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Transition amid Risks

with a Special Focus on Intergovernmental Fiscal Relations

WORLD BANK GROUP
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ABBREVIATIONS

AMISOM	African Union Mission in Somalia
AML/CFT	Anti–Money Laundering/ Combating the Financing of Terrorism
CBS	Central Bank of Somalia
CDD	Customer Due Diligence
COFOG	Classification of Functions of Government
FAO	Food and Agriculture Organization
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FIA	Financial Institutions Act
FGC	Financial Governance Committee
FGS	Federal Government of Somalia
FMS	Federal Member States
GDP	Gross Domestic Product
GFS	Government Finance Statistics
HIPC	Heavily Indebted Poor Countries
IDPs	Internally Displaced Persons
IMF	International Monetary Fund
ICU	Islamic Courts Union
IJA	Interim Jubba Administration
ISWA	Interim South West Administration
JPLG	Joint Program on Local Governance and Decentralized Services
KYC	Knowing Your Client
MDA	Ministries Departments and Agencies
MoPIC	Ministry of Planning and International Cooperation
MTBs	Money Transfer Businesses
MTOs	Money Transfer Operators
OAG	Office of the Auditor General
ODA	Official Development Assistance
PFM	Public Financial Management
PSG	Peace and State-building Goals
SEMG	Somalia and Eritrea Monitoring Group
SFMIS	Somalia Financial Management Information System
SlSh	Somaliland Shilling
SNA	Somali National Army
SOS	Somali Shilling
SPS	Sanitary and Phytosanitary
VAT	Value Added Tax
UN	United Nations
UNDP	United Nations Development Programme
UNFPA	United Nations Population Fund
UNICEF	United Nations Children's Fund
USAID	United States Agency for International Development

FOREWORD

I am very pleased to introduce the first in a series of Somalia Economic Updates. With this series, the World Bank aims to shine a spotlight on Somalia's economy, assess economic trends, and provide regular analysis that we hope generates debate among Somalis both inside and outside the country.

The first edition is titled *Transition amid Risks*. Like others, the Bank is encouraged by the progress that Somalis have made in the last three years to rebuild their country. Against immense challenges, reforms to economic and public finance management are setting new standards of accountable governance and sustainable development for Somalia. These changes are essential if the country is to generate the investment, services, and jobs that its youthful population need. So far, there are positive signs that the economy is responding: Somalis are returning from abroad, shops are opening, new financial institutions have been licensed,and property markets are booming.

However, the challenges are still daunting. Macro-fiscal management, revenue mobilization, and the enactment of key legislation are all still in need of continued attention and support. Businesses, as vibrant and as central as they have been in Somalia's story, may soon reach the limits of their growth if the state fails to provide the public goods that any private sector needs: physical security, security of contracts, and regulation that ensures fair competition, a level playing field, and the basis for investment.

The first in this series of economic updates features a Special Focus on Intergovernmental Fiscal Relations. It is timely that Somalis engage in a structured and technically informed debate about the nature of economic and fiscal relations within Somalia. At its heart, intergovernmental fiscal relations is about economic solidarity. Like any country, Somalia will have natural inequities across regions and among people. The response to these inequities will lay the foundations for longer-term development.

We hope you find this first edition valuable and look forward to our continued engagement in Somalia.

Bella Bird

World Bank Country Director for Somalia

GOGOLDHIG

Waxaan aad ugu farax sanahay inaan idiin soo bandhigo taxanihii koowaad ee *Warbixinta Dhaqaalaha Soomaaliya*, Bangiga Adduunka isagoo ka duulaya qoraaladan taxana ah ujeedadiisuna tahay inu ifiyo dhaqaalaha Soomaaliya, si uu u baaro aragtiyaha dhaqaale ee jira, soona gudbiyo falanqayn joogta ah taas oo aan rajaynayno inay ka soo baxaan doodo dhex mara dhamaan dadka Soomaaliyeed ee dal iyo dibadba joogta.

Qoraalka kowaad waxaa cinwaan looga dhigay **MAAREYNTA KHATARTA XAALADA KALA GUURKA**. Sida qolyaha kaleba qabaan, wuxuu Bangiga Adduunku bogaadiyay horumarka ay Soomaalidu ka samaysay xaga dib u dhiska dalkeeda saddexdi sano ee la soo dhaafay. Ka sakow caqabadaha baaxada leh ee jira, isbedelada dhaqaale iyo maaraynta nidaamka maaliyadeedba waxay jaangoynayaan heerarka isla xisaabtanka, maamul-wanaaga iyo joogtaynta horumarka Soomaaliya. Isbedeladdani waa kuwo muhiimad u leh marka dalku abuurayo maalgashi, adeegyo, iyo shaqooyinka ay u baahan yihiin dadweynaha dhalinyarada u badan. Inta la ogyahay, waxaa jira calaamado muujinaya in dhaqaaluhu soo hagaagayo: Soomaalidii dibadaha ayey ka soo noqonayaan, waxaa la furanaya Dukaamo, hay'ado maaliyadeed oo cusub baa ayaa ruqsadihii samaystay, iyo suuqa hantida ma guurtada ah oo sare u sii kacay.

Si kastaba ha ahaate, caqabaduhu weli waa kuwa jira. Maaraynta dhaqaalaha guud, dakhli uruurinta, iyo fulinta shuruucda muhiimka u ah oo ay xeer-dejintu ansixiyeen waa kuwa weli u baahan taagerid iyo feejignaan joogta ah. Ganacsigu, waa mid kobcaya wuxuuna tiir dhexaad u noqday waxyaabaha ay Soomaalidu aad u hadal hayso, haddii ay dawladdu ku guul-daraysato inay fuliso baahida guud ee laga mamaarmanka u ah ganacsiga gaarka loo leeyahay, waxaa durbadiiba xadidmaya kobacii inuu qof waliba u helo fursad uu ku guulaysan karo, taaso ah saldhiga maalgaashiga.

Muuqaalada taxanaha ee warbixinta dhaqaalaha Soomaaliya *waxay si gaara diirada u saaraysaa nidaamka maaliyadeed ee federaalka*. Waa waqtigii ay Soomaalidu si habaysan oo farsamo ku dhisan u qaban lahayd doodo la xiriira nooca dhaqaale iyo xiriirada maaliyadeed ee Soomaaliya ka dhaxayn kara. Gunaanadkii, tani waa dhaqaalaha oo la wadaago. Sida dal walba, Soomaaliya waxaa ka jira isu dheelitir la'aan u dhaxaysa xaga khayraadka dadka iyo Goboladaba. Ka jawaabida isu dheelitir-la'aantani waxay aasaaska u dhigaysa horumarka mustaqbalka fog. Waxaan idin rajaynayaa inaad qoraalkan ka heli doontaan waxyaabo muhiim ah, Isla mar ahaantaana annaga oo joogtayn doona xiriirka Bangiga Adduunka iyo Soomaaliya ka dhexeeya.

Bella Bird

Agaasimaha Bangiga Adduunka ee Soomaaliya

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MAIN MESSAGES AND KEY RECOMMENDATIONS

Somalis face a daunting development challenge to overcome the legacy of two decades of sustained conflict and fragility—but substantial progress is now being made. The new government inherited a dysfunctional economy facing high levels of poverty and inequality, a youth bulge, high unemployment, and large infrastructure gaps. The Federal Government of Somalia (FGS) has embarked on a process of structural, legislative, and institutional reform. The economy is starting to respond: Somalis are returning from abroad to invest, shops are opening, and the property market is booming. The International Monetary Fund (IMF) and the World Bank estimate Somalia's GDP at about $5.7 billion in current dollar terms in 2014.

Somalia's vibrant private sector may reach the limits of its potential if further reforms to the enabling environment, particularly to security and access to finance, are not pursued. Throughout the years of conflict and fragility, Somalia's private sector helped maintain economic activity. However, in the absence of appropriate sector regulation, the emergence of monopolistic or anticompetitive behavior may be discouraging new businesses from entering the market and small and medium-size business from growing.

The de facto intergovernmental fiscal arrangements that are emerging as interim state administrations are formed will affect what is politically possible to negotiate as part of the constitution-making process. In particular, state administrations are occupying most available tax bases, limiting the scope for the federal government to play its proper role in redistribution. It will be challenging for states to give away these revenue bases unless they also hand over cost responsibilities. For its part, the federal government is not in a fiscal position to accept the handover of functions to the federal level, unless it also gains control over more revenue bases to pay for them.

Inequitable distribution of resources was a fundamental cause of conflict in Somalia; it must be addressed in the design of the new arrangements. The distribution of the main revenue bases—in particular, customs revenue—is likely to be creating inequality across states. Addressing inequality requires that poorer states receive transfers, either from the central government (provided it has sufficient revenues to do so) or from other states that are better off. The design of intergovernmental fiscal arrangements for Somalia must address this challenge. In the absence of a solution, it seems likely that states will erect domestic customs barriers, which will undermine growth of Somalia's small and fragile economy.

ENHANCING GROWTH AND MACROECONOMIC STABILITY

The rehabilitation of public institutions that can generate public goods and services will be an enabler of long-term economic development, but it will rely on increasing the state's fiscal capacity. Meeting Somalia'ssocioeconomic challenges is difficult, given the legacy of weak institutions and regulatory frameworks, weak governance, and limited public services delivery. The reform of public institutions takes 20 years even in the fastest-reforming countries. The FGS and subnational governments are prioritizing the establishment of credible public finance institutions for macro-fiscal management. Revenue mobilization of additional business turnover taxes is a critical priority if the state is to increase its fiscal capacity and extend services to the population. In parallel, the authorities are trying to attract new talent into reformed civil service institutions at the federal and subfederal levels, in line with fiscal space.

Improving human and economic development outcomes is central if Somalia is to sustain its transition from conflict to stability. With estimated per capita GDP of $435 in 2013, Somalia is the fifth poorest country in the world, reflecting two decades of conflict.During this time, physical infrastructure was destroyed or not maintained, and two generations of Somalis went without education. Only 42 percent of school-age children are estimated to be enrolled in primary school, of which just 36 percent are girls. Youth are disproportionately affected by poverty and unemployment and areprey to recruitment into militia or radicalized groups.About 67 percent of 14- to 29-year-olds are believed to be unemployed. More spending to the social sectors is key to addressing these major developmental challenges.

DEVELOPING INTERGOVERNMENTAL FISCAL ARRANGEMENTS

Somalia's new fiscal arrangements should be designed to (a) work as a coherent system, preserving a strong common economic space across the country, and (b) provide scope to address inequities across regions. These objectives reinforce each other. If states without access to strong revenue bases are supported through transfers, they will be less likely to look for economically harmful ways to raise revenue. As political bargains are struck, efforts should be made to achieve balance between functional responsibilities and the availability of revenue to fund them.

Somali stakeholders should be prepared to develop a sustainable fiscal bargain incrementally, renegotiating as fiscal circumstances and the interests of states and federal government change over time. It may not be possible to reacha permanent fiscal bargain immediately. The focus now should be on developing robust intergovernmental institutions to facilitate ongoing negotiation and negotiating a way forward rather than finding a final fiscal arrangement.

TALO SO JEEDINTA IYO FARIIMAHA UGU MUHIIMSAN

Soomaali waxay wajahaysa caqabado ba'an si horumar u gaadho uguna guulaysato raadadki ay ku reebeen nuglaanshaha iyo colaadii ay labaatankii sanno ee la soo dhaafay- laakiin waxaa hadda la sameeyey horumar la taaban karo. Dawladan cusub waxay dhaxashay dhaqaale aan shaqayn oo ay soo wajahday saboolnimo iyo sinnaan la'aan heerarkoodu sarreeyo, da'yartii oo badatay, shaqo la'aan baahsan, iyo dayac balaaran o ku dhacay kaabayaashi dhaqaalaha. Dawaladda Federaalka Soomaaliya (DFS) waxay dardar gelisay hannaanka geedi-socodka ee qaab-dhismeedka, shuruucda, iyo dib u habaynta hay'adaha dawliga ah. Dhaqaalihi wuxu bilaabay ka soo kabasho: Somaalidi waxay ka soo laabteen dibadihii si ay dalka maalgashi ugu sameeyaan, ganacsigiina wuu xoogaystay, iyo weliba hantidi ma guurtada ahayd oo qiimaheedui uu sare u kacay. Hay'adaha Lacagaha Adduunka (IMF) iyo Bangiga Adduunka waxay Soomaaliya ku qiyaaseen wax soo saarkeeda (GDP) $5.7 Bilyan marka loo eego sarifka dollarka ee sanadkii 2014kii.

Kobaca wax soo saarka gaarka loo leeyahay ee Soomaaliyeed wuxuu gaari lahaa meeshiisa ugu sarraysa haddi lagu samayn laha isbedello xaaladaha u saamaxaya kobocooda, gaar ahaan nabadgelyada iyo helitaanka maaliyadeed, mana aha kuwo la dabagalay. Tan iyo sanadihi colaada iyo nugaylka lagu jiray, waxaa hawlaha dhaqaalaha gacan ka gaysta inay sii socdaan ganacsiga ama laamaha gaarka loo leeyahay ee Soomaaliyeed. Si kastaba ha ahaatee, maqnaashaha hay'adihii sida saxda ah wax u ilaalin lahaa ee waaxdan, waxay dhalisay in suuqyadi ganacsiga cid gaar ah ay u xiran tahay iyo in suuqyadii ay yeeshaan dabeecad aan tartan ku dhisnayn, waxayna taasi niyad jab ku keenaysa ganacsiyada cusub ee suuqa ku soo biiri laha iyo in ganacsatadii dhexdhexaadka ahayd uu kobacoodii hakad galo.

Sharciyada xiriir-maaliyadeedka ay yeelanayaan maamul-Goboleedyada hada dhismay, iyo Dawaladda Federaalka waxay saamayn ku yeelan doonaan suurtogalnimada wada xaajoodka siyaasadeed marka laga hadlayo geedi-socodka diyaarinta Dastuurka. Gaar ahaan, waxay hadda maamuladani canshuuro ka uruuriyaan dhamaan inta badan goobihi canshuuraha laga qaadi jiray, taasina waxay xadiday doorkii ay Dawaladda Federaalku wax ku kala qaybin lahayd. Sidoo kale waxaa caqabad noqonaysa Dawlad Goboleedyadu inay wareejiyaan goobaha saldhiga u ah dakhli ururintooda inta ay ka helayaan wax u damaanad qaada mas'uuliyada bixinta kharashkooda guud. Sidoo kale, Dawlada Federaalku ma ogolaan karto inay ku wada wareejiso Dawlad-Goboleedyada nidaamka maaliyadeed ilaa ay iyado mas'uuliyada goobaha saldhiga u ah canshuur uruurinta la wareegto ka dibna ay dib u qaybiso.

U Sinaan la'aanta khayraadka waa sababta saldhiga u ah colaada Soomaaliya; waana in laga hadlaa marka la diyaarinayo nidaam cusub. Wax ka qabashada sinaan la'aanta waxay u baahan tahay inuu jiro dakhli ku filan oo ay qaybin karto ama maamulada kale ee uu dakhligoodu sareeyo. Astaynta xiriir-maaliyadeedka maamulada Soomaaliya ka dhexeeya waa inuu ku dhiirada wax ka qabashada caqabadahan. Haddaan la samayn xal waxay u ekaanaysa in maamuuladu ay samaystaan gidaarro ay kastamadooda ku ilaashadaan.

DHAQAALAHOO SALDHIGA IYO KOR U QAADIDDA KOBACA

Dib u habaynta hay'adaha dawlada iyo dayac-tirka kaabayaasha dhaqaale waxay wax ka tarayaan horumarinta dhaqaale ee mustaqbalka fog, laakiin taas waxay ku xiran tahay sida ay dawladu karti ugu yeelato kobcinta dakhligeeda guud. Wax ka qabashada caqabadaha ku xeeran nidaamka dhaqan dhaqaale ee Soomaaliya waa mid adag, iyado laga eegayo liidaashada hay'adaha dawliga iyo nidaamka wax lagu ilaaliyo, maaumul xumo iyo adeega bulsho oo xadidan. In dib loo habeeyo dawligu waxay qadataa 20 sano xita dalalka ay dib u habayntooda hawli ku socoto. Dawlada Federaalka iyo maamul-goboleedyada waxay ku hawlan yihin dhisida hay'adoodihi maaliyadeed oo hufan si ay u maareeyan miisaanyidahooda. Dakhli uruurinta oo canshuuraha logu kordhiyo ganacsatada waa mid ku adag dawlada si ay u kordhiso miisaaniyadeeda iyadoo mudnaanta siinaysa adeega bulsho. Sido kale, waxay maamuladu isku dayayaan in soo jiitaan soomalida aqoonta u leh inay dib u habayn ku sameeyaan Hay'adaha shaqaalaha rayidka min heer federal ilaa mid maamul iyagoo ku xisaabtamaya misaaniyadahooda.

Natijooyinka ku aadan hagaajinta nolosha dadka iyo horumarinta dhaqaalaha waa u udub dhexaad Soomalia si ay u adkayso kala guurka laga guurayo coolada loona guurayo deganaansho. Soomaaliya waxay noqotay dalka shanaad ee ugu saboolsan dunida marka la eegay qofka Soomaliga dakhliga soo galay oo ahaa $435 sanadki, 2013. Markaad dib u milicsatid labadi rubuc qarni ee colaadu jirtay xiliyadan waxaa burburay kabayaashi dhaqaaalaha ama lama dayactirin iyo waliba laba jiil oo Soomaaliyeed oo aan waxbarasho helin. Waxa lagu qiyaasay 42% keliya oo da'di wax barashada gaadhay ayaa is qortay dugsiyada hoose oo ay 36% ay hablo yihiin. Dhalinyarada ayey si aan xad lahayn u saamaysay saboolinmadi iyo shaqo la'aanti waxaana ugaarsaday maleyshooyinki iyo kooxaha xagjirka ah. Da'ada u dhaxaysa 14 ila 29 jirka ayaa la rumaysan yahay in ay shaqo la'yihiin qiyaasti 67%. Waxaana lagaga bixi karaa haddi kharash badan loo qoondeeyo qaybaha arrimaha bulshada.

DIYAARINTA NIDAAMKA MAALIYADEED EE KA DHAXAYA DAWLADAHA

Nidaamka misaaniyadeed ee Soomaaliyadeed waa in loo asteeya (a) in loo shaqeeyo nidaam isku xiran, si loo ilaaliyo dhaqaale xoogan oo dalkoo dhan ka wada dhaxeeya, (b) diyaarin qaab wax looga qabto sinaan la'aanta ka jirta gobolada. Ujeedooyinkani waa kuwo midba midka kale kaabaya.

