Policy paper: SDP.F20.04

SOMALI DIALOGUE PLATFORM

12 September 2022

Policy options for agreeing a model for fiscal federalism

Kulan Consulting

Introduction

Somalia first formally adopted a federal model in 2004 with the establishment of the Transitional Federal Charter. Since then, it has been deepened and clarified with the adoption of the Provisional Federal Constitution in 2012 and the subsequent formation of the country's Federal Member States (FMS). This process has provided the basis for cooperation and co-existence, albeit limited, among Somali leaders and institutions.

Even so, important parts of Somalia's federal model remain undefined, including agreement on a model for fiscal federalism—in other words, which level of government has the power to raise and spend revenue. This is a critical pillar of the federal architecture, as it ultimately defines the level of autonomy FMS will have vis-à-vis the Federal Government of Somalis (FGS). This makes it a very contentious issue, with FMS seeking to maximize their autonomy and the FGS seeking to assert greater control. The fiscal arrangement is not just about managing relations between FGS and FMS institutions, however, and has broader implications for Somalia's economic development. Fiscal policy can have huge impacts on economic growth, internal trade and competition, and the quality of service delivery. Moreover, it is critical to managing inequalities between groups and geographies.

Important progress has been made in clarifying Somalia's fiscal model. Political agreements managing revenues from licences on fisheries and tuna fishing have been struck, though only partially implemented. A framework for sharing revenue from petroleum and other extractives was agreed in 2018 in Baidoa, but has yet to attain full buy-in despite being signed in to law in 2019. The Public Financial Management and Revenue acts of 2019 also added specificity to some important areas, but again their legality is yet to be fully enforced.

Regardless, several key weaknesses remain in the fiscal settlement, with the status quo being that FMS raise, administer and spend all revenue in their territories, while the FGS has responsibility for revenue in Mogadishu. In other words, there is no functional revenue sharing outside of ad-hoc agreements around international trade and grants. This has created inequalities, as by far the largest tax base in Somalia comes from taxes on international trade (which constitutes 33 per cent of all revenue raised). Trade taxes, which are mostly collected from the seaports of Mogadishu, Kismayo and Bossaso, are not distributed evenly across Somalia's geography. This has meant Puntland and Jubbaland have had an autonomous revenue stream with which to fund basic government administration and functionally autonomous security services. The FGS, for its part, has benefited from the revenue raised from Mogadishu port, using it to cover government spending on administration and security. Those FMS without seaports, however, are mostly dependent on ad-hoc transfers from the FGS, meaning their administrations face greater challenges in strengthening their institutions. Moreover, there is no overarching policy-based agreement in place on the distribution of the next largest from of income – foreign grants – which account for 27 per cent of total revenue raised. On top of this, local governments have generally not been able to establish a viable model for fiscal governance.

This state of affairs presents a major challenge to Somalia's political trajectory. Competition between different levels of government over revenue sources can lead to conflict and political instability. Given the inequalities of the current arrangement, this may provoke further grievances between different groups, undermining critical development objectives. Local government, which is seen as a key pillar of peacebuilding and democratic governance, will be unable to play this role if there is no route allowing this tier of administration to become fiscally sustainable.

Clarifying fiscal arrangements is therefore not only critical but will require extensive political dialogue. This paper seeks to support political processes that can address this lack of consensus by outlining and analysing options for fiscal arrangements within Somalia's federal model. It is intended to inform and encourage political dialogue among both Somali policymakers and the wider public, and is accompanied by a series of other options papers on contentious aspects of the country's political settlement, including distribution of powers, Mogadishu's status and the security architecture. The product has been developed in consultation with a range of technical experts and political influencers as part of the Platform's 'F20' initiative, which collaboratively explores solutions to contentious issues in Somalia's political settlement.

Framework for analysis

This paper identifies three broad areas that any meaningful political process would have to tackle in order to address fiscal arrangements within Somalia's federal model:

1. **Revenue assignment:** Involves determining which level of government is responsible for:
   a. raising and owning revenue from a certain 'tax base', such as international trade, business taxes and income tax;
   b. determining tax rates for each tax base;
   c. collecting and administering tax for each tax base.
2. **Expenditure responsibilities:** Involves determining which level of government is responsible for expenditure in a given area – usually the level assigned the power to deliver the goods or services in question.
3. **Fiscal transfers:** Involves determining whether and how revenue is allocated from one level of government to another, in this case usually from the FGS to FMS. Fiscal transfers fulfil three inter-related purposes:
   a. **Managing inequalities between FMS in terms of revenue raised**, which often involves sharing revenue between the FGS and FMS using a transparent formula that may be negotiated, based on a per capita basis, or grounded in other factors;
   b. **Filling the 'fiscal gap' in cases where FMS do not have sufficient resources to fulfil the functions they are constitutionally mandated to deliver**, with fiscal transfers often based on the gap between agreed FMS budgets and the resources available to them;
   c. **Supporting delivery of FGS priority areas** even if funds are administered by FMS, which usually involves 'earmarking' funds for specific services in line with FGS policy and regulation, thereby restricting the role of sub-national units in determining the use of funds.

