prove to be counterproductive. Therefore, the revision can take place not more than once a year and should be aligned with the budget cycle.

Revenue-generating states may require additional incentives and guarantees to agree on revenue sharing. This could be achieved through building in an incentive mechanism, whereby a ceiling of minimal revenues collected every year is set. In the case of a larger than predicted revenue collection by any port authority, extra revenue may be agreed to remain in the collecting port and not transferred to the equalization pot.

Customs harmonization among the three ports would need to continue in parallel with customs administration reforms. Tax competition is high between the FGS and the FMS, which creates a potential 'balkanization' of Somalia's economic space. Corporations could be taxed multiple times by national and sub-national tax administrations using various rates. Harmonizing customs tariff rates and implementing national valuation across the three main ports will help creating a level-playing field and avoid distortion of resources. Administration of trade taxes may remain at the member states level until agreements are reached about the 'nationalization' of trade taxes.

The revenue-sharing principles and criteria would need to be articulated in the finalized Constitution. The principles agreed in the new Constitution would need to be both clear and at the same time broad enough to be applied to the sharing of other sources of revenue, such as budget support, and natural resources including oil and fisheries. On the other hand, the revenue-sharing criteria would need to be more specific and reflected in the Revenue Administration Act and other legislative acts, while the formula itself may be flexible and agreed upon as part of the budget preparation process.

[2] Benadir is an administrative region in southeastern Somalia that covers the same area as the Capital Mogadishu.

E) Conclusion

As Somalia will continue relying on trade taxes for the foreseeable future, an equitable revenue-sharing mechanism is crucial for the stability of the country. Revenue sharing and fiscal equalization have a great potential for building mutual trust among Somalia constituents. By creating interdependence, revenue sharing may strengthen intergovernmental ties, including on the part of Puntland, which may otherwise further distance itself from the federation.

The revenue-sharing approach proposed in this essay represents one simple and easily adaptable option for the way forward. The next step is for the federal government and member states to further discuss this and other proposals through a broad consultative process.

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