Haddi maamuladu ayan lahayn saldhig xoogan oo dakhligoodu ka soo galo waxaa lagu caawimiyaa nidaamkan oo wax loogu soo diro (transfer) si ayan qaab khatar ah dhaqaale ugu raadin inay dakhli ku helaan. Haddi u gorgortanka siyaasadeed u hakad galo waan in juhdi la geliyaa sidii horumar looga samayn laha isu dheelitirka wixii waajibaad fulineed ah iyo helitaanka dakhligii lagu fulin lahaa hawlahaasi.

Daneeyayaasha Soomaaliya waa inay u diyaar garooban sidii loo diyaarin lahaa joogtaynta gorgortanka misaaniyad kordhinta, iyo in dib looga wada xaajoodo hadba xaalada miisaaniyadeed iyo danaha maamulada iyo ta federaalka oo isbdelo ku yimaada.

Suurtogal noqon mayso in heshiis joogto ah laga gaaro gorgortanka maaliyadeed waqtigan dhow. Balse waa in diirada la saara diyaarinta hay'ado wax qaban kara ee maamulada iyo dawlada federaalka kuwaaso fududeeya wada xaajoodyada hadda soo socda iyo in laga xaajoodo sidii horay loogu sii socon laha si loo gaaro heshiis kama dambays ah oo ku saabsan maaraynta maaliyadeed ee ugu dambaysay.

EXECUTIVE SUMMARY

Somalis face a daunting development challenge to overcome the legacy of two decades of sustained conflict and fragility—but substantial progress is now being made. Since 1991 and the collapse of the Siad Barre regime, Somalia has experienced cycles of conflict and fragility that fragmented the country, undermined legitimate institutions, and created widespread vulnerability. The new government that emerged following the Transitional Federal Government and the Roadmap to End the Transition in 2012 inherited a dysfunctional economy facing high levels of poverty and inequality, a youth bulge, high unemployment, and large infrastructure gaps. Against a backdrop of political progress marked by the emergence of new Federal Member States (FMSs) within the new constitutional framework and continued insecurity, the Federal Government of Somalia (FGS) has embarked on a process of structural, legislative, and institutional reform.

The economy is starting to respond: Somalis are returning from abroad to invest, shops are opening, and the property market is booming.

Improving human and economic development outcomes is central if Somalia is to sustain its transition from conflict to stability. With an estimated per capita GDP of $435 in 2013, Somalia is the fifth poorest country in the world, reflecting two decades of conflict. During this time, physical infrastructure was destroyed or not maintained, and two generations of Somalis went without education. Only 42 percent of school-age children are estimated to be enrolled in primary school, of which only 36 percent are girls. Infant mortality rates of about 92 per 1,000 live births and under-five mortality rates of 150 per 1,000 live births are higher than Sub-Saharan averages. Somalia's very high fertility rate (6.2 births per woman) mean that the country is young, with more than 70 percent of the population under 30. An estimated 43 percent of the population lives on less than $1 dollar a day. Youth are disproportionately affected by poverty and unemployment and are prey to recruitment into militia or radicalized groups. About two-thirds of people 14–29 are believed to be unemployed.

> "Even though economic activities in various sectors are recovering, Somalia remains one of the poorest countries in the world

Diaspora remittances have played a vital role in sustaining the economy and supporting household incomes. Somali's diaspora is estimated to have sent more than $1.3 billion home in 2014—nearly twice the level of development aid ($642 million) and five times the level of humanitarian aid ($253 million). Remittances account for about 24 percent of GDP, far outweighing government revenues, and help to support livelihoods for an estimated 40 percent of the population. Remittances help finance Somalia's large trade deficit of more than 50 percent of GDP, paying for about 40 percent of total imports.

Somalia's growing isolation from the global financial system and the perceived exposure of money transfer businesses (MTBs) to terrorist financing jeopardizes this crucial source of finance. The phenomenon of financial "derisking" following enforcement actions against some international banks has affected Somali MTBs in Australia, the United Kingdom, and the United States, prompting new initiatives by the FGS and its partners to redouble their efforts to address domestic regulatory gaps. The pending passage of the anti–money laundering and countering terrorist financing bill is a critical priority if these initiatives are to become fully functional.

Somalia's vibrant private sector may reach the limits of its potential if further reforms to the enabling environment, particularly security and access to finance, are not pursued. Throughout the years of conflict and fragility, Somalia's private sector helped maintain economic activity. Some entrepreneurs flourished by providing money transfer, transport, and telecommunications services. However, in the absence of appropriate sector regulation, the emergence of monopolistic or anticompetitive behavior may be discouraging new businesses from entering the market and small and medium-size business from growing. The lack of financial intermediation has constrained business growth, as businesses must rely on their own funds or borrow from friends or family members to expand—a constraint that favors the rich. Access to affordable and predictable power sources is also a major constraint on business—a subject that will be covered in more detail in future editions of this series.

The rehabilitation of public institutions that can generate public goods and services will be an enabler of long-term economic development, but it will rely on increasing the state's fiscal capacity. Addressing Somalia's socioeconomic challenges is particularly difficult given the legacy of weak institutions and regulatory frameworks, weak governance, and limited public services delivery. The reform of public institutions takes time—an estimated 20 years even for the fastest-reforming countries. The FGS and subnational governments are prioritizing the establishment of credible public finance institutions for macro-fiscal management. The federal budget represents a very small share of GDP (3 percent), most of it going to salaries. Revenues are growing year on year, but their sole source is trade taxes, which are likely to be distortionary. Mobilization of additional business turnover taxes is a critical priority if the state is to increase its fiscal capacity and extend services to the population. At the same time, the government is trying to attract new talent into reformed civil service institutions at the federal and subfederal levels, in line with fiscal space.

"Mobilization of additional business turnover taxes is a critical priority if the state is to increase its fiscal capacity and extend services to the population

Unpacking the fiscal architecture and five key principles

The politics of state formation requires a parallel effort to establish functional intergovernmental fiscal relations based on economic solidarity. The need for progress is increasingly apparent: The FGS, Puntland, and the Interim Jubbaland Administration are dependent on port revenues. The Interim South West Administration, the Galmudug Interim Administration, and the remaining central state (expected to form this year) will not have access to a major port from which to draw revenues. Significant fiscal inequity across states seems likely to emerge. Without access to other revenues, poorer states are resorting to erecting domestic trade barriers, with damaging effects for the broader economy. In such a context, some degree of fiscal consolidation through an intergovernmental fiscal framework is necessary, but forging such a framework requires political agreement, state capacity, and fiscal space. A durable intergovernmental fiscal architecture will involve the distribution of spending responsibilities, the assignment of revenue-raising powers, and a system of transfers that can address inequality across regions. Such arrangements are complex. In other countries they have emerged not through formal agreement but through an incremental process overseen by a set of flexible institutions.

Unpacking the elements of fiscal architecture into functions and spending responsibilities and the tax and transfer system may help focus stakeholders on the fiscal implications of political bargains. Intergovernmental financing arrangements operate as a system; decisions on some components thus circumscribe the design options for other components. Five principles maybe useful to inform the development of the new intergovernmental architecture.

1. **A dynamic, organic approach should be grounded in cooperative intergovernmental institutions.** In all countries, intergovernmental fiscal arrangements often evolve over time. Such evolution is particularly likely in fragile contexts, where the fiscal landscape and balance of interests among stakeholders is likely to change. Given the dynamic conditions, an incremental approach, under which fiscal design evolves through successive agreements over time, may be more realistic. The immediate focus should therefore be on nurturing intergovernmental mechanisms through which these agreements can be negotiated on an ongoing basis.
2. **Intergovernmental financing arrangements work best as a coherent whole.** Decisions on the design of one component will affect what is feasible for other components. Fundamentally, resources and cost responsibilities should be matched. A degree of political expediency or compromise is inevitable and indeed important, but some regard for how those decisions affect the overall balance in the system should be maintained.
3. **Fiscal arrangements should support a strong and unified economic space.** Given the small size of its economy, Somalia cannot afford to put obstacles in the way of the free movement of goods, services, and labor. First principles suggest that mobile bases should be taxed at the national level, but doing socould leave states more dependent on the central government, which may not be politically acceptable. Considerations of efficiency suggest harmonization of tax administration functions, even if not of taxing powers; they also suggest that there may be some asymmetry in state functions, at least in the interim, given that states have highly variable levels of capacity.
4. **Resources should be distributed in an equitable and inclusive manner.** Resource competition and unequal access to limited resources prolonged the conflict in Somalia. Unequal access to resources is also likely to trigger the movement of people across regions, as insecurity has already prompted migration to urban areas. Addressing inequality will require a significant redistribution of revenues among FMSs. This redistribution could be achieved through sharing arrangements agreed upon by the states or through transfers from federal to state governments. If the transfers are the preferred option, the FGS will need additional revenues—either by quickly mobilizing additional revenue bases or by transferring revenue bases from states to the center.
5. **The assignment of functions should aim at efficiency.** The more functions lower levels of government are responsible for, the more responsive services will be to the needs of citizens. But Somalia is a poor country with limited capacity. At least in the short term, it does not make sense to have multiple organs of government developing the capacity to do the same things.

> “Given the small size of its economy, Somalia cannot afford to put obstacles in the way of the free movement of goods, services, and labor

This is the first Economic Update for Somalia since the 2005 World Bank Country Economic Memorandum for Somalia. The long conflict made monitoring of economic and social data nearly impossible since the late 1980s. With the relative stability of the past few years, new data have become available. The update is divided into two parts. Part I presents information on the social, economic, and governance status of Somalia. Part II focuses on intergovernmental fiscal relations.

NUXUR URURIN

Horumarka Soomaaliya wuxu wajahaya caqabado ba'an si u uga gudbo raadadki ay reebeen nuglaanshaha iyo colaada mudadi labaatanka sanadood ka badnayd - laakiin hadda waxaa la gaaray xooga horumar ah.

Tan iyo 1991ki iyo ka dib burburki Dawladdii Maxamed Siyaad Barre, Soomaaliya waxay waayo-arag u noqotay colaad iyo nuglaansho isdaba jooga taaso dalkii kala qoqob ku riday, waxaana meesha ka baxay sharciyadi ay lahaayeen hay'adahi dawliga ahaa iyo inay abuurantay taag darnaan baahsan. Dawladan cusub ee Federaalka waxay timi ka dib marki Dawladdii hore ee ku meel gaarka ahayd u waqtigeedi dhamaaday lagagana baxay geedi-socodki la magac baxay (Roadmap) sanadki, 2012 ki, waxayna ka dhaxashay dhaqaale aan shaqaynaynin oo ay soo wajahday saboolnimo iyo sinaan la,aan heerarkoodu sareeyo, dhalinyarro shaqo la,aani hayso iyo kabayaashi dhaqaalaha oo gaabis balaaran ku yimi. Inkasto xaladahaasi o dhan jiraan, haddana yagleelida maamul-goboleedada cusub waxay calaamad horumar siyaasadeed u noqotay in la raaco sida u qabo Dastuurka cusub iyado ay jirto nabadgelyo daradii, waxay kallo Dawlada Federaalka dejisay hab lagu horumarinayo qaab-dhismeedka, shuruucda iyo dib u egis lagu sameeyo hay'adaha dawliga. Dhaqaalihi wuxuu bilaabaya inu ka jawaabo: In Soomaalidi ay dibedaha ka so labanayaan si ay dalka maalgashi ugu sameeyaan, waxaa furmaya ganacsi cusub iyo in qimihii hantida ma guurtada ahayd uu sare u kacayo.

Natijooyinka ku saabsan hagaajinta nolosha dadka iyo horumarinta dhaqaalaha waa u tiir dhexaad Soomaaliya si ay u adkayso kala guurka oo laga guurayo colaada loona guurayo degenaansho.

Soomaaliya waa dalka shanaad ee dunida ugu saboolsan iyado lagu qiyaasay in qofka Soomaaliga ay ku soo beegmayso $435 dakhliga guud ee dalka sanadkii, 2013, markaynu dib u milicsano labadi rubuc qarni ay colaadu jirtay. Waxaana xiliyadan burburay kabayaashii dhaqaalaha ama aan la dayactirin, iyo waliba laba jiil oo Soomaaliya ayaan waxbarasho helin. Boqolkiiba 42 caruurta da'ada waxbarashada gaartay ayaa Dugsiyada hoose la qoray oo ay boqolkiiba 36 gabdho yihiin. Heerka dhimashada caruurta 1000 ki caruura oo ay da'doodu ka yartahay shan sano ee dhalata waxaa geeriyoota 92 , waxayna heerka dhimashada 150 ka sareeyaan 1000 ki caruura ee dhalata dalalka ka hooseeya Saxaara Galbeedka Afrika. Soomaliya heerka taranteeda aad buu u sareeya oo (Qofki Dumara waxay dhasha 6.2) taa macnaheedu waxa weeye Soomaaliya waa dal curdin ah , halka boqolkiiba 70 ay dadku da'doodu ka yar tahay 30 jir, Waxaa kaloo lagu qiyaasay boqolkii 43 dadka nolol maalmeedkoodu inay ka yar tahay wax dhan hal doolar maalintii. Dhalinyaradu waxaa aad u saameeyey saboolnimada iyo shaqo la'aan taaso sababtay inay qortaan Maleeshooyinki iyo kuwa xagjirkaba iyagoo markoodi horaba laba dalool saddex dalool 14 – 29 la aaminsanaa inay shaqo la'aayeen.

Lacagaha ay Qurbo joogta soo diraan waxay door muhiim ah ka qaateen tageeridda dakhliga qoysaska iyo joogtaynta dhaqaalaha.

Soomaalida Qurbo joogta ah lacagaha ay dalka usoo diraan waxaa lagu qiyaasay in ka badan $ ki1.3 bilyan sanadki, 2014 – taaso ku laba jibaarantay lacagta deeqda horumarineed ku baxady ($642 milyan) iyo shan jibaar heerka lacagta gargaarka aadaminimo iyana ku baxday ($253 milyan). Xawilaaduhu waxay dakhliga guud ee dalka ka yihiin boqolkiiba 24 taaso in badan ka miisaan wayn dakhliga dawladda, waxay kalo xawaalduhu dadweynaha ka sacidaan xagga nolosha qoysaska boqolkiba 40. Xawaaladaha waxay taageero maaliyadeed ka geystaan faraqa balaaran ee ka jira ganacsiga Soomalida boqolkiiba 50 ee GDP, waxay kalo bixinayeen boqolkiiba 40waxa dalka u soo dega.

Go’doonsanaanta ay Soomaaliya kaga jirto Nidaamka Lacageed ee dunida iyo tuhunka ah in Xawaaladaha (MTBs) ay argagisaxida lacagaha u gudbiyaan ayaacuryaamisay lacagahi dibeda laga soo diraayey.

Waa ifafaale cusub, xanibaadaha lagu soo rogay xawaaladaha iyo talaabooyinkii sharciyadeed oo ay adeegsadeen qaar ka mid Bangiyo Caalamiya taaso saamayn ku yeelatay Xawaladihii Soomaalida eek a jiray Australiya, Boqortooyada Ingriiska, iyo Maraykanka , waxay dhiirgelisay in Dawlada Federaalka iyo bah-wadaagteeda ay hal abuuraan inay dardargeliyaan wax ka qabashada xeerarka maaliyadeed ee iyo dalka waxyaabaha aan u qabsoomin. Hindise sharciyeedyada la xiriira lacagaha sida sharci darada laysu daba mariyo iyo ka hortaga lacagaha loo xawilo argagixisada waxay noqon lahayd talaabo mudnaanteeda leh haddi la dhaqan geliyo hindiseyaashas.

Wax-so-saarka gaarka loo leeyahay ee Soomaaliyeed ee kobcaya wuxuu gaari lahaa meel sare haddii dib u eegis lagu samayn lahaa xaaladaha u saamaxaya koriimada gaar ahaan nabadgelyada iyo helitaanka maaliyadeed- weli ma’aysan hanan.

Tan iyo intii colaada iyo tabardaridu lagu jiray wax-so-saarka gaarka loo leeyahay ee Soomaaliyeed wuxuu si waday hawlihii dhaqaale ee dalka. Qaar ka mid ah ganacsatada yaryar waxay ka macaasheen dirida lacagaha xawaalada, gaadiidka iyo adeegyada isgaarsiinta. Sidaa darted, maqnaashaha xeerarkii wax kala xadidi lahaa ayaa waxay sababtay inay soo ifbaxaan kuwo aan cidina la tartamin (Monopolistic) oo aan ogolayn tartanka xorta ah waxayna niyad jab ku riday ganacsatadii yaryareed inay suuqaba soo galaan iyo inay kobcaan kuwi meel dhexaadka ahaa. Maqnaanshaha ay hay’addi maaliyadeed oo wax kala nidaamin lahayd ay meesha ka maqan tahay waxaa hakad ku dhacayaa in ganacsigii uu koro, sida hada wax ku socdaan waa ganacsatadii oo lacagteedi is kharash garaysa ama amaah u doonata saaxibadood ama ehelkooda – dabranaantaas waxunba ka faa’idaya kuwa tujaarta ah. Waxa kalo ganacsiga caqabad weyn ku ah helitaanka iyo awoodi maaliyadeed ee lagu heli lahaa dabka korontada- waana maado aynu uga hadali doono si faahfaahsan mustaqbalka qoraalada cutubyadeena dambe.

Dayactirada dhismayaasha hay’adaha dawliga waxay wax ka tarayaan adeega bulsho iyo kabayaasha kuwaaso suurtogal ka dhigaya horumarka dhaqaale ee mustaqbalka, laakiin waxay ku xirnaan doonta awooda miisaaniydeed ee dawlada.

Wax ka qabashada caqabadaha ku xeeran habka dhaqan- dhaqaale ee Soomaaliya waa kuwo adag gaar ahaan waxyaabihi ay dhaxashay sida, hay’ado taag daran iyo qaababki wax lagu ilaalinayey, maamul xumo iyo adeeg bulsho oo kooban. In dib loo eega hay’adaha dawliga ah waqti bay qaadanaysa – Dawladda Federaalka Soomaaliyeed iyo dawlad goboleedyadu waxay dhisanayaan nidaam maaliyadeed oo wax ku ool ah kaaso maareeynaya miisaaniyada guud ee dalka. Qoondada miisaaniyada Federaalka wax yar bay ka tahay dakhliga guud GDP (Boqolkiiba 3) inta badan waxay ku baxda mushahar shaqaale. Dakhligu wuu kobcaya sanadba sanadka ka dambeeya, laakin wuxu ka soo gala keliya canshuuraha ganacsiga iyado xad dhaaf ah. Ururinta canshuurta macaashul macaashka ee laga qaadayo ganacsatada waa mid aad muhiim u ah waa haddi ay dawladu mudnaanteedu ay tahay in kordhiso misaaniyadeeda si ay adeeg bulsho u qabato. Sidoo kale, haddi ay dawladu ugagoleedahay inay ku soo jiidato Soomaali aqoon leh si loogu meeleeyo hay’adihii dib u eegistu lagu sameeyey min federal ilaa dawlad-goboleedyada iyadoo lagu xisaabtamayo misaaniyad sanadeedka.