A successful political process would likely lead to improved consensus on these three key areas. In support of this, this paper outlines and analyses three broad policy options for fiscal arrangements within Somalia's federal model:

1. **Centralized:** Revenue raising and expenditure mostly controlled by the FGS.
2. **Diffuse:** Revenue raising and expenditure mostly controlled by FMS, with the exception of some key areas.

3. **Decentralized:** FGS plays a greater role in revenue raising, but FMS have greater autonomy in expenditure and service delivery.

Each option is analysed in turn with a view to setting out their respective advantages and disadvantages, with suggestions put forward under each contentious area as to the role federal, state and local government might play. Linkages with other parts of the federal model are highlighted, in particular the security architecture and allocation of powers (see the relevant Platform policy papers).

Policy options

Option 1: Centralized

This model centralizes most revenue-raising and expenditure powers in the hands of the FGS, with an established system of fiscal transfers whereby the FGS would disburse conditional grants to FMS and set the policy for how these funds are to be used. FMS would only raise taxes in specific areas with localized incidence, and the FGS would determine most of its expenditure. The role of local government would be minimal. This would likely align with a highly centralized security architecture and distribution of powers in which the FGS holds greater responsibility than is currently the case.

Fiscal powers	Federal	State	Local
Revenue assignment	FGS decides all revenue assignments, including defining the tax base, setting tax rates and collecting tax Central collection and administration of most taxes, including trade and income taxes	FMS collect a few taxes that are 'direct' with localized incidence, such as property tax or retail tax.[1] Base and rates are determined by federal tax policy	Minimal
Expenditure responsibilities	FGS has larger share of expenditures across sectors, including key areas such as national security, infrastructure and social services FGS sets policy on what can be spent by each level of government and plays an oversight role	FMS receive budget allocations from FGS based on expenditure policy set by the FGS FMS have reporting responsibilities to the FGS	Minimal
Fiscal transfers and revenue sharing	FGS furnishes earmarked transfers, the purpose and intended sector of which remain in line with federal policies, with the FGS providing oversight of expenditure FGS sets policies for managing and distributing revenue from national resources	FMS receive fiscal transfers earmarked for spending on specific policy areas in line with the FGS-determined budget allocation	Possible transfers from sub-national to local government

Possible advantages:

- Centralized assignment of revenue can result in greater tax efficiency and provides scope for redistribution between regions, thereby addressing inequities across FMS.
- Prevents sub-national governments from defining the tax base in contradictory ways, setting different tax rates, and hindering business mobility across the regions.

1. 'Direct' taxes are taxes paid directly by an entity to a government authority; taxes with 'localised incidence' include tax bases that are more often geographically fixed, such as property tax.

- Greater autonomy and control allows the FGS to prevent tax exporting, whereby FMS tax the residents of other FMS.

- Allows the FGS to lead a wider, unified state-building agenda.

Possible disadvantages:

- Creates much greater sub-national fiscal dependency on the FGS, potentially resulting in the preferences of local citizens being ignored and provoking grievances among FMS.

- Centralizing revenue and spending powers could increase competition for control of the FGS, which, in the absence of trust, could lead to conflict.

- Depending on how functions are allocated, the FGS would likely have more taxing power and fewer expenditure responsibilities, while sub-national governments would have comparatively less taxing power and more spending functions. This may result in a fiscal gap at the sub-national level, coupled with limited local ability to close that gap and meet expenditure needs.

- Limited opportunities for checks and balances among the layers of government, as power is concentrated in the centre.

Option 2: Diffuse

In this model, FMS are mostly autonomous in terms of raising revenue and expenditure. Of the three options, this is closest to the status quo, with FMS largely responsible for taxes and expenditure in their own jurisdiction. The role of local government in fiscal arrangements would likely vary significantly, depending on the policies of each state. Such a model would likely parallel a security architecture that assigns significant responsibility to FMS, especially in terms of policing and even command and control of the army. It would also likely parallel allocation of most powers to the FMS and local level.