Siyaasada lagu dhisayo dawlad-goboleedyada waxay u baahan tahay in dedaal la mid ah lagu bixiyo samaynta nidaam miisaaniyadeed oo ka dhaxeeya dawladaha taaso ku dhisan dhaqaale wadaag.

Baahida loo qabo in horumar la gaadho waa mid cad oo muuqda. Dawladda Federalka, dawlad goboleedyada Puntland iyo Jubbaland dakhligoodu wuxuu ku xiran yahay dekedaha. Maamulada ku meel gaarka ahi ee Koonfur Galbeed iyo kan Galmudug iyo ka dhimane ee maamulka bartamaha (kaaso la filaayo sanadkan) iyagu ma laha dekedo waaween uu dakhli ka so gallo. Waxaa dhici karta sinaan la'aan xagga maaliyadeed inay ka soo baxdo maamulada. Haddayan lahayn ilo kale oo dakhli ka soo gallo maamulada aan haysan tabar dhaqaale oo badan waxay miciin bididoonan inay gidaarro u

dhistaan ganacsiga isaga kala goosha dalka taaso keeni karta dhibaato saamaynteeda ku yeelata dhaqaalihi guud ee dalka. Xaaladan oo kale waxay u baahan tahay in laysu taago oo lala habeeyo miisaaniyadaha maamuladani waana lagamamaarn, laakiin farsamada noocani waxay u baahan tahay marka hore heshiis siyaasadeed, kartida maamulka iyo farqiga ka jira miisaaniyadooda. Qaabaynta miisaaniyadaha maamulada oo waara waxay la falgalaysa mus'uuliyada qaybinta kharashaadka, cidda loo xilsaarayo awoodaha dakhli ururinta iyo habka wax loogu wareejinayo si wax loogu qabto gobolada ay sinaan la'aantu ka jirto. Habkan oo kale waa mid murugsan, wadamada kale oo Sida Soomaaliya soo maray kagama ay soo gubin hab heshiis la wada galay balse waxay kaga gudbeen hab geedi-socoda oo wax kordhin ah iyado ay dusha kala socdaan hay'ado loo dhisay.

Kala saaridda qodobada asaaska u ah naqshada miisaaniyadeed loona kala qaado- waajibaadka, cidda mas'uulka ka ah kharashaadka iyo canshuurta iyo habka lacag wareejinta taaso ka caawinaysa daneeyayaasha in gorgortankooda siyaasadeed saamayn ku yeelato miisaaniyada.

Nidaamka maaliyadeed ee maamuladda ka dhexeeya waa in uu u shaqeeya hab la yaqaan go'aanada laga qaadanayo qaybo waa in loo dejiya in qaybo kale lagu wareejinkarro. Shan mabaadi' baa faa'ido u yeelan karta in lagu wargeliyo marka lo horumarinyo naqshada cusub ee dawlada ka dhaxaynaysa.

1. **Waa inay hay'adaha ka dhaxaynaya dawladaha loo dhisa qaab iskaashi uu ka dhaxeeyo, firfircoon oo isku wada xiran.** Dalalko idil, nidaamka miisaniyaeed ee dawladaha ka dhaxeeya badanaaba si tartib tartiib ah ayu u horumara waana xaalad ugaara dalalka colaada ka soo doogaya, waana meel la doonayo in loo sameeyo miisaaniyad wanaagsan iyo in la isu-dheelitiro danaha ay daneeyayaashu (bah-wadaagta) leeyihiin waana tan la doonayo in isbedel lagu sameeyo. Marka la helo hay'addo firfircoon oo si qaabaysan oo heshiisyo u gaaraya markaasaa xaqiiqada loo dhawaanayaa. Diiradda hore waa in la saara sidii loo horumarin lahaa nidaamka ka dhaxeeya dawladaha ee wada xaajoodka xagga heshiisyadda uu u noqon lahaa mid sal leh oo si socda.

2. **Nidaamka maaliyadeed ee ka dhaxeeya dawladaha wuxuu si wanaagsan u shaqayn karaa markay isku wada xiran yihiin dhamaantood.**

   Go'aanada wax loogu qoondaynayo qayb waxaa surtogal ah inu samayn ku yesho qayb kale, asal ahaan dhaqaalaha la haysto iyo mus'uulida kharashka waa inay isku jaan go'an yihiin, ilaa heer hadday duruuf siyaasadeed timado ama is-afgarad la gaarro waa lama huraan waana muhiim. Laakiin qaarba waxay tixgelinayaan sida ay go'aanada oo kale ay saamayn ugu yeelan karaan nidaamka xisaab xirka iyana waa in la ilaaliya.

3. **Nidaamyada misaaniyadeed waa inu tageersan yahay dhaqaale midaysan oo xooggan.**

   Soomaaliya iyado dhaqaalaheeduba uu aad u yar yahay ma awoodo inay caqabado hordhigto isu socodka badeecadaha inay si xor ah isaga kala gooshaan, adeegyada iyo shaqada. Mabaad'ida kowaad waxay ku talinaysa alaabada ama badeecadaha guur guura (mobile bases) waxaa laga canshuuraya heer qaran, laakiin hadday taasi dhacdo waxay u ekaanaysa in dawlada goboleedyadu ay ku xirnaadan dawladi dhexe taaso noqonaysa siyaasad ahaan midaan la aqbli karin. Waxaa aad u shaqaynaysa in laysu soo dhaweeyo maamulida canshuuraha waana talo tixgelinteeda mudan xita hadaysan ahayn kuwii awooda u lahaa canshuur qaadista, waxay kaloo talo ku soo jeediyen in ay dawladu laba dhinacba u kala shaqayso ugu yaraan xiliga ku meel gaarka si ay dawlad goboleedyadu karti ugu yeeshaan ka gudbida maraaxilka kala duwan ee ay marayaan.

4. Khayraadka waa in si caddaalad ah loo qaybiya loona dhan yahay

Ku tartanka kheyraadka iyo u sinaan la'aanta helitaanka kheyraadka kooban waa wixii si daba dheereyey colaada Soomaaliya, waxay kalo u sinaan la'aanta keentay dadko si baahsan isugu kala gooshay goboladi, nabadgelyo daradii iyo in dadkii soo hayaamay ay magaalooyinka buux dhaafiyeen. Wax ka qabashada sinaan la'aanta waxay u baahan tahay in ahmiyad la siiyo qaybinta dakhliga loona qaybiyo dawlada goboleedyada iyo federaalka (FMSs). Wax qaybsigan waxaa lagu gaari karaa hab lagu heshiiyey oo wax lagu qaybsado oo lala galo maamulada ama ay dawlada federaalku ku so wareejiso dawlad goboleedyada. Haddi wax soo wareejintu laysku raaco, dawlada federaalku waxay u baahanaysa dakhli dheeri ah-laba midood ama waxaa si dhakhsi ah dakhliga dheeriga ah looga soo ururinaya saldhigyada dakhliga ama waxa laga soo diraya saldhigyada dakhliga ee dawlad goboleedyada.

5. Waajibaadyada la qaybsaday waa inay hufnaani ku dheehan tahay.

Inta ay dawladu laamaheeda hoose ay si mas'uulid leh ay u shaqaynayaan, ayaa wax badan oo baahiya adeega bulshada loo qabanaya muwaadininta, walo Soomaaliya ay tahay dal sabool ah oo ay kartideeda waxqabad ay xididan tahay. Ugu yaraan waqtiga dhaw macne samayn mayso inay dawladu yeelato hay'ado badan oo hawlo isku wada mid ah fuliya.

PART I: SOCIAL, ECONOMIC, AND GOVERNANCE STATUS

1. Context and Objectives

Two and a half decades of conflict, concentrated mainly in southern Somalia, destroyed much of the country's governance structure, economic infrastructure, and institutions. Following the collapse of the Siad Barre government, in January 1991, Somalia experienced deep cycles of internal conflict that fragmented the country, undermined legitimate institutions, and created widespread vulnerability. The prolonged conflict transformed the economy, with many economic and political actors facing incentives to perpetuate conflict in order to sustain and divert associated revenue streams.

During the conflict, some parts of Somalia were able to attain relative stability. When the central government collapsed, in 1991, it lost its authority in many parts of the country. In this vacuum, the regional states of Puntland and Somaliland emerged. They established basic political and administrative institutions, provided social and educational services, facilitated an active civil society, supported a growing private sector, and maintained security.

In May 1991, the north-western regions of Somalia (encompassing the former British Somaliland) unilaterally declared themselves independent of the rest of Somalia. Within years Somaliland succeeded in achieving reconciliation among its clans and establishing the basic apparatus of a functioning state, including new security forces and a taxation system.[1] Successive electoral processes have seen the emergence of political parties, an opposition, and a tradition of peaceful transfers of power. The private sector plays a key role in Somaliland, including providing the government with both political backing and the funds needed for main state-building initiatives.

Meanwhile, in 1998, in north-eastern Somalia, Puntland proclaim edits autonomy. It built administrative structures and a system of self-government based on democratic norms. As this report documents in its Special Focus Section, Puntland's constitution allows the government to perform all the functions of a state, including revenue mobilization to support basic services, including security. Puntland is the prototype for Somalia's new FMSs.

After a turbulent period of transitional governments, in 2012 a new Federal Government emerged in Mogadishu within the framework established by the Provisional Constitution. A successful political transition was matched by parallel progress on the security front. With the help of the 22,000-strong African Union Mission to Somalia (AMISOM) force, Somali forces, including aligned clan militia, liberated parts of southern Somalia, including strategic urban centers, from Al Shabaab. Though weakened, Al Shabaab retains significant terrorist capacity and has focused on asymmetric attacks targeting government and international targets, including in Kenya. While southern Somalia is still experiencing active conflict, Somaliland and Puntland have remained relatively peaceful, although Al-Shabaab infiltration into Puntland's mountainous areas has been growing. Following the political transition in 2012 the international community agreed to the Somali Compact with the FGS, based on the principles of the Busan New Deal.[2] The Compact, which was agreed to at the Brussels Conference in September 2013, provides an organizing framework for the delivery of assistance to Somalia in line with national priorities and increasingly delivered by Somali institutions.

1 Somaliland's claim to independence from Somalia has not been recognized. The territory therefore remains legally a region of Somalia. Under the New Deal Compact for Somalia, the international community agreed to a "Special Arrangement for Somaliland," recognizing its special circumstances. Political talks between Somalia and Somaliland are ongoing.

2 The New Deal for Engagement in Fragile States was agreed to at the Fourth High-Level Forum on Aid Effectiveness in Busan, the Republic of Korea, in 2011. It is an agreement between fragile and conflict-affected states, international development partners, and civil society to improve current development policy and practice in fragile states.

The Provisional Constitution establishes federalism as the basis of Somalia's new governance framework, providing for the emergence of new FMSs.[3] Under this arrangement, the federal government and the FMSs are to share power and deliver services to benefit all their citizens in a cooperative manner. The Provisional Constitution left many areas open for further negotiations, particularly questions relating to allocation of law-making, revenue-raising, and spending powers. Negotiations over a final constitution that would regulate how the FGS and FMSs will work together are taking place and are expected to be finalized by 2016. Once formed, FMSs will (a) become counterparts for the Federal Government in the constitutional negotiations as representatives of the wishes and aspiration of the people they represent; (b) allow the formation of the Upper Chamber of the Parliament (Senate), which will be key to ratifying agreements; and (c) allow for the formation of legitimate constitutionally required commissions.

2. Social and Poverty Status

Somalia is one of the world's poorest countries; extreme income poverty is prevalent throughout the country. Based on the findings of the 2013 Somaliland Household and Enterprise Survey, a household needs So.Sh. 207,300 (about $1.00) per adult per day in urban Somaliland and So. Sh180,900 (about $0.90) per adult per day in rural Somaliland to meet basic need. Households living on less than this are considered poor, which results in poverty rates of 37 percent in rural Somaliland and 30 percent in urban Somaliland. Only 26 percent of 15- to 55-year-olds in rural Somaliland and 33 percent in urban Somaliland are employed (wage or self-employment).

People living in camps for internally displaced persons (IDPs) are significantly poorer than people who live in residential neighborhoods of Mogadishu. The Mogadishu High Frequency Survey was piloted in October and November 2014. Data from the pilot suggest that, compared with the rest of the city, the poorest 40 percent of the population in Mogadishu live in significantly larger households. Among these people, 38 percent live in a household headed by a woman, and only 15 percent have. Half of household in IDP camps drink untreated water, 90 percent of household heads never attended school, and only one out of five children currently attends school.

The World Bank will undertake critical surveys to plug the data gaps. The innovative approach to collect critical socioeconomic data from households will be scaled up in October and November 2015 across Somalia, including in Mogadishu and urban and rural areas in Somaliland and Puntland.[4] These data will be critical to improve the understanding of the size and structure of the Somali economy, update the consumer price index, and estimate the extent of poverty and inequality in the country. The data will also inform the formulation and setting of priorities in the National Development Plan and help rebuild statistical capacity and infrastructure in Somalia.

[3] The Interim Jubba Administration was created in 2013 as a result of agreement between the Federal Government and Jubba delegations. In 2014, the Interim Southwest Administration was created, through a process supported by the Federal Government. In July 2015, the Interim Galmudug Administration was formed. The process of achieving reconciliation, electing legislative assemblies, and establishing functioning regional governments is still ongoing.

[4] The Somalia High Frequency Survey is highly innovative. It leverages private sector know-how and open-source applications to collect high-quality data under difficult field conditions. In fragile states and areas beset by conflict and insecurity, safety and risk considerations limit the time available for face-to-face interviews. These concerns make it difficult to supervise the quality of data collection in the field and prevent administering detailed household consumption recall modules and using traditional poverty and inequality measurement methods. The Somalia High Frequency Survey embodies a number of innovations to overcome these constraints. It provides the authorities with a new approach to collect the data required to estimate a reliable poverty profile of the population in such a context.

2.1 A Young and Rapidly Growing Population

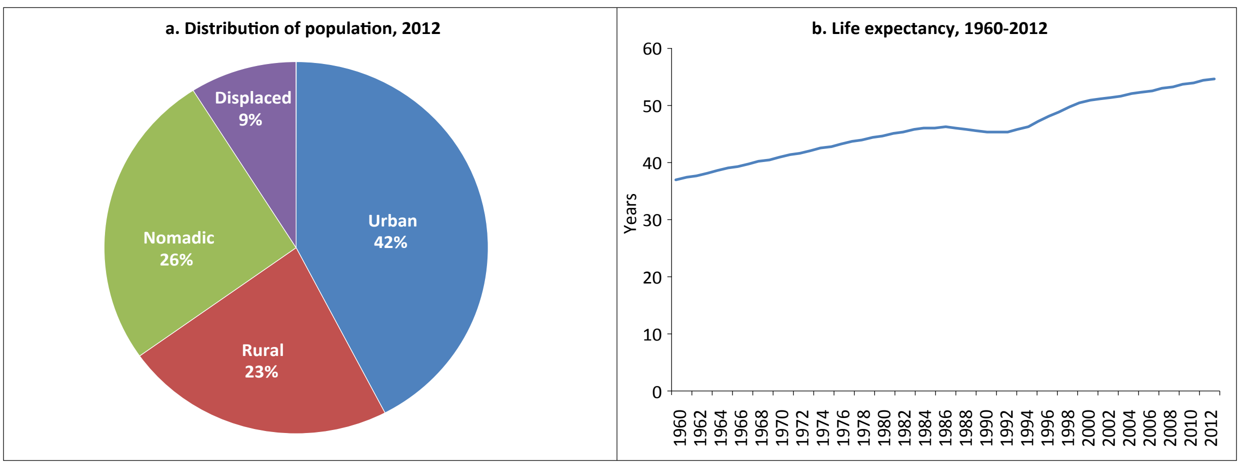
In 2014 the United Nations Population Fund's Population Estimate Survey (PESS) produced the first population estimates for Somalia in many years. It estimated Somalia's total population at 12.3 million in 2013 (Figure 2.1, panel a.). It is important to note that these results were widely contested in Somalia. The population estimate reflects an annual average population growth rate of about 2.9 percent between 1990 and 2013, driven by high fertility rates of 6.2 births per woman. Life expectancy is improving after a decline during the war period, reaching 55 years in 2012 (Figure 2.1, panel b), slightly lower than the Sub-Saharan Africa average of 56.

Somalia's very high fertility rates mean that the country is young, with more than 70 percent of the population under the age of 30. About half the female population is of child-bearing age (15–49). Therefore population growth will remain strong for many years to come. Poverty and unemployment disproportionately affect young people: about two-thirds of Somalis 14–29 year unemployed. Unemployment leaves youth vulnerable to recruitment by militia and radical groups and can undermine efforts to stabilize the country, including areas newly recovered from Al Shabaab. Sustainable job creation is a central challenge for Somalia's leadership and its international partners.

2.2 Weak Social Indicators

Conflict, poverty, and limited access to health care are responsible for very weak health outcomes. High mortality rates are driven by high death rates in the early stages of life. In 2012 infant mortality was estimated at 92 per 1,000 live births, and under-five mortality was 150, far in excess of the Sub-Saharan average (Table 2.1). Maternal mortality was 850 deaths per 100,000 live births. These rates have changed only slightly since 1970, despite a functioning government until the early 1990s. The civil war reduced these rates. In 1991 and 1992,crude mortality rates surpassed those in Ethiopia during the famine of 1984–85. Access to an improved water source and sanitation remains below the Sub-Saharan average, with just 36 percent of Puntland's rural population and 61 percent of its urban population having access to improved water resources. Access to improved water source in Somaliland remains an even greater challenge, with only 3 percent of households in rural areas obtaining water from improved sources compared with about 47 percent in urban areas.[6]

Figure 2.1: Both the size of the population and life expectancy have been rising in Somalia



Source: World Development Indicators (2015) and UNFPA (2014) estimates

6 World Bank (2015): Somaliland Poverty Profile and Overview of Living Conditions.

7 UNICEF (2011): Somalia Multi-Cluster Survey.

Table 2.1: Social indicators in Somalia

Indicator	Somalia	Sub-Saharan Africa
Life expectancy at birth, 2012 (years)	55	56
Mortality rate, 2012 (per 1,000 live births)		
Infant	92	63
Under five	150	96
Maternal mortality, 2012 (per 100,000 live births, 2013)	850	—
Access to improved sanitation, 2011 (percent)	23	30
Access to improved water source, 2011 (percent)	32	64
Gross primary school enrollment, 2007 (percent)	29.2	—
Gross secondary school enrollment, 2007(percent)	7.3	—

Source: World Development Indicators 2015.
Note: — Not available.

Somalia's health care system was wiped out during the conflict and remains weak today. Most hospitals and health centers face equipment shortages, have poor infrastructure and weak management capacity, and depend on donor funding or out-of-pocket patient expenditure for their functioning. As a result, access is particularly limited for the poor.

Literacy rates are low, especially among women 15–24. Ninety percent of all schools were destroyed during the war. With no functioning public education system, two generations of Somali children missed out on education. As a result, adult literacy in Somalia is just 38 percent, one of the lowest rates in the world. The rate of literacy among women 15–24 is just 44 percent in Somaliland and 37 percent in Puntland. In both regions, the lowest literacy rates are in rural areas. These statistics are particularly worrisome given evidence that for every extra year of education young women become literate child mortality decreases by 9.5 percent.

Despite improvements in recent years, school enrollment in Somalia remains low. Only 42 percent of school-age children are enrolled in primary school, of which only 36 percent are girls. UNICEF estimates the number of out-of-school children and youth (people 6–18) at 4.4–5.9 million. Less than 8 percent of secondary school–age children attend secondary school. Overall, 80 percent of school-age children in Somalia do not go to school. Children who do attend school face many obstacles, including inadequate facilities, a shortage of qualified teachers, inadequate textbooks, lack of a standardized curriculum, and gender disparity in enrollment.

THE STATE OF SOMALIA'S ECONOMY

3. The State of the Economy

3.1 Real Sector

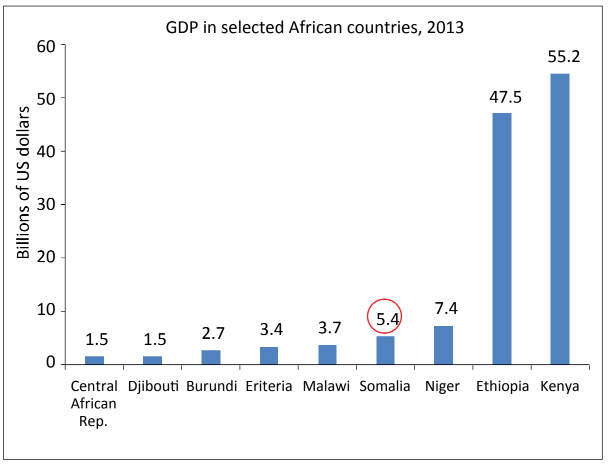
The national accounts data for Somalia are outdated; only very preliminary estimates of GDP are available. Comprehensive official statistics for Somalia, including national accounts, exists through 1990. In 2002 the United Nations Development Programme (UNDP) estimated household per capita income at $226. In 2014 the International Monetary Fund (IMF) and the World Bank produced a set of preliminary national accounts. All of these data should be interpreted with caution, given the difficult circumstances in which they were collected.

Somalia's GDP in 2013 was estimated at about $5.4 billion. In current dollar terms, Somalia's economy is larger than the economies of the Central African Republic, Djibouti, Burundi, Eritrea, and Malawi (Figure 3.1). Out of 46 Sub-Saharan African countries, Somalia's economy ranks 16th from bottom in terms of size. Total GDP estimates imply a per capita GDP of $435, making Somalia the fifth-poorest country in the world (after Malawi, Burundi, the Central African Republic, and Niger) (Figure 3.2). Somalia's per capita income is 20–40 percent higher than GDP per capita, because massive inflows of remittances allow households to top up own-generated income (used to measure GDP per capita).The recent estimate of Somaliland's GDP by the World Bank put it at $1.6 billion in 2012. Estimates by the authorities in Puntland estimate its GDP at $1.3 billion in 2010.

Somalia's GDP is dominated by private consumption and imports (Figure 3.3). Household consumption, financed by remittances, was equivalent to more than 100 percent of Somalia's nominal GDP in 2014, with food and beverages accounting for about 60 percent of the total. Nonfood goods (cleaning products, medication, paper and paper products, office supplies, and other nondurables) accounted for about 34 percent of the total consumption. Net investments accounted for only 8 percent of GDP. Exports were equivalent to about 14 percent of GDP, while imports accounted for more than two-thirds of GDP. The large trade deficit was financed mainly by remittances and international aid.

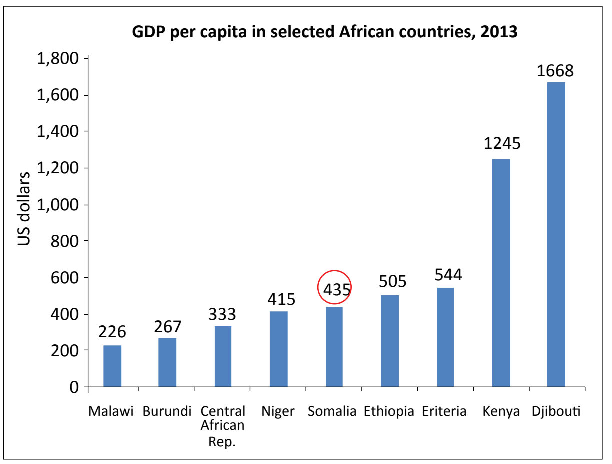
Consumption was already the key driver of the economy in the prewar period, accounting for almost 98 percent of GDP on average in the period 1985–90 (Figure 3). The situation is similar in Somaliland and Puntland, where the share of household consumption is equivalent to 130 and 112 percent of GDP, respectively; government

Figure 3.1: Somalia's GDP amongst the lowest in the region



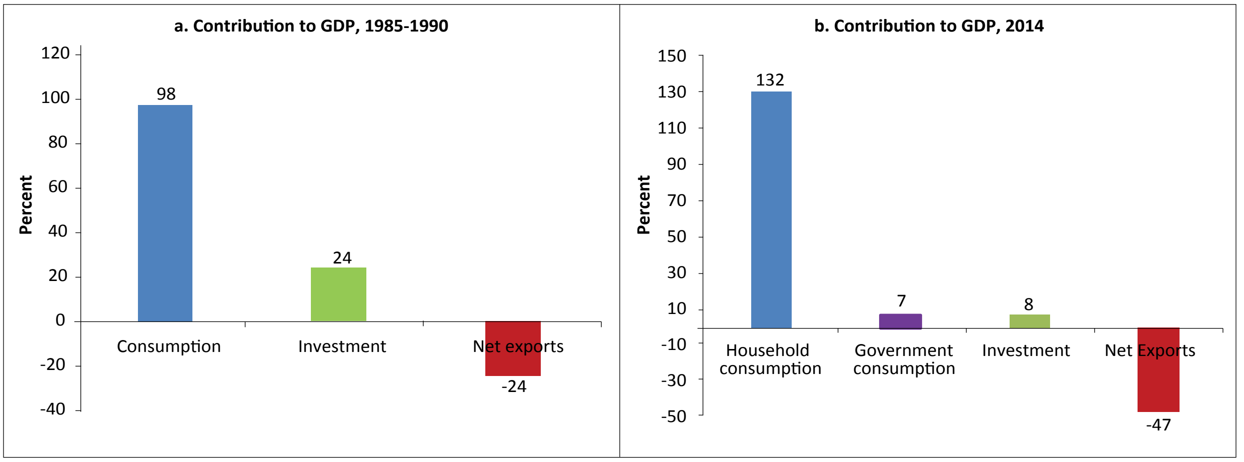
Source: World Development Indicators 2015 and World Bank and IMF staff estimates 2014.

Figure 3.2: Somalia's GDP per capita is the 5th lowest in the World



Source: World Development Indicators 2015 and World Bank and IMF staff estimates 2014.

Figure 3.3: Somalia economy remains consumption driven



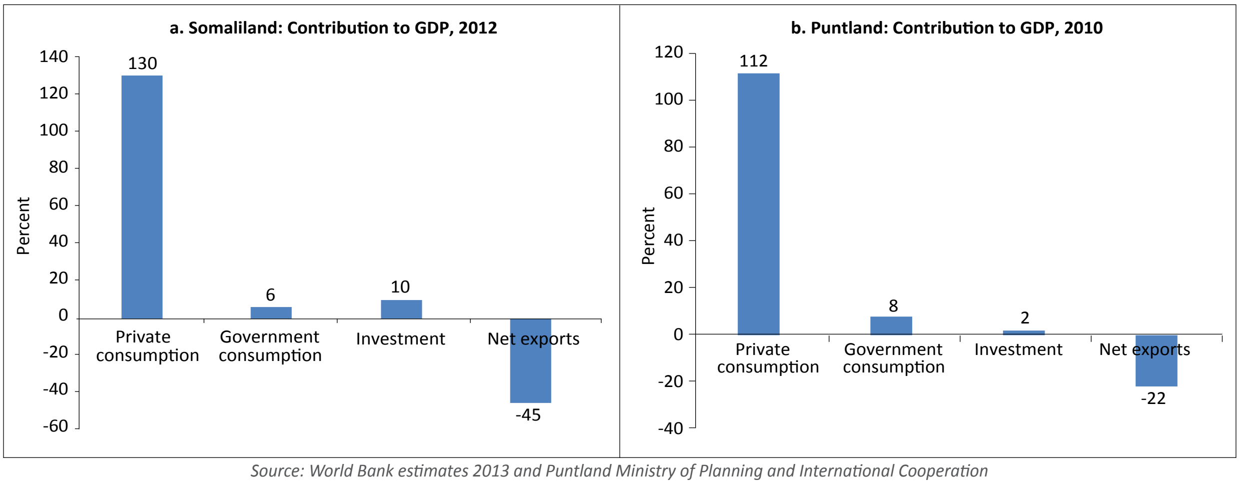
Source: World Development Indicators 2015 and World Bank staff estimates 2014.

expenditure accounts for 6 percent of consumption in Somaliland and 8 percent in Puntland. Net exports (exports minus imports) reduce GDP by 45 percent in Somaliland and 22 percent in Puntland (Figure 3.4). Investment was higher in Somaliland (10 percent of GDP) than in Puntland (2 percent of GDP).

The private sector proved resilient during the conflict. Through droughts and the civil war, Somali entrepreneurs adapted and some even flourished in a regulation-free environment. In the 1970s and 1980s, the public sector provided most of the output of the small industrial sector and many services; during the conflict, private sector economic activity, particularly in financial, transport, and telecommunication services, grew. However, the incumbent private sector that emerged during the conflict has sometimes and in some sectors tended toward anticompetitive behavior, blocking competition in key markets, including the supply of electricity and water, and opposing the need for sector regulation. These actions can discourage the establishment of new businesses and hinder small and medium-size ones from growing.

With political stability, government expenditure has started to expand as a share of GDP. The FGS accounted for only about 1 percent of total GDP in 2012. However, this share is rising: Federal expenditure increased from \$35.1 million in 2012 to \$117.4 million in 2013 (a 234 percent increase) and stood at \$151.1 million in 2014. This increase

Figure 3.4: Consumption is the main contributor to GDP in Somaliland and Puntland

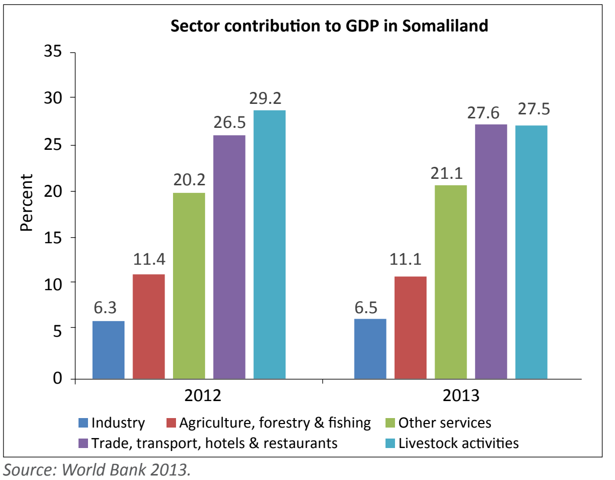


Source: World Bank estimates 2013 and Puntland Ministry of Planning and International Cooperation was driven mainly by compensation of employees and use of goods and services. The same scenario is observed in Somaliland, where government revenue increased from $84 million in 2011 to $114 million in 2014 and is projected to reach $152 million in 2015. Puntland expenditures increased from $52.7 million in 2012 to $62.0 million in 2013. Continued improvement in the security situation in Somalia is attracting business activities, as more areas come under government control.

Diaspora remittances are central to Somalia's economy, providing a lifeline to large segments of the population. Remittances are estimated at $1.2—$2.0 billion, equivalent to 23–38 percent of GDP. Remittances have been important in cushioning household economies, creating a buffer against shocks (drought, trade bans, interclan warfare). They fund direct consumption, including education and health, and some investment, mostly in residential construction, allowing Somalia to sustain its high consumption rates and to finance a large trade deficit. As in many other developing countries, remittance flows in Somalia outweigh both international aid flows and foreign direct investment (FAO2013. Although some remittances are invested, most are spent on consumption, with significant subsequent effects on poverty and inequality. Evidence from the 2013 Somaliland Household Survey, shows that 31 percent of urban households and 16 percent of rural households received remittances (World Bank 2015a). Households that received remittances tended to work fewer hours and to consume more than households that did not, particularly in urban Somaliland. Laborforce participation rates among remittance receivers were half those of people who did not receive remittances. In urban Somaliland, average household consumption was 21 percent higher among remittance-receiving households. In the absence of robust domestic regulation in the sector, this critical resource for Somali households is under threat, as Part II of this report shows.

Livestock is the largest sector in Somalia, the largest employer in rural areas with nomadic cultures, and the largest export. While engaging much of the population nationally, livestock is concentrated in the arid and semi-arid north (Somaliland and Puntland). It is the major export commodity, accounting for more than 80 percent of total exports. According to FAO (2015), Somalia exported a record 5 million heads of livestock to markets in the Gulf of Arabia in 2014 (4.6 million goats and sheep, 340,000 cattle, and 77,000 camels), with an estimated total value of $360 million. The livestock industry has been recovering following the lifting of a nine-year ban on the import of livestock from Somalia (aimed at preventing the spread of Rift Valley fever),with exports of live animals on the increase at both the Berbera and the Bosaso ports. The resurgence of the livestock sector reflects the large investments being made to help make the sector more competitive in international markets. With donor support, investments in livestock infrastructure, fodder production, and livestock vaccination and treatment services are paying off. (Vaccination aims at limiting transboundary animal diseases, which can kill large numbers of animals, resulting in food shortages, market disruptions and trade and export barriers.)

Figure 3.5: Livestock and services are the key drivers of Somaliland's GDP



Source: World Bank 2013.
Note: Figures are in constant 2012 prices.

Crop-based agriculture and fishing could play a significant role in driving economic growth. In southern Somalia, the Juba and Shebelle rivers provide constant supply of water for crop farming. But lack of extension services and modern farming techniques, dilapidated irrigation infrastructure, in addition to the general insecurity and disputed property rights in the region, have led to low productivity and low yields. Somalia's long coastline is home to some of the richest fishing grounds in the world, with large tuna shoals migrating from north to south and back. Deep-sea fishing in the Indian Ocean has been limited, however, with local communities fishing the shallow water close to the shore in small boats, partly because of the collapse of government, the failure to adequately police coastal areas, and the lack of regulation in a sector that has consequently been dominated by illegal fishing. Despite substantial potential, the contribution of fishing to GDP remains minimal.

3.2 The Monetary and Financial Sector

The financial system in Somalia that emerged from the conflict is dynamic but very narrow. In January 1991 all state institutions that provided and regulated financial services, including the Central Bank of Somalia (CBS) and the entire banking system, collapsed. The collapse of the commercial banks in the 1990s—and the loss of depositors' money—eroded public confidence in government and banks. During the long conflict, private money transfer businesses (MTBs, or hawalas)—and more recently, mobile money operators—emerged and flourished in an unregulated environment, but they provided neither deposit-taking nor banking services. With no functioning commercial banks in Somalia, the monetary stock consisted exclusively of cash.

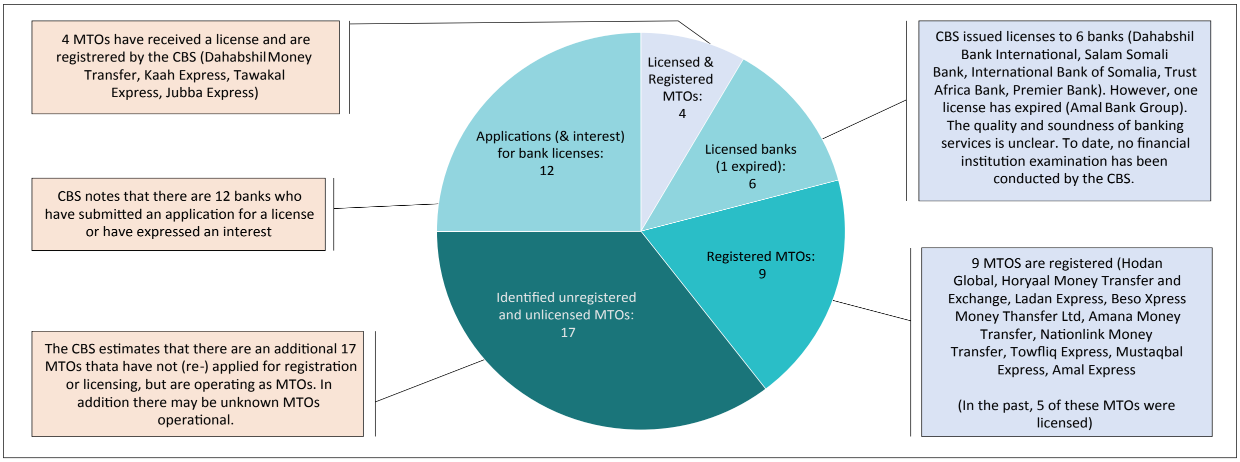
The CBS is gradually starting to reestablish its authority and institutional capacity. After ceasing to exist at the outset of the civil war in January 1991, the Transitional Government of Somalia reopened the CBS in 2009. Despite serious capacity gaps and high turnover of governors (three in 2013 alone), new reform efforts are gaining momentum. The governor and board of directors appointed in 2014 are operating in line with requirements of the Central Bank of Somalia Act, structures and policies are in place to improve core transaction processes, a first set of financial statements were produced in 2013, and the CBS is now starting to act as the fiscal and financial agent for the FGS. With support from the World Bank, the CBS will put in place a core banking software and associated software in 2015 to improve its support to government payments.