Fiscal powers	Federal	State	Local
Revenue assignment	FGS can only set tax policy and collect taxes for areas deemed to be under federal jurisdiction and/or limited to its geographical location FGS sets tax policy in certain areas to maintain relatively similar revenue assignments, thereby deterring competition between FMS	FMS autonomously define tax bases and set rates, impose taxes, and administer revenue under their jurisdiction FMS collect and administer most taxes, including trade taxes	Varies by state
Expenditure responsibilities	FGS has a more limited role, with bulk of expenditure responsibilities assigned to FMS FGS takes on expenditure for more national-level policies, such as macroeconomic management, market regulation, foreign policy, immigration and national security	FMS spend on and administer most goods and services FMS set their own budgets based on individual states' needs and policy priorities, funded by their own revenue collection	Varies by state
Fiscal transfers and revenue sharing	Minimal fiscal transfers between the FGS and FMS, though exceptions may be made for significant revenues from natural resources, with specific sharing formulas developed for these	Minimal fiscal transfers between FMS and the FGS, other than agreed exceptions	Varies by state

Possible advantages:

- Article 50 of Somalia's constitution states that 'Power is given to the level of government where it is likely to be most effectively exercised'. It can be argued that local governments have a better understanding of their residents' needs and so are better positioned to provide goods and services.
- Greater opportunity for feedback loops between citizens and local government, potentially resulting in increased accountability and improved service delivery.
- Given this option is closest to the status quo, it may be the easiest to implement politically.

Possible disadvantages:

- May result in more inter-regional inequality, with a weaker federal system offering less scope for redistribution.
- Inequality may increase due to disproportionate access to natural resources and disproportionate needs (e.g. higher level of poverty in some FMS).
- Less tax efficiency due to duplication of work and inconsistency at the sub-national level, as well as tax competition between FMS.

- Lack of checks and balances as power is concentrated at FMS level, with only limited federal oversight.
- Undermines the scope for a unified state-building agenda, as FMS would be very independent of the FGS and each other.

Option 3: Decentralized

This model lies somewhere between the previous two. The FGS would have more revenue-raising powers than in option 2, including international trade, although levying taxes on less mobile tax bases could still be left to FMS. Moreover, even if the FGS collects a greater proportion of revenue, FMS would – through a system of less conditional fiscal transfers – have greater responsibility over various aspects of expenditure. The role of local government could also be standardized, empowering the level of government closest to citizens when it comes to service delivery. Despite revenue raising being more centralized than in option 2, this model would still be compatible with a more decentralized security architecture and allocation of powers, and could be facilitated by establishing an intergovernmental finance commission to develop depoliticized formulas for fiscal transfers. Establishing an independent revenue authority, with both FGS and FMS input, could also introduce efficiencies in tax collection.

Fiscal powers	Federal	State	Local
Revenue assignment	FGS and FMS share revenue assignments in terms of who owns a tax base, setting rates and collecting tax depending on which level is most suited FGS has power over taxes important for macroeconomic stabilization (e.g. customs and VAT), redistribution of income (e.g. personal income) and unevenly distributed revenue sources (e.g. natural resources) All levels of government can have benefit taxes (e.g. business tax) aligned to services provided by them	FMS have taxing powers for taxes that are 'direct' and less mobile (i.e. taxpayers cannot easily move from region to region), such as land tax, wages, vehicles and sales tax All levels of government can have benefit taxes (e.g. business tax) aligned to services provided by them	All levels of government can have benefit taxes (e.g. business tax) aligned to services provided by them
Expenditure responsibilities	Expenditure assignments shared based on whichever level of government is best positioned to provide/deliver services FGS has sole responsibility in key areas such as national security, foreign policy, immigration and monetary policy FGS maintains policy and oversight functions related to critical goods and services (e.g. health and education) to maintain quality	FMS administers delivery of services (e.g. health, education and local policing) where better positioned to deliver locally	FMS can further decentralize service delivery and revenue collection, capacitating local government for delivery and administration
Fiscal transfers and revenue sharing	Fiscal transfers could address inequalities between regions by covering unconditional general budget support for FMS, based on an agreed and transparent formula. This could initially be based on a negotiated settlement, and eventually a per capita basis Alternatively, such transfers could be determined by FMS budget allocations and used to cover resource gaps Revenue-sharing agreements on natural resources formalized in a formula with defined criteria and associated weighting	FMS receive fiscal transfers from the FGS, whether in line with their budgets or based on a revenue-sharing formula Given natural resources are unequally spread, FMS would each have an equal voice in determining revenue-sharing policies, thereby avoiding significant discrepancies in access	Scope for transfers from FMS to local government, as delegated by the FGS/FMS

Possible advantages:

- Balances the needs and responsibilities of the FGS and FMS.
- Division of responsibilities is based on whichever level of government is best positioned to deliver to its citizens, and reflected in their spending power.