Somaliland and Puntland have established their own banks (a central bank in Somaliland and a state bank in Puntland. The banks have several branches and offer very limited commercial banking services in deposit accounts and trade finance. Their primary function is to serve as treasurer of their regional governments.

The private financial sector is modernizing rapidly, putting pressure on CBS regulatory and supervision capacity. In 2012 the government passed a Financial Institutions Act (FIA 2012), which created a national framework for financial institutions to operate in Somalia, supervised by the CBS. Before 2012 and in the absence of a domestic banking system linked to the global financial infrastructure, an extensive network of MTBs developed to facilitate international remittance flows and domestic financial transactions. That network of MTBs is in the process of becoming regulated and supervised under the FIA 2012. In 2015 the CBS issued registration regulations and licensing regulations for MTBs. Figure 3.6 shows the financial institutions operating in Somalia that the CBS recognizes.[8]

[8] The CBS is focusing on registration. Under the regulations, licensing demands a higher standard to be met by the applicant and more information disclosures to test the fitness and propriety of owners, partners, directors, and officers. Others measures include mandatory requirements to have an in-house Anti–Money Laundering (AML) program with training and an AML officer. AML also requires validation and verification of the information and statements made by applicants. Under these regulations, the CBS is also required to review risk and risk-management elements and to modulate the level of sophistication needed on an institution-by-institution basis commensurate with the level of risk. The review process under the registration regulation is limited to CBS officials checking the content of information in order to confirm the completeness of applications.

Figure 3.6: The Central Bank recognizes 48 financial institutions in Somalia



Note: Data are as of March 2015.

The CBS does not have the capacity to perform due diligence or supervise banks to give security to Somalis about the financial health of licensed banks. No financial institutions in Somalia can issue letters of credit (the standard trade financing instrument) to banking institutions abroad. Exporters and importers must work through banks in third countries to process letters of credit, which adds costs and takes time. The situation is expected to improve as the CBS continues to implement much-needed reforms in the financial sector by modernizing the licensing, regulation, and supervision of banks.

Somalia's economy remains highly dollarized, leaving the CBS with no capacity to manage the national currency. All major transactions in Somalia are undertaken in US dollars. The monetary authorities cannot directly affect the volume of foreign currency in circulation. As long as there is little or no bank credit outstanding, they cannot influence interest rates or affect the money supply by changing bank reserve requirements. The last official Somali shilling note was printed during the Siad Barre regime. The stock of Somali shillings consists of a mix of official and counterfeit bank notes accumulated over the years; 95 percent of the local currency in circulation maybe counterfeit. Local currency is used only for transactions under the value of $1. The largest Somali shilling note (1,000) is worth just $0.05. To introduce a new currency to replace the counterfeit or old currency, the CBS would need to substantially enhance its capacity to manage the financial sector and monetary policy. In the region, Somaliland has adopted the Somaliland shilling (SlSh), which is used only in Somaliland.

The lack of banks is a binding constraint to businesses. Lack of financial intermediation in Somalia has constrained business growth, as businesses are forced to use their own funds or borrow from friends or family members to expand. The lack of credit facilities perpetuates elite capture, as people with resources or access to resources remain in a better position to invest. Most business owners use their own funds, borrow from friends and family, or rely on remittances for investment funds (World Bank 2013). Access to finance is a major binding constraint to growth for small and medium-size enterprises in Somalia, with less connected businesses and businesses owned by women at a particular disadvantage (USAID 2014).

The number of MTBs has increased, easing payments, but they are inefficient and costly, and the sector is under pressure from international "derisking." *Hawalas* process transactions and payments only between people within their networks. Using *Hawalas* to transfer large amounts of funds is expensive, because, unlike banks, which charge a fixed fee, their fees are a percentage of the value transferred.

>> Box 3.1: How is "derisking"affecting Somalia?

The Financial Action Task Force (FATF) defines derisking as "the phenomenon of financial institutions terminating or restricting business relationships with clients or categories of clients to avoid, rather than manage, risk." Banks in Australia,the United Kingdom,and the United States, among others,have closed the accounts of money transfer operators because of perceived legal and regulatory problems, sanctions, and anti–money laundering/combating the financing of terrorism (AML/CFT) risks.

Account closures have caused changes in how the market works in the United Kingdom and the United States, but anecdotal evidence collected by the World Bank and data from Remittance Prices Worldwide indicate that costs to consumers have not changed significantly. Costs could rise if competition in the remittance market in Somalia falls substantially.

The British government, in conjunction with the World Bank, is developing the Safer Corridor Initiative. This effort aims to tackle key deficiencies in the UK-Somalia remittance corridor until a sounder financial system is in place in Somalia and to accelerate and support the development of that financial system. Any measures to improve transparency and compliance will involve taking actions at the first mile (the United Kingdom), second mile (the United Arab Emirates), and third mile (Somalia). Third-mile measures will be the most difficult to implement, because Somalia's financial sector has not developed in a formal way and the country remains extremely isolated from the global financial infrastructure.

In 2014 the FGS took measures to formalize Somalia's financial sector. The CBS licensed and registered six banks and nine MTBs and registered nine MTBs under the registration and licensing regulations passed by the CBSin 2014, developed with the support of the World Bank. Somalia does not yet have a system in place for knowing your client (KYC) or customer due diligence (CDD) requirements. Some money transmitters are considering using biometric identification to meet KYC requirements.

The FATF recommends the application of a risk-based approach to address AML/CFT risks. This approach allows countries and financial institutions to apply simplified AML/CFT measures when risks are assessed to be low. However, major financial institutions are currently operating in a risk-averse environment. Given the complexities of this corridor, they seem unwilling to try to mitigate the risks associated with servicing these money transfer operators.

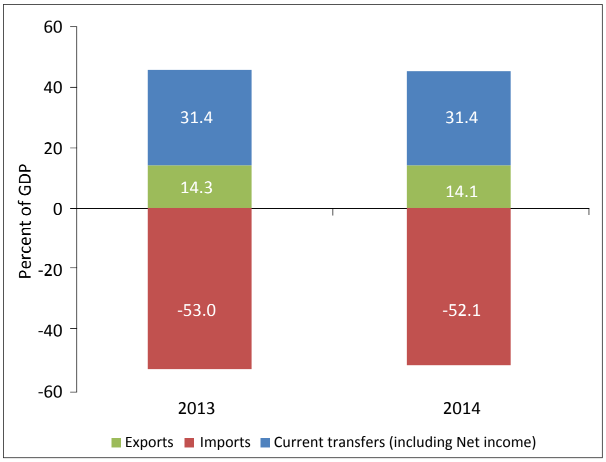
Source: Cirasino and Pesme, 2015.

3.3 International trade a key feature of the Somali economy

International trade appears to have grown steadily over the past six years, although the absence of reliable data makes trade difficult to assess. Data on exports and imports through major ports are collected in physical quantities but are not reliable. More reliable aggregate trade data reported by trading partner countries show that imports reached $3.3 billion in 2013 and are projected to reach $3.7 billion in 2015. The largest recorded imports through the Berbera and Bosaso ports are food (sugar, khat, wheat and wheat flour, rice, and cooking oil); building materials; and fuel. Khat, a mild narcotic, is the second top import product after sugar. Exports almost tripled during the past six years, reaching $779 million in 2013. Livestock continues to dominate exports (and did so even during the years when Somali livestock to Saudi Arabia was banned), followed by charcoal, fish, and hides and skins.

The economy is highly dependent on imports. In 2013 Somalia ran a trade deficit of 39 percent of GDP, after importing goods and services worth 62 percent of GDP and exporting goods worth just 14 percent. The deficit was financed through remittances (equivalent to 41 percent of GDP) and direct donor support(equivalent to 9 percent of GDP) (Figure 3.7). The large trade deficit signals opportunities for Somalis to produce for the domestic economy, boost exports, and reduce reliance on imports. Somalia's imports of $705 million in 2010 comprised basic consumer goods, such as vegetables (28 percent), raw sugar cane (10 percent), and rice (7 percent). These imports came from Ethiopia (32 percent), Kenya (23 percent), China (10 percent), Oman (9 percent), and Brazil (9 percent). Given Somali's climate and floods in river areas, heavy reliance on domestic production would expose Somali households to much greater volatility and price shocks. At the same time, heavy reliance on imports leaves the economy vulnerable to external price shocks.

Figure 3.7: Imports dominate Somalia's economy



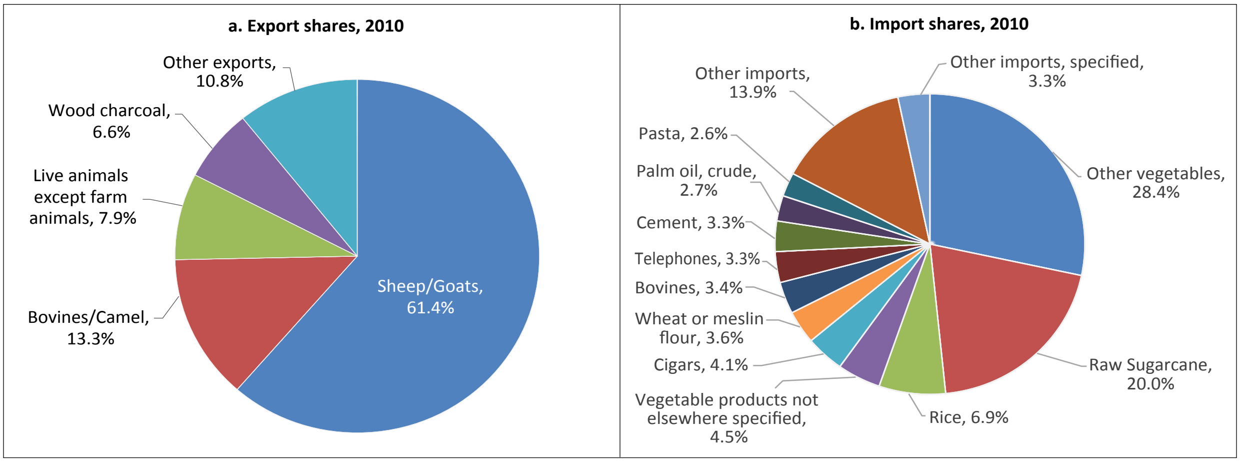
Source: Somalia authorities and estimates by the International Monetary Fund and World Bank 2015.

Somalia is highly dependent on a small number of export products and overseas markets. Livestock accounted for more than 80 percent of total export earnings in 2012. About 80 percent of total exports go to the United Arab Emirates, Yemen, Saudi Arabia, and Oman. With such dependence on a narrow export market, a single disruption can create havoc, as it did when Saudi Arabia banned animal imports from Somalia in late 1990s. In 2010 the total value of exports was $232 million, made up of goats and sheep (61 percent), bovines (13 percent), live animals except farm animals (8 percent), wood charcoal (7 percent), and oil seeds (4 percent) (Figure 3.8). In Somaliland these sectors provide half of economic value added and create 80 percent of job opportunities. In Puntland livestock accounts for an estimated 40 percent of GDP, 60 percent of employment opportunities, and 80 percent of foreign exchange earnings (MoPIC 2013b).

The potential to increase exports is substantial, as fisheries and horticulture remain under exploited. Success will depend on the ability of producers to meet international standards for food safety and develop a quality control and sanitary and phytosanitary (SPS) certification system (USAID 2014).

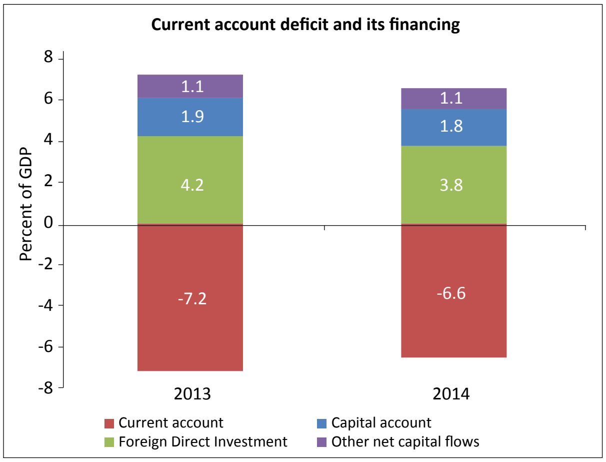
Lack of access to foreign capital limits Somalia's current account financing options mostly to foreign direct investment (FDI), heightening exposure to unpredictable project finance. The current account deficit was 7.2 percent of GDP in 2013 and 6.6 percent in 2014. It comprised a trade deficit of 38.7 percent of GDP, net income of –8.9 percent of GDP, and net current transfers (including remittances, off-budget grants, and direct donor support) of 40 percent of GDP. The size of the current account deficit is associated with external vulnerability Somalia faces in the very

Figure 3.8: Somalia exports far fewer goods than it imports



Source: MIT Economic Complexity Observatory short to medium term. Long-term flows, including FDI of 4.2 percent of GDP and capital flows of 3.0 percent, financed the current account deficit in 2013 (Figure 3.9). If FDI were to slow, the economy would have no mechanism for mobilizing foreign capital inflows.

Figure 3.9: Long-term flows finance Somalia's current account deficit



Source: Estimates by the International Monetary Fund and World Bank (2015).

Local conflicts and political competition have weakened formal trade integration between Somalia and the wider Horn of Africa. The Horn of Africa is home to 140 million people, many of whom depend on pastoralism and earnings from livestock. The region has weak formal trade integration but intensive informal trade, facilitated by interlinked communities. Fluid social and economic patterns amid scarce resources lead to frequent local conflicts over rangeland, water points, and trade routes, which create instability and political tension. Despite the considerable economic benefits that would result, these factors, combined with broader interstate competition over access to markets and resources, have stalled formal economic integration. Sustained peace in Somalia, which is strategically located as a trade gateway, could help reshape wider relations within the Horn of Africa, unlocking the region's trade potential.[9]

Potential reserves of oil and gas provide Somalia with opportunities to boost economic growth, but in the absence of an agreed regulatory framework, they could rekindle internal conflict. Seismic studies suggest that the Somali basin may contain hydrocarbon reserves. Although commercial exploitation would be decades away, if well managed these resources could fund economic development. During the Siad Barre regime, foreign companies acquired exploration licenses. Subsequently, regions and states entered into their own contracts with oil companies, sometimes overriding licenses issued by the former regime. This practice continues today and poses real risks to the successful outcome of the state formation and constitutional negotiations. Somali stakeholders need to agree on a shared vision for the sector's development, based on technically dialogue and best practices.

3.4 Fiscal Policy

Public budgets have expanded significantly in the Federal Government of Somalia (FGS), Puntland, and Somaliland, driven by some year-on-year increases in revenue. FGS total revenue (including grants) grew by more than 300 percent, from $35.1 million in 2012 to $145.3 million in 2014 (these revenue outturns still reflect very low shares of GDP: 1.0 percent and 3.7 percent of GDP, respectively). FGS expenditure also expanded by the same margin during this period, from $35.1 million to $151.1 million. The same trend is observed at the regional level: Puntland's revenue and expenditure have grown significantly with revenue growth averaging 13 percent in 2007 to 2013 and expenditure growth averaged 19 percent in this period. Somaliland's revenue has grown considerably, from $19.4 million in 2002 to $123.3 million in 2013, while total expenditure followed a similar trend, recording a 22 percent average growth during this period. Overall, the budgets are expected to expand significantly as service delivery is extended across the country. The basic norms of fiscal management are weak with

9 Ethiopia is still quite restrictive regarding trade policy, but more formal trading arrangements with neighbouring countries may cut down on the thriving re-export business through Somalia ports.

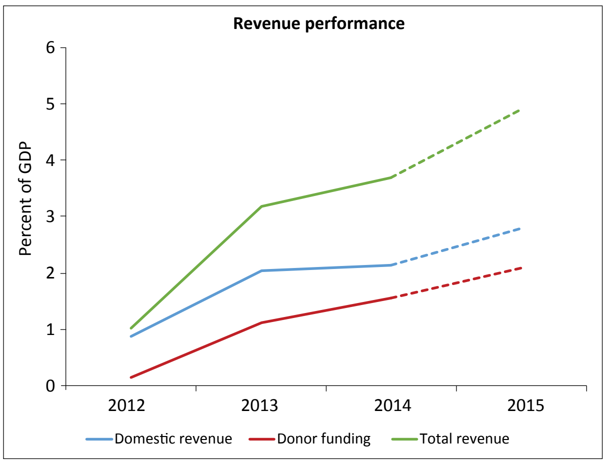
unrealistic revenue forecasts compounded by weak expenditure, lack of staffing controls and ad hoc cash rationing. This has led to a structural budget deficit at the federal level and arrears accumulation undermining budget credibility: the FGS's stock of arrears reached $30.4 million in 2013.

3.4.1 Improved revenue mobilization efforts are paying off

FGS revenue and grants outturns rose 24 percent in 2014 in nominal terms. In 2012, the FGS mobilized only $30 million in domestic revenue, equivalent to 0.9 percent of GDP, and $5 million in external assistance to the budget (Table 3.1). Revenues and grants rose from 1 percent of GDP in 2012 to 3.7 percent in 2014 and are projected to reach $199 million in 2015, up from $145.3 million in 2014. However, domestic revenue collection and grants underperformed in 2014, particularly indirect and other taxes.

Domestic revenue (excluding grants) increased by 11 percent in 2014 to $84.3 million (2.1 percent of GDP), financing 56 percent of recurrent expenditure. Domestic revenue contributed 70 percent of total revenue on average in 2012–14, driven mainly by tax revenue. This trend is expected to continue, with domestic revenue projected to reach 2.8 percent of GDP in 2015 (Figure 3.10).

Figure 3.10: The Federal Government of Somalia's efforts to mobilize revenue are paying off



Source: FGS Ministry of Finance (2015).

FGS revenue forecasts in the 2015 budget though revised downwards remains high compared to outturns in both 2013 and 2014. The 2014 revenue projection was $188 million, a 60 percent increase from the 2013 outturn of $117 million. The revenue outturn for 2014 was $145.3 million, a shortfall of $43 million, or 23 percent, of budgeted levels. The 2014 budget was predicated on significant increases in revenue from income and corporate taxes and taxes on goods and services, which did not fully materialize. Consequently, the FGS has now passed a revised budget with revised total revenue in 2015 amounting to $199 million down from the original budget of $240 million. Total revenue in 2015 is mainly driven by domestic revenue at 57 percent while donor grants account for 43 percent. Producing the 2015 revised budget by the FGS signals the government's commitment to responsible macro-fiscal management.

Taxes on international trade drive total tax revenue, accounting for 91 percent of total taxes on average between 2012 and 2014. International trade tax revenue rose from $24 million in 2012 to $64 million in 2014, an increase of more than 160 percent (see Table 3.1). It is expected that as governments exert increased effective territorial authority, they will be able to collect more taxes. Since April 2013, the FGS has been collecting tariffs at the Mogadishu port and airport, which raised total domestic revenue to $84 million in 2014. In 2013, 90 percent of all tax revenue was derived from taxes on international trade but this fell to 87 percent of total tax revenue in 2014.

Personal and business income taxes as well as indirect taxes bring in limited revenue. Although income tax revenues rose by 57 percent and taxes on goods and services by 50 percent in 2014, the two sources brought in less than $10 million, against a target of $39 million. Income taxes were 78 percent below target and taxes on goods and services 75 percent lower. Income tax receipts contributed only 1.5 percent and other taxes (except taxes on international trade) contributed 11.4 percent (Table 3.1).

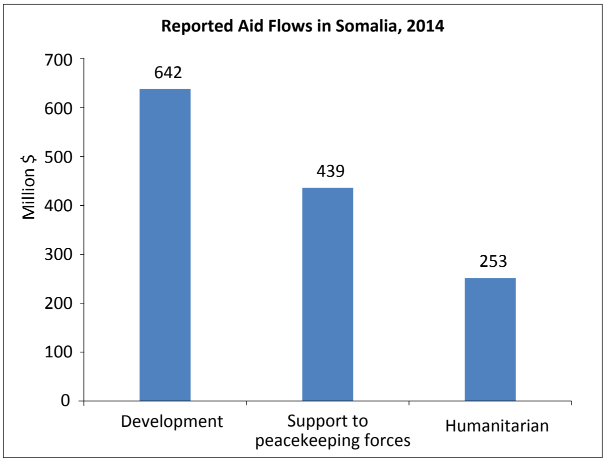
[5] While Ethiopia is still quite restrictive regarding trade policy, more formal trading arrangements with neighbouring countries may cut down on the thriving re-export business through Somali ports.

Table 3.1: FGS Actual and budgeted revenue and grants, 2012–14, (Millions of US dollars)

Item	2012	2013		2014		2015		Growth in Revenue	
	Million US$								
	Actual	Budget	Actual	Budget	Actual	Budget	Revised	2012-2013	2013-2014
Revenue and Grants	**35.1**	**114.3**	**117.4**	**188.5**	**145.3**	**239.9**	**199.0**	**234%**	**24%**
Domestic Revenue	**30.2**	**53.9**	**75.8**	**115.3**	**84.3**	**123.4**	**113.9**	**151%**	**11%**
Tax Revenue	**25.3**	**51.4**	**65.1**	**108.0**	**73.8**	**103.1**	**85.7**	**157%**	**13%**
Tax on Income, Profit and Capital Gains		3.5	65.1	5.1	1.1	4.6	4.7		57%
Taxes on goods and services	1.3	14.4	0.7	33.9	8.4	25.8	10.7	331%	50%
Trade taxes	24.0	33.4	5.6	69.0	64.3	72.7	70.3	145%	10%
Non-Tax Revenue		2.5	58.7	7.3	10.5	20.3	28.1		156%
Domestic loan and grants	0.0	0.0	4.1	0.0	0.0	0.0	0.0		-100%
Grants	**4.9**		**41.7**	**73.2**	**61.0**	**116.5**	**85.2**	**751%**	**46%**
Bilateral	4.9		41.7	64.0	59.0	39.9	35.4	751%	42%
Multilateral			0.0	9.2	1.9	76.7	49.8		
% of GDP									
Revenue and Grants	**1.0**	**3.1**	**3.2**	**4.8**	**3.7**	**5.9**	**4.9**		
Domestic Revenue	**0.9**	**1.5**	**2.1**	**2.9**	**2.1**	**3.0**	**2.8**		
Tax Revenue	**0.7**	**1.4**	**1.8**	**2.7**	**1.9**	**2.5**	**2.1**		
Tax on Income, Profit and Capital Gains	-	0.1	0.0	0.1	0.0	0.1	0.1		
Taxes on goods and services	0.0	0.4	0.2	0.9	0.2	0.6	0.3		
Trade taxes	0.7	0.9	1.6	1.8	1.6	1.8	1.7		
Non-Tax Revenue	-	0.1	0.1	0.2	0.3	0.5	0.7		
Domestic loan and grants	-	-	0.2	-	-	-	-		
Grants	**0.1**	**-**	**1.1**	**1.9**	**1.6**	**2.9**	**2.1**		
Bilateral	0.1	-	1.1	1.6	1.5	1.0	0.9		
Multilateral	-	-	-	0.2	0.0	1.9	1.2		
Memorandum									
Total GDP (Current US$Millions)	**5,008**	**5,352**	**5,352**	**5,706**	**5,706**	**5,953**	**5,953**		
Somaliland	1,550	1,657	1,657	1,771	1,771	1,894	1,894		
The Rest	3,458	3,695	3,695	3,935	3,935	4,059	4,059		

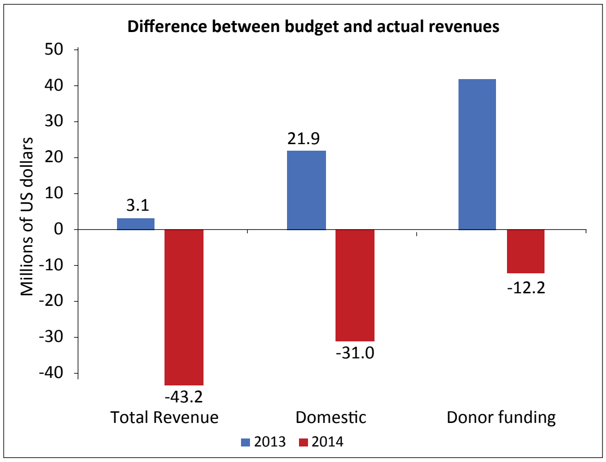
Source: Appropriation Act for 2015 .Budget and various budget documents from the FGS Ministry of Finance

Figure 3.11: Development partners continue to support Somalia's reconstruction and development



Source: 2015 Aid Flows Draft Report by the Somalia Aid Coordination Unit (Office of the Prime Minister).

Figure 3.12: Actual revenue collection by the FGSexceeded budgeted amounts in 2013 but fell well short in 2014



Source: FGS Ministry of Finance (2015).

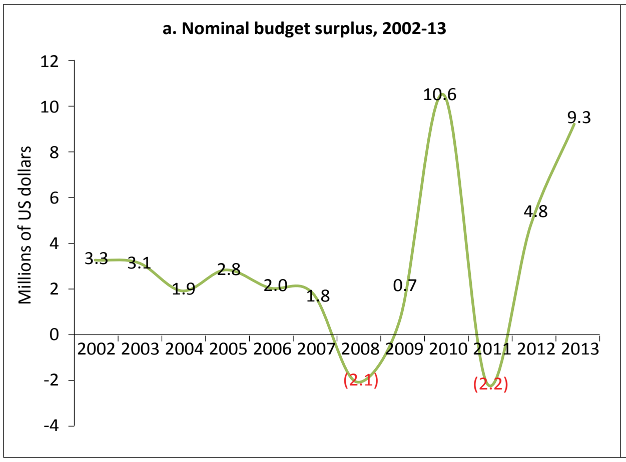
Development partners have continued to support Somalia's reconstruction and humanitarian activities with reported total aid amounting to about $1.3 billion in 2014. This comprised of nearly $700 million in aid for development, about $253 humanitarian, and about $439 support to peacekeeping forces (Figure 3.11). It is important to note that not all of the development aid are channeled through treasury thus these funds remain off-budget. Although domestic revenues remain the dominant source of revenue for the government, the FGS still relies heavily on external assistance, which rose by 46 percent of total revenue ($42 million) in 2013 to $61 million in 2014 and its estimated at 43 percent of total revenue ($85 million) in 2015 (Table 3.1).

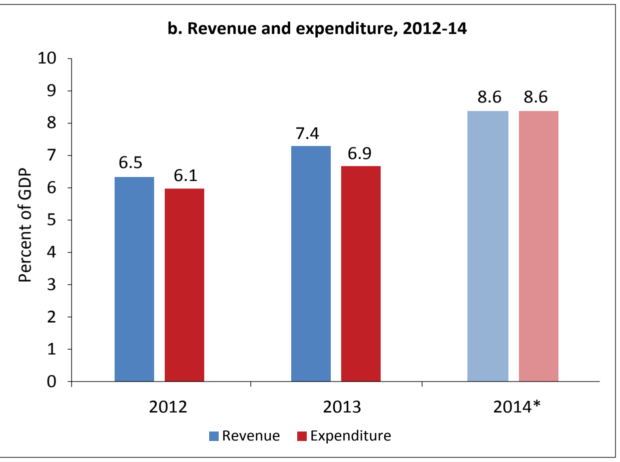
Although revenue collection has improved significantly, Somalia still faces serious revenue mobilization challenges. At the federal level, revenue collection capacity is weak, and the absence of a legal and regulatory framework constrains revenue mobilization from the dynamic telecommunication and financial sectors. In 2012 the FGS received only $1 million in direct tax from businesses. Donor on-budget grant whilst providing about half the revenue, is increasingly unreliable, as pledges for assistance fail to materialize in time or at the levels pledged. The 2014 and 2015 budgets have been characterized by overly optimistic revenue forecasts often resulting from political pressures, leading to severe cash rationing and generation of expenditure arrears and domestic borrowings.

Revenues in Somaliland and Puntland have increased significantly in line with the high expenditure needs. Since 2002, the Somaliland government only incurred a deficit twice—in 2008 and 2011 (Figure 3.13, panel a.) and has financed them through domestic borrowing from businesses and money transfer companies.

Somaliland's domestic revenue is driven by tax revenue, mainly import duty. Sales tax, harbor tax, export levy (livestock), and administration tax are the other key drivers of revenue. These five tax sources contribute about 80 percent of the total revenue on average between 2002 and 2013. Though declining in share, import duty contribution to total revenue averaged 48 percent in 2002 to 2013. Sales tax contribution has remained steady during this period averaging 10 percent, except in 2010 when its share declined to 7.9 percent. Port and administration taxes are declining as a share of the total as other revenue sources increase.

Figure 3.13: Despite high expenditure needs, Somaliland has been able to spend within its means

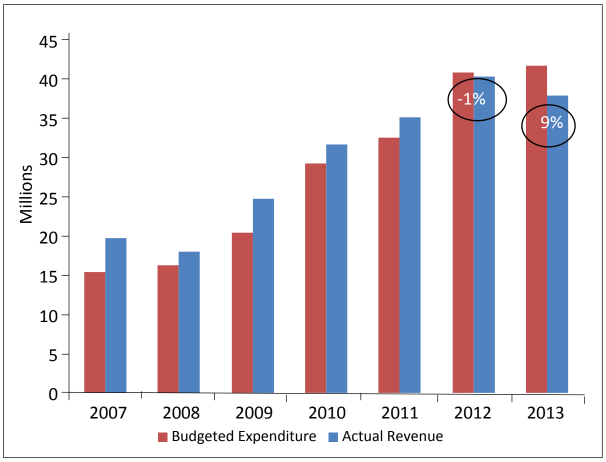




Source: World Bank calculations based on Somaliland Ministry of Finance data (2014)

Puntland's budget continues to grow though it faced deficits in 2012 and 2013 (Figure 3.14). As a result, arrears (both payroll and running costs) have now reached significant levels. Although accurate accounting is not available, the arrears as of December 2014 were estimated at $24.9 million (63 percent of the average total revenue for 2012 and 2013). There are many contributing factors to Puntland's current fiscal situation, including: declining revenues, exchange rate fluctuations, reallocation of budgetary funds leading to overspending on discretionary expenditures, growth of the public payroll, and poor public finance management.

Figure 3.14: Puntland budget on upward trend



Source: World Bank calculations based on 2014 Ministry of Finance data.

Puntland revenue collection increased, but the base remains narrow. Revenues increased from $20 million in 2007 to $40.9 million in 2012 (an increase of 104 percent) before declining 6 percent in 2013. Most of Puntland's revenues come from customs and related taxes on international trade, which together accounted for 63 percent of total revenues in 2012 and 67 percent in 2013. A narrow base renders Puntland's revenues vulnerable to external shocks. In 2014 the government initiated a revenue mobilization campaign to increase tax revenue. Results are yet to be seen.

In the FGS major issues with domestic revenues include overreliance on taxes on trade and critical mobilization issues concerning income and corporate taxes and domestic indirect taxes. The effective income tax rate on government employees is about 5 percent. In the private sector, almost no income tax is collected, and no taxpayer registration system is in place. Zero corporate tax was reported in 2014, against a budget projection of $2 million. As with income tax, no taxpayer registration system appears to be in place.

Turnover taxes on businesses are another potential source of domestic revenue, but a legal framework and buy-in from the private sector are missing. Under the current arrangement, introduced in 2014, one of the five telecoms operators (Hormuud) pays $400,000 a month in turnover taxes. This arrangement is an interim measure until the new communications law is passed (a step envisaged for 2015) and the ministry can begin collecting license fees, taxes, and spectrum fees. Once the law is passed, telecommunications revenues are expected to reach $1 million a month, with annual telecommunications revenue projected at $10 million for 2015. Only $4.8 million was collected from telecommunications in 2014, against a target of $12 million. Projected revenue collection from money transfer companies in 2014 was estimated at $12 million, but no money had been collected from this sector by December. The 2015 draft budget envisages $3.6 million in revenue collection from this source, but there does not appear to be a clear plan for realizing this target. Turnover taxes on electricity companies were projected at $500,000 in the 2014 budget, but no revenue was collected. The projection for 2015 is $2.5 million, but no plan appears to be in place for collection.

The challenge of low revenues and pressing needs to deliver public services has made budgeting difficult. With territorial gains, the FGS is facing pressure to deliver services, as evident from its budget proposals, which show rising budgeted expenditures and optimistic revenue expectations. The result is that spending is trimmed based on realized revenue in a cash budget situation in which borrowing is not possible.

Revenue collection is a sensitive area and will require substantial public-private dialogue. It is a priority for sustainable state-building in Somalia. The development of a realistic revenue mobilization plan could include a focus on simple-to-administer taxes of selected types of businesses, including hotels and telecom, electricity, money remittance, and water companies. Key priorities will be the passage of a telecommunications act and the alignment of a tax-to-GDP policy objective that is in line with regional benchmarks. Clarification of revenue assignments across levels of government (see Part II) will also be essential. Increased revenue mobilization in Somalia will require building stakeholder support through dialogue; adopting transparent public finance management; and visibly delivering public goods, including security, physical infrastructure, and basic services, especially in the education and health sectors.

3.4.2 Expenditure is concentrated on salary and security and weak budgetary controls and execution have led to buildup of arrears

FGS total expenditure grew from 1 percent of GDP in 2012 to 3.8 percent in 2014, with almost 100 percent of the budget going to recurrent costs (Table 3.2). Expenditures more than quadrupled, rising from $35.1 million in 2012 to $151.1 million in 2014. According to the 2015 revision, the FGS budget is expected to reach $199 million (4.9 percent of GDP). The budget is subject to sharp volatility, however, depending on the security situation and the availability of funds from development partners. Only 56 percent of the total recurrent expenditure was financed by domestic revenue in 2014. Based on the 2015 revised budget, domestic revenue could finance all compensation of employees and about 46 percent of goods and services, leaving donor funds to finance the rest of the budget.

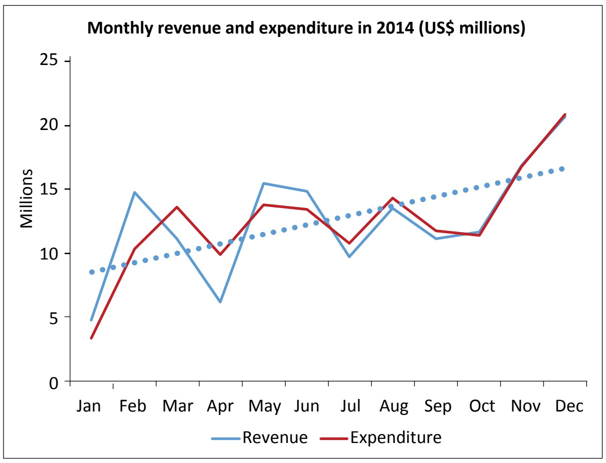
Monthly expenditures closely matched monthly revenues during 2014, reflecting the cash-based nature of budget management, but arrears continued to accumulate. Expenditures averaged $12.5 million a month, while revenues averaged $12.6 million. Budget figures in 2014 suggest that total monthly expenditures on compensation of employees (including security sector allowances) averaged $6.4 million, including $2.0 million in wages and salaries and $4.3 million in allowances. Revenues and expenditure outturns tend to be slow at the beginning of the year, picking up toward the end of the year (Figure 3.15).

Table 3.2: Composition of expenditure by the Federal Government of Somalia, 2012–15

Item	2012 Actual	2013 Budget	2013 Actual	2014 Budget	2014 Actual	2015 Budget	2015 Revised
Million US$							
EXPENDITURE	**35.1**	**144.3**	**117.4**	**216.2**	**151.1**	**239.9**	**199.0**
RECURRENT EXPENDITURE	**35.1**	**137.1**	**117.4**	**203.9**	**150.9**	**226.0**	**184.5**
Compensation of employees	13.5	70.4	51.9	91.0	77.2	108.3	79.1
Use of goods and services	18.9	62.7	54.5	67.4	57.6	82.7	75.8
Grants	2.7	0.0	7.5	11.5	10.1	14.8	15.2
Contingency	0.0	3.6	3.5	3.6	3.8	3.2	2.7
Repayment of arrears and advances	0.0	0.0	0.0	30.4	2.2	17.0	11.7
CAPITAL EXPENDITURE	**0.0**	**7.2**	**0.0**	**12.4**	**0.2**	**13.9**	**14.5**
Capital	0.0	7.2	0.0	12.4	0.2	13.9	14.5
% of GDP							
RECURRENT EXPENDITURE	**1.0**	**3.7**	**3.2**	**5.2**	**3.8**	**5.6**	**4.5**
Compensation of employees	0.4	1.9	1.4	2.3	2.0	2.7	1.9
Use of goods and services	0.5	1.7	1.5	1.7	1.5	2.0	1.9
Grants	0.1	-	0.2	0.3	0.3	0.4	0.4
Contingency	-	0.1	0.1	0.1	0.1	0.1	0.1
Repayment of arrears and advances	-	-	-	0.8	0.0	0.4	0.3
CAPITAL EXPENDITURE	**-**	**0.2**	**-**	**0.3**	**0.0**	**0.3**	**0.4**
Capital	-	0.2	-	0.3	0.0	0.3	0.4
Memorandum							
GDP (excl. Somaliland)	**3,458**	**3,695**	**3,695**	**3,935**	**3,935**	**4,059**	**4,059**

Source: FGS Ministry of Finance (2015).