- Requires greater cooperation between the FGS and FMS, providing a basis for a unified state-building agenda while allowing crucial autonomy.

Possible disadvantages:

- Given the cooperation required between different levels of government, will take considerable time and consensus to reach agreements and is the hardest to achieve politically.
- Both the FGS and FMS will need to give up a degree of their current political autonomy to achieve the benefits of revenue sharing and cooperation.

Transitioning from the status quo

If a decision is made to transition away from the status quo (in effect the diffuse option) to one of the other options, 'how' to get to the selected fiscal federalism model is just as critical as 'what' model is selected. Regardless of which model is chosen, a political strategy based on sound technical options that allow for the careful sequencing of reforms is required. Taking the shift to a centralized mechanism for administering international trade taxes as an example, the sequenced process could take the following form:

1. Develop a strategy grounded in the needs of a political and economic context in which neither the FGS nor FMS have sufficient resources to cover their budget needs. This requires shifting from a value (resources)-based discussion to a systems-based discussion. Such a conversation would focus less on the division of current resources and instead look to establish a system that facilitates the sharing of future resources.

2. Define the policy/roles of the FGS and FMS in relation to revenue assignments, specifically who owns a tax base, who sets the rates and who collects. To increase cooperation, responsibilities can be shared, with the FGS collecting on behalf of FMS or vice versa.

3. Establish unified rates and collection systems that are administered at every port across the country, and put transfer mechanisms in place that are automated and seamless. This could take the form of trade tax revenue being deposited in the treasury accounts of relevant FMS immediately after collection. Transfers between the FGS and FMS can be captured in accounting as the Central Bank of Somalia already has the capacity to hold treasury accounts in multiple locations.

4. Set timelines for a transition period that sequences the roll-out of administration systems prior to the division of trade revenues. For example, a five-year period could be set during which FMS maintain all taxes collected from their respective ports irrespective of increases in value or unequal access. Following this transition period, the agreed law and policy on revenue-sharing formulas would be introduced. This allows for capacity building of FMS ports, which should result in increases in revenues and in turn provide a more accurate and solid base for policy negotiations on revenue-sharing formulas.

5. As an equalization measure, the FGS can continue supporting those FMS that do not have a functioning port. As the FGS will continue to bring in more in trade taxes than any of the FMS, fiscal transfers will mainly be going from the FGS to FMS during the transition period.

6. The FGS can also support the development of inland revenue within FMS. This will result in increased overall revenue within FMS and the FGS, as well as allowing for a better understanding of total revenues to support policy negotiations on revenue-sharing formulas.

7. Establish technical committees drawn from the appropriate institutions at both FGS and FMS level to begin the data-collection groundwork required to support options for revenue-sharing formulas.

8. Develop data-driven, policy-based revenue-sharing formulas that will guide the sharing and distribution of trade revenues following the five-year transition period.

Considerations for the way forward

Agreement on Somalia's fiscal arrangements is a critical priority. Inclusive and high-level political dialogue is needed in order to build trust around agreeing a model. To be effective, such dialogue must be linked to discussions on other contentious parts of the political settlement – see the Platform's paper on enabling an integrated but sequenced approach to such political process. The Intergovernmental Fiscal Forum can also play an important role in this process, providing and iterating options in tandem with political-level mechanisms for dialogue. Importantly, the transitional approach laid out in this paper should be given careful consideration, as it includes interim measures and mechanisms that can establish the confidence needed to finalize Somalia's fiscal federalism model in the long term.

Credits

This policy paper is a product of the Somali Dialogue Platform and Kulan Consulting. The Somali Dialogue Platform is a programme which supports Somalis to achieve consensus on contentious political issues and is implemented by the Rift Valley Institute. The Somali Dialogue Platform is funded by the UK Foreign, Commonwealth and Development Office (FCDO), the Ministry of Foreign Affairs of Denmark, and the United States Agency for International Development (USAID). The views expressed do not necessarily reflect the official policies of the UK Government, the Government of Denmark or the US Government. The Platform maintains editorial independence on all its products.

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