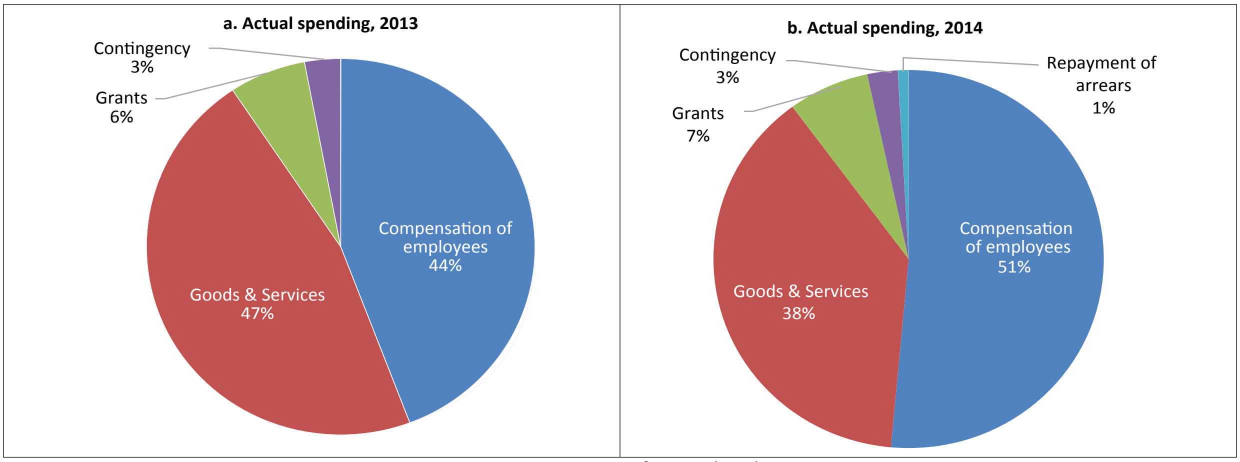
Figure 3.15: Monthly expenditures by the Federal Government of Somalia closely matched monthly revenues in 2014



Source: FGS Ministry of Finance (2015).

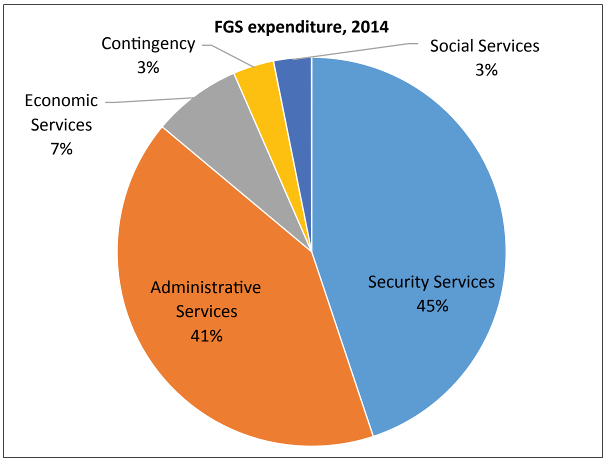
Compensation of employees and purchases of goods and services consume a significant portion of FGS expenditures. Wages and salaries accounted for 44 percent of expenditures in 2013 and 51 percent in 2014 (Figure 3.16). The next largest category of expenditure is goods and services, accounting for 47 percent of expenditures in 2013 and 38 percent in 2014. Operating expenditures are concentrated primarily in the security sector (Figure 3.17). Most line ministries have very little funding available for operating expenditures (only 5 percent of education and 14 percent of health spending was dedicated to operating costs in 2014, for example).

Figure 3.16: Wages and salaries eat up a significant portion of Federal government's recurrent budget



Source: FGS Ministry of Finance (2015).

Figure 3.17: Security and administrative services accounted for the lion's share of total expenditure in 2014



Source: FGS Ministry of Finance (2015).

Security remains a top priority for the FGS, which allocates a growing share of its budget to the sector. The budget for the sector amount to \$57.2 million in 2015, 29 percent of the total budget. Actual spending on the sector was \$67 million in 2014 (45 percent of total spending of \$151 million).[151] The armed forces account for the largest share, followed by the police force (Table 3.3). Given the high level of insecurity in Somalia, heavy spending on security may appear justified, but it crowds out essential spending on social and economic services that could address underlying causes and help generate stability.

The highest-spending institution in 2014 was the armed forces, which accounted for 29 percent of total spending (\$43 million), more than half of it (\$21 million) allocated to allowances. The progressive build-up of arrears was particularly acute in the armed forces, where arrears at the end of 2013 were \$30.4 million (16 percent of the budget). Only \$2.2 million of this amount was paid in 2014, and an additional \$13.8 million was accrued, mostly for wages and salaries. The build-up of arrears is not a good signal and adversely affects service delivery. As of the end of 2014, the estimated stock of arrears was \$43 million.

As in the FGS and Puntland, the security sector in Somaliland accounts for the largest share of total expenditure, averaging 46 percent in 2011–13. The second-largest spending category, administration and general services sector, accounted for about 29 percent in the same period. The two sectors accounted for more than 70 percent of spending in the Somaliland budget, with the remainder allocated to the economic and social services sectors. Spending on economic services averaged 13 percent in 2011–13. Spending on social services, mainly health and education, accounted for 12 percent of total spending (Figure 3.18).

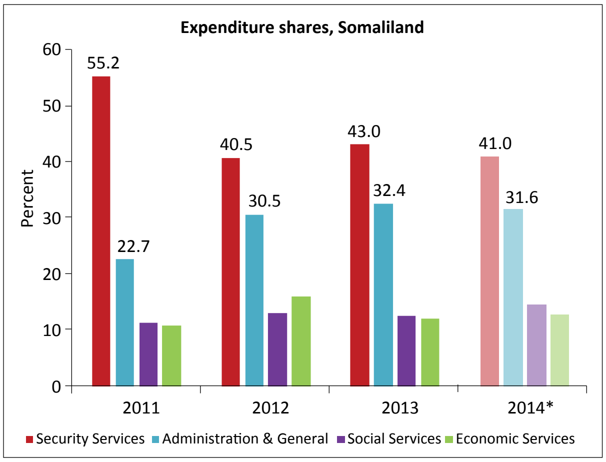
[10] The security sector comprises the Ministry of Defence, the Armed Forces, the Military Court, the Ministry of National Security, the Ministry of National Security, the Police Force, the National Security Force, and the Immigration Department.

Table 3.3: Security sector budget of the FGS, 2014 and 2015 (millions of dollars)

Item	2014		2015	
	Budget	Outturn	Budget	Revised
Armed Forces	49.7	43.3	58.8	34.5
Police Force	13.9	11.1	14.4	6.8
National Security Force	10.4	8.6	8.9	10.1
Immigration Department	1.7	1.7	1.7	1.7
Ministry of National Security	2.3	1.4	2.5	2.1
Ministry of Defense	0.9	0.7	1.0	1.0
Military Court	0.6	0.6	1.0	1.0
Sector total	**79.6**	**67.4**	**88.3**	**57.2**

Source: FGS Ministry of Finance (2015).

Figure 3.18: By far the largest spending category in Somaliland is security



Source: Data from Somaliland Ministry of Finance.

Government expenditures in Puntland are highly concentrated in a few agencies, some of which appear not to be subject to normal budgetary controls. The top 10 expenditure heads received 88 percent of total government expenditures in 2012 and 92 percent in 2013; the top four expenditure heads received 63 percent in 2012 and 69 percent in 2013. General Expenditures (GE) A and B, which are not associated with any specific ministry, department, or agency (MDA), accounted for 53 percent of total spending in 2013.[11] The Puntland president has authority to initiate and approve GE A; the minister of finance has similar powers over GE B. The security sector is the next-largest spending category, receiving 18 percent of the budget (31 percent when security-related expenditures are included).

3.4.3 Arrears in the FGS and Puntland are significant

The building of arrears in the FGS signals lack of expenditure control and undermines cash budgeting. Arrears at the end of 2013 amounted to $30.4 million (16 percent of the budget), which were carried over into the 2014 budget. The full extent of arrears is not known, but it can be roughly estimated by taking the difference between the budgeted figure of $91 million for compensation of employees and the actual figure, as wage estimates are usually closer to what should have been paid. For the stock of outstanding arrears, the estimate as of the end of 2014 is $42 million (the stock of arrears at the end of 2013 minus net repayment of $1.3 million and new accrual of $12.9 million in 2014).

Salary and allowances drive arrears in Puntland. Salary and allowance arrears as of December 2014 are estimated at$19.7 million, out of total arrears of $24.9 million. A key factor driving the arrears in Puntland is off-budget activities: off-budget revenues are associated with corresponding off-budget expenditures. In 2013 off-budget expenditures accounted for 22 percent of official budget expenditures and 18.5 percent of total expenditures. Off-budget expenditures are not subject to normal budgetary controls and are generally under the control of the head of the institution responsible for the spending. Monthly

11 GE A appears to not be bound by budgetary controls. It is a major driver of arrears.

budget execution analysis for May–December 2013 show that all MDAs are not treated equally: Some MDAs accumulated none or very little salary and allowances arrears, while others failed to pay their employees.

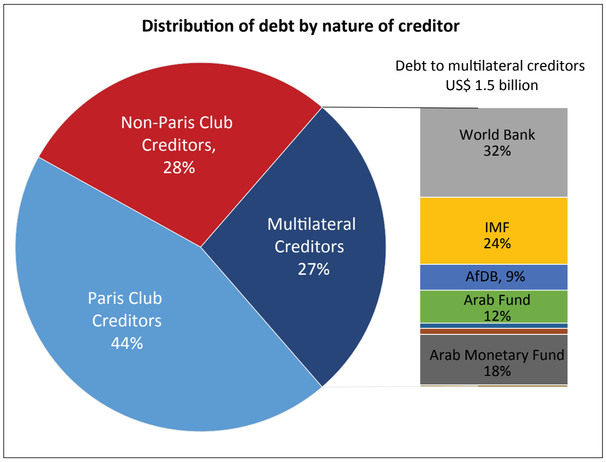
Expenditure management is also weak. Puntland's chart of accounts does not conform to the Government Financial Statistics Manual (GFSM 2001), making it challenging to use as intended. There are also gaps in the payment mechanism. In some cases, authorized officials from some MDAs withdraw cash from the Puntland State Bank to pay salaries and make payments to vendors for goods and services received.

3.5 Debt Arrears and Eligibility for Debt Relief (HIPC)

Somalia accumulated substantial debt in the Cold War era. Relations with international creditors were frozen in the late 1980s, when financial policies slipped out of control. Because of significant arrears on past debt-servicing obligations, the lack of a fully functional national government, and the unstable security situation, Somalia neither borrowed nor serviced its public debt after the 1990s. Decades of conflict significantly reduced Somalia's ability to pay its external debt.

Somalia owes an estimated $5.6 billion to multilateral and bilateral creditors (Figure 3.19). It owes $1.54 billion (27 percent) to international financial institutions, mainly the World Bank, the IMF, and the Arab Monetary Fund. Of this amount,$1.23 billion is accumulated arrears (Figure 3.19). Somalia also owes $4.1 billion to bilateral creditors accrued during the Cold War era, mainly the United States and the Russian Federation; $2.5 billion to Paris Club members (mainly the United States, the United Kingdom, the Russian Federation, France, Italy, and Japan); and $1.6 billion to non–Paris Club countries (including the United Arab Emirates, Saudi Arabia, and China).

Figure 3.19: Somalia owes an estimated $5.6 billion to multilateral and bilateral creditors



Source: World Bank, 2013

As one of the world's poorest countries, Somalia is eligible for the Heavily Indebted Poor Countries (HIPC) Debt Relief Initiative. Arrears to external creditors have blocked access to international financial resources to finance reconstruction. Somalia is working with its development partners to resolve the debt problem and exploring ways to qualify for relief under the HIPC Initiative. After reaching the HIPC Completion Point. It would be eligible for additional debt relief under the Multilateral Debt Relief Initiative (MDRI) from the World Bank and AfDB debt and Beyond-HIPC Relief from the IMF. To reach the Decision Point, Somalia would need to reconcile its external debt data with creditor claims and put a debt management system in place. Somalia and its creditors must therefore reconstruct the debt database that was destroyed during 20-plus years of civil war. It must also rebuild the debt management capacity that was lost during the years when there was no functioning government. In addition, the FGS is expected to develop the poverty reduction strategy through a participatory process, commit to public financial management reform, build a track record of policy performance monitored by the World Bank and IMF, undertake a program of structural and social reforms endorsed by the World Bank and IMF, generate satisfactory economic performance, and be able to make payments to the IMF and World Bank to meet its new obligations.

GOVERNANCE

4. Governance

4.1 The Public Financial Management (PFM) System

Building a public financial management (PFM) system is a fundamental part of the FGS's process of reestablishing itself as a functioning entity after decades of conflict (FGS Ministry of Finance 2015). PFM institutions and systems govern how governments collect, allocate, spend, and account for public money. PFM reform—improving business processes, technology, policy and regulations, organization, and human resources—is critical, because without a well-functioning public financial system, a government cannot collect and account for resources effectively, deliver services, and gain the trust and confidence of the population.

The civil war did not destroy Somalia's federal-level PFM systems. A government-led self-assessment of PFM undertaken in 2013 showed that many basic prewar operating capabilities remain in place, although they are neither effective nor efficient. It found that systems had become highly personalized and informal. The self-assessment provided a basis for the FGS to develop a PFM reform path. These reforms are informed by experience in other fragile and conflict-affected contexts. The reform trajectory is incremental, builds on existing systems, and uses a flexible learning-by-doing approach to allow constant review and adaptation as new information and challenges emerge.

PFM reform takes at least a generation. It took the 20 fastest-moving countries an average of 20 years to achieve functioning bureaucratic quality and 27 years to bring corruption under reasonable control, according to the 2011 World Development Report. It is important not to place too many demands and expectations on PFM institutions in too short a period, because failure to deliver against unrealistic expectations produces a loss of confidence and legitimacy (World Bank 2011).

4.1.1 The legal and regulatory framework for PFM is inadequate and is being revamped

The FGS relies on PFM regulations enacted in 1961, with some amendments made in 1971. These regulations provide guidance for revenue collection, annual budgeting, and the budget formulation process, as well as some provisions on budget execution, procurement, and banking arrangements. However, the regulations are inadequate to address comprehensively the complex environment in which the FGS now operates.

The FGS is committed to improving financial governance and accountability, but it lacks a sound legal framework. The government has made progress in improving the weak PFM legal and regulatory framework. In 2013 it established a Financial Governance Committee (FGC), a hybrid government/international oversight mechanism that has helped coordinate policy dialogue and increased the accountability of Somalia's concessions and procurement policies and practice. The FGC aims to increase financial accountability and build confidence in country systems, support ongoing efforts to strengthen institutions and capacity, and spearhead actions to strengthen public finance and central bank management. Figure 4.1 illustrates progress so far.

Continued effort is required from all stakeholders to ensure that sound PFM laws are passed and implemented. The draft laws, including the PFM bill, the procurement bill, and the audit bill, have not been enacted in Parliament. The government needs to disseminate the laws, implement them, and train staff in their use. Years of de facto PFM practice that diverged from an out-dated legal framework means that adherence to laws and regulations is weak. Reform on this front will need to be complemented with intensive support to other change management dimensions.

Figure 4.1: Somalia has adopted new laws, regulations, policies, and procedures governing public financial management

LAWS	REGULATIONS	POLICIES & PROCEDURES
• Revenue & Taxation Law	• Revenue & Taxation Administration Regulations • Sector specific regulations i.e. ICT	• Aid Management Policy • Use of Country Systems Policies and Procedures • Revenue & Tax administration procedures • External assistance procedures manual
• Anti-Money Laundering Law	• Anti-Money Laundering regulations • Asset Recovery Management • Financial Intelligence Unit regulations	• Fiscal Federation Policy • Debt Relief roadmap
• Public Financial Management Law • Procurement Law • Budget Appropriation Act	• PFM regulations • Banking Payment System regulations • Security Sector Expenditure procedures	• Financial procedures manual • Procurement procedures • Government-to-business/civil servants payment procedures
• PFM Law		• Management Reporting
• Budget Appropriation Act		• Asset Management

Not started **In progress** **Completed/passed**

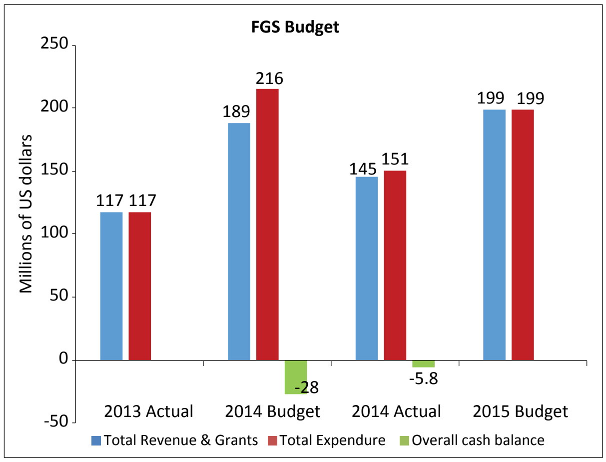
Source: Draft FGS Fiscal Governance Strategy 2015.

4.1.2 Budget formulation procedures are in place, but implementation is a challenge

Financial regulations established budget formulation procedures, but most of them are not being followed, according to the PFM self-assessment. The lack of a standard Chart of Accounts complicates budgeting. Participation is very limited, with ministries lacking ownership of their budgets or even awareness of the allocations made to them.

A credible and predictable budget framework is one of the foundation stones of financial accountability and transparency. The FGS is making progress on this front, in partnership with the international community. Unlike the 2014 budget, which had an unfunded shortfall of $27.7 million, the revised 2015 budget is balanced (Figure 4.2), although revenue projections seem ambitious at$199 million compared with previous outturns. The budget primarily covers recurrent costs, which account for 93 percent of the budget, leaving little scope for delivering the tangible and rapid results demanded by the Somali people. Compensation of employees accounts for 40 percent of the total budget in 2015, down from 51 percent of actual expenditure in 2014. The Federal Government collected $145 million in actual revenues in 2014.

Figure 4.2: Fiscal balance is set to be restored in 2015



Source: FGS Ministry of Finance (Appropriation Act for 2015 Budget).

The FGS has taken a critical step in upgrading its budget classification (or Chart of Accounts) to a multidimensional structure, including organization, fund source, programs/projects, economic classification, and, geographic location. The new fund and program segments are being piloted under World Bank–funded projects. The organization segment has also been mapped to allow for production of reports by Classification of Functions of Government (COFOG) and Peace and State-Building Goals (PSG). The economic segment is used to produce IMF-Government Finance Statistics (GFS) reports.

4.1.3 Budget execution has improved, but it is still lacking in many respects

A Somalia Financial Management Information System (SFMIS) is operational. All revenue and payment transactions are now processed through it and reconciled with the CBS. The SFMIS is user-friendly, robust, and secure. It focuses on capturing the approved budget, payments, and revenues; accounting for and posting financial reports; and ensuring budget controls. Budget and financial reports are now posted on the Ministry of Finance website as part of the government's commitment to transparency. Through an incremental approach, other modules can be gradually implemented in the SFMIS, with emphasis on training and change management.

The foundations of the new payment established are gradually taking shape. The government is addressing the need for financial controls for operating expenditures, which are currently made on the basis of cash advances to line ministries, with ex post controls and little differentiation of roles in the payment process. The government has established a Payment System Reform Task Force to develop a new system for all line ministries. It will include ex ante controls and strict differentiation of roles in the payment process. Line ministries initiate transactions and submit payment vouchers to the Ministry of Finance for recording and payment. A vendor database is being established to ensure direct payment to final beneficiaries, with strengthened controls using bar-coded payment instructions. The CBS has issued interim licenses to six commercial banks and nine money transfer agencies; direct transfers can be made to the vendor accounts in these institutions to reduce the risk of cash processing at the CBS. A Treasury Single Account has been formally established is working now in place through which all revenue should be paid and all payments made.

With the help of international partners, the government is leading the change management process for the operating costs payment process. It is helping design a revised process with added controls. The Somalia Financing Facility projects window is supporting the establishment of a robust procurement process within the Ministry of Finance for the delivery of civil works projects, an important system for the long-run financing Somalia's huge needs. Efforts are underway to ensure that this valuable experience is mainstreamed into government operating procedures.

Significant progress has been made in payroll control. Civil service salaries channelled through the strengthened payroll system accounted for about 14 percent of total FGS spending in 2014. Civil servants are now paid only after two-part authentication of unique identification numbers and biometric information. The process still involves manual reconciliation of multiple paysheets and a single geographic point of pay. Subsequent steps require reconciling multiple payrolls into a single list, decentralizing payments, and rolling out a comparable system for the payment of salaries of police and military personnel. Discussions are underway to deposit salaries directly into civil servants' bank accounts once bank licensing and payment systems are strengthened.

4.1.2 Procurement rules need strengthening

Procurement of goods and services does not follow procurement rules, according to the self-assessment report. The award of contracts is not based on open competition. No justifications are made for the procurement decisions made. Through the FGC, the FGS has made some progress updating the procurement regulations, and it is reviewing contracts. The prime minister and the minister of finance have begun to act on FGC recommendations for some contracts.

The Ministry of Finance has developed a Procurement Amendment Bill, which has been endorsed by the Council of Ministers and now awaits passage by Parliament. Other documents that have been prepared to introduce a competitive and transparent public procurement system include standard bidding documents for supplies and works for national and international competitive bidding, a user guide for the standard bidding documents for the procurement of supplies, procurement procedural forms, and a proposed organizational structure and job descriptions for the Public Procurement Authority. The degree of transparency and competition in procurement will be tested after adoption and implementation of these procurement rules and tools in executing the budget. Capacity building of procurement department officers in the Ministry of Finance and line ministries is required to ensure effective implementation of the procurement rules.

The experience of tendering for concessions, especially for assets considered national or strategic, has highlighted the need for a stronger framework for procurement and concessions. The UN Somalia and Eritrea Monitoring Group (SEMG) highlighted the practice of "secret contracting," whereby concessions are signed in a nontransparent and ad hoc manner. The absence of a clear legal or regulatory framework for concessions, including procedural transparency, has often led to agreements with unfavorable terms for the FGS and Somali citizens. A draft procurement and concessions act was approved by the Council of Ministers in April 2014 but is still awaiting parliamentary approval. Weak interministerial coordination and extremely limited internal procurement, legal drafting, and negotiation capacities will make implementation of the act and creation of its enabling institutions, including the proposed Interministerial Concessions Committee, a formidable challenge.

4.1.3 Oversight institutions are being put in place

The Office of the Auditor General (OAG) has been created. Following the appointment of the new auditor general, in March 2014, the OAG made some progress in auditing the 2013 financial statements, submitting its report to Parliament in June 2014. While Article 114 of the Provisional Constitution establishes the OAG as an independent office, legal reform of its role is required to bring the law into line with the Constitution. Under the 1972 Law on the Magistrate of Accounts, the auditor general is appointed by and reports to the president, weakening the independence and ability of OAG to function as a supreme audit institution. An audit bill has been prepared to establish a more independent OAG.

Parliament has taken steps to establish its oversight role. It has repeatedly asserted its legal role in approving large concession contracts and sought to renegotiate or cancel a number of contracts that have been brought to its attention. Parliamentary committees have summoned ministers for questioning of these contracts. The Parliamentary Finance Committee conducted a public hearing on the 2012 audit report, and a procedures manual was developed to enable it to do its oversight role on a consistent basis in the future.

Federal financial accountability institutions have been under resourced and marginalized for decades. They require sustained support to be empowered to perform their functions. Very little information has been made available for external audit or parliamentary review and scrutiny, and institutions have been starved of resources and subjected to targeted attacks. Under these circumstances, significant support must be granted to the OAG and Parliament to fulfil their roles, together with the judiciary. This process is a long one. The government and development partners should not be distracted by the proliferation of new financial accountability institutions, which will fragment scarce reform capacity.

Technical dialogue between the government and development partners on broader issues related to financial accountability have taken place in the context of the PSG5 Working Group on Revenue and Services. Development partner support to areas including revenue mobilization; intergovernmental fiscal relations; linkages between PFM reform and service delivery; and strengthening of viable Somali oversight activities(for example, external audit and legislative scrutiny) has also been discussed in this forum and agreed to with government and other stakeholders.

4.2 Anticorruption and Accountability

International governance indexes rank Somalia last or near last on corruption and accountability. In its rankings of more than 200 countries, the World Bank Governance Indicators place Somalia last or near last on control of corruption, government effectiveness, political stability and absence of violence/terrorism, regulatory quality, rule of law, and voice and accountability. In 2014 Transparency International ranked Somalia 174th of 175 countries. The Ibrahim Index of African Governance ranks Somalia last, with a mere 8.6 out of 100 points—16.2 points behind the second-last country (Chad). Alternative accountability mechanisms, such as the media or civil society, are barely functioning: Reporters without Borders ranks Somalia 176th out of 180 countries in terms of press freedom.

Somalia has suffered from severe corruption and embezzlement of public funds, the absence of any accountability mechanisms for public servants or politicians, and the flourishing of networks that profit significantly from their absence. The lack of accountability mechanisms undermines the process of stabilization and state formation. The persistence of spoilers at most levels of governance erodes confidence that change is afoot and jeopardizes the emergence of a new cadre of honest administrators. Continued predatory behavior by public and private actors in the political, economic, and security arenas has sowed mistrust between the state and civil society and left a vacuum of public authority that traditional authorities, religious leaders, and rent-seeking networks of de facto authority have filled.

Although the number and scope of incidents has declined since 2012, predatory behavior by political actors at the center and in the emerging state administrations remains a problem. To reduce the incidence of predatory behavior, the Financial Governance Committee (FGC) was created to advise and support the FGS on fiduciary issues. It has achieved some success in bringing fiduciary challenges to light and helping give the FGS the tools with which to negotiate better terms with foreign companies. No significant contract restructuring has yet taken place, however. Funds that do make it into the Treasury account at the CBS are still misappropriated, although they are subject to stronger controls than some reports acknowledge. Payment requests are subject to greater commitment and budget controls, and efforts are being made to ensure the traceability of payments to registered vendors. The roll-out of the SFMIS is contributing to promoting better adherence to these controls and more accessible information on payments. The ongoing support of the World Bank to PFM will strengthen these formal accountability mechanisms.

The passing of the bill establishing the Anti-Corruption Commission in January 2015, the President's commitment on various occasions to the fight against corruption in Somalia, and the progressive interpretation of his mandate by the Attorney General of Somalia will be important steps to trace. Central Bank reform, asset recovery, strengthened commitment to PFM reform, and increased transparency regarding public contracts will be important building blocks in creating a more resilient and capable accountability system.

OUTLOOK

5. The Outlook for 2015–17

5.1 The Importance of Security

Growth in Somalia could accelerate in 2015–17 if the fragile peace in the South-Central region continues, AMISOM troops continue to contain Al Shabaab, the FGS gains more territorial presence, and the international community continues to support the FGS. The security situation profoundly affects investment, trade, and fiscal and monetary policy. A fundamental precondition for macroeconomic viability in the short to medium term is a durable resolution of political differences.

Growth will continue to be consumption driven, fueled by remittance inflows and enhanced donor support. Investment demand is projected to pick up. As peace is secured and stability maintained, a larger share of remittances will be allocated to investments, which will drive growth. Livestock will remain the main economic activity.

A first test of stability will be the electoral transition process slated for 2016. If elections are peaceful and credible, consumption, investment, and foreign inflows (remittances, donor flows, and FDI) are likely to increase. Much of the increased investment is projected to be used to purchase imported equipment to renovate dilapidated infrastructure and housing, leading to strong growth in imports.

The security situation in Somaliland and Puntland is adequate for economic activity. In contrast, problems in the South-Central region make growth difficult. The fight to eradicate the militants has slowed economic activity, especially in Mogadishu, as most government resources go to the security sector. Given the precarious security situation, fundamental economic reforms are unlikely to receive the priority they deserve. Security challenges also discourage the private sector from investing in long-term production-oriented activities. Any deterioration of the security situation, including fallout from the 2016 general election, will have an adverse impact on revenue by limiting the government's ability to collect taxes and reducing growth prospects. If security declines, macroeconomic projections are unlikely to be realized in 2015–17.

Foreign assistance could decline if political dialogue is not maintained. Given Somalia's dependence on foreign aid, any disruption in donor support—as a result of frustration with the reform process or political bickering, for example—would severely curtail budget implementation. Foreign assistance is channeled both on and off budget. Direct budget support from donors represented 36 percent in 2013 and 39 percent in 2014. Off-budget donor financing totaled $137.1 million (73 percent of the 2014 budget).

5.2 Reforms Needed to Spur Growth

Higher growth in the longer run requires increases in exports. If peace and security are restored, stronger consumption and investment will fuel aggregate demand in the short to medium term. Over the longer run, exports need to increase. Spurring exports requires priority reforms, including establishing a viable, properly supervised and regulated banking sector; reaching a decision point on HPIC to allow access to multilateral concessional financing; and levelling the playing field for the private sector.

Fiscal reforms are needed to make Somalia's budget credible. The FGS was able to produce a fully funded draft budget in 2015, but the apparent recurrence of arrears underscores the need for continued attention to macro-fiscal management. Revenue projections have tended to be unrealistic, leading to expenditure rationing and arrears during budget execution. In addition, trade taxes account for more than 60 percent of domestic revenue, and a significant portion of the budget is dependent on unpredictable donor resources. Promising attempts to elaborate the 2016 budget according to medium-term fiscal planning and economic fundamentals are welcome.

The financial sector needs to be formalized to increase financial stability. Implementation of policies and standards that are in line with international best practice for bank supervision and regulation would increase the safety, soundness, and integrity of the banking system. There is an urgent need to formalize the Somali financial sector to reduce money laundering and terrorism financing risks and help ensure that critical remittance corridors remain open. Powers to regulate the financial sector and ensure stability have been given to the CBS through the Central Bank Act. However, legal tools to counter money laundering and the financing of terrorism are still in a draft stage, with both an AML/CFT and an anticorruption law in the works. The capacity of the CBS to perform its supervisory role will need to be significantly enhanced. No significant examination has been performed of Somali financial institutions. The CBS and private actors have engaged in dialogue and a licensing process has been implemented, but lack of institutional knowledge, coherent procedures, staff continuity, and limited regulatory clarity are hindering progress.

Operationalizing the 2011 Financial Institutions Act would accelerate growth and potentially create economic opportunities for a wider share of the population. High growth in Somalia is predicated on implementation of the banking law that was approved in Mogadishu. It is hoped that commercial banking will begin once regulations are in place, an automated clearinghouse is established, and bank supervisors are trained. Achieving the high rates of growth necessary to significantly reduce poverty will require increased mobilization of domestic and foreign savings to support higher rates of private sector investment. Reinvigorating the financial sector is a critical step toward setting Somalia on the road to sustained self-sufficiency, creating economic opportunities, and reducing poverty. The financial sector needs to build the correspondent banking relationships necessary for issuing letters of credit, and it needs to provide banking services to the government, Somali investors, and small and medium-size enterprises. In implementing the new law, the federal government should initially focus on expanding financial services by attracting sound and credible commercial banks to Somalia and expanding nonbank financial institutions to provide small-scale and microcredit, in order to boost saving mobilization.

Reliable statistics are critical for policy formulation, planning, budgeting, and service delivery. They also play a central role in supporting the implementation of policies. Monitoring and evaluation in particular supports transparency and accountability. Somalia has no formal mechanism for validating the accuracy and reliability of the data generated from official sources, surveys, or secondary sources. The absence of formal statistical systems and continuing conflict in some areas has led to fragmented and incomplete data collection. Some basic macroeconomic statistics, including national income and balance of payments data, do not exist. Also lacking are the statistics needed to design and implement social services. A national strategy for data development, based on a strong partnership between data producers and users, is needed. Reestablishment of the Somali statistical system is an urgent priority, which will require new institutional structures and generous foreign technical and financial assistance.

PART TWO: SPECIAL FOCUS

Intergovernmental Fiscal Relations in Somalia: Challenges and Lessons from International Experience

This Special Focus highlights international experience—and theory drawn from that experience—and analyzes what it means for Somalia given the fiscal architecture that is emerging. It comprises five section. Section 6 provides a brief overview of key principles drawn from the analysis that follows. Section 7 overviews progress in forming the federal state of Somalia. It reviews the history of unitary democracy, centralized dictatorship, and state collapse and examines the emergence of a nascent federal system. Section 8 presents a framework for thinking about the design of intergovernmental financing arrangements. It reviews the de facto intergovernmental financing arrangements that are being established as FMSs are forming and examines how they are likely to affect the development of durable intergovernmental fiscal arrangements as the constitution-making process unfolds. The section concludes with observations that it may be more realistic to expect fiscal arrangements to evolve over time, as fiscal conditions change and as trust develops between the stakeholders Section 9 considers the institutional requirements of a well-functioning federal system, particularly in relation to the negotiation and operation of intergovernmental relations. It suggests next steps for collecting information and conducting analysis that will inform a well-considered process of designing the intergovernmental fiscal system.

6. Key Principles Governing Intergovernmental Relations

Somalia is at a turning point; creating a workable system of government will be central to its recovery. Since the mid-1990s, a series of peace efforts have made slow but significant progress toward restoring legitimate government. The Provisional Constitution adopted in 2012 foreshadowed a final constitutional process that will culminate in 2016. As security across the country improves, interim state administrations have emerged and are laying the foundations of a new system of government. Optimism is increasing regarding the possibility of forming a legitimate and functioning, albeit weak, state.[12]

There is now consensus among Somali leaders that a federal system of government provides the best chance of bringing together the fragmented state. The idea of a federal system of government was first proposed in 2004, when the interim federal charter was adopted. It gained momentum with the adoption of the Provisional Constitution in August 2012. The Constitution lays the foundations for the creation of a viable federal system of government through the FGS. However, much remains to be done to fashion the constitutional framework into a workable multilevel government architecture that can support both economic growth and improved standards of living for the people of Somalia.

The construction of a federal state is complicated by the preexisting rights of Puntland and by the de facto intergovernmental fiscal architecture that is emerging as interim state administrations form. The Provisional Constitution allows preexisting states (of which Puntland is the only practical example) to exercise powers given by their state constitutions, if they were adopted before the Provisional Constitution. Puntland now performs all the functions of an independent state, including raising revenue from all possible sources, maintaining an armed security force, and issuing visas to foreign nationals. It is the only entity providing state-level services to its citizens. In the absence of any constitutional prescription, the interim state administrations are emulating Puntland by assuming full revenue and expenditure powers. The state-formation process is thus fundamentally shaping the options for the intergovernmental fiscal architecture of a more permanent federal Somali state. The risk is that over time—the balkanization of states will become more entrenched, limiting the role that can be played by the federal government.

12 The constitution-making process has not sought to engage with Somaliland, which asserts its own independence. It is not anticipated that Somaliland will be part of the federal state in the near future. Accordingly, the discussion which follows covers those entities that are considered to be bound by the provisional constitution.

>> Box 6.1: What Is a federal system?

According to the Forum of Federations (a global network of federalism and devolved governance) federalism is:

> essentially a system of voluntary self-rule and shared rule. This is implied in the derivation of the word federal, which comes from the Latin *foedus*, meaning covenant. A covenant signifies a binding partnership among co-equals in which the parties to the covenant retain their individual identity and integrity while creating a new entity that has its own integrity or entity as well. A covenant also signifies a morally binding commitment in which the partners behave toward each other in accord with the spirit of the law rather than merely the letter of the law. A covenant is more than a contract; it commits the parties to an enduring, even perpetual, relationship and to an obligation to achieve the ends of the agreement and to resolve peacefully the conflicts that invariably arise in every relationship.

Federalism is thus "both a structure and a process of governance that establishes unity on the basis of consent while preserving diversity by constitutionally uniting separate political communities into a limited, but encompassing, polity."

Source: www.forumfed.org

The state formation process is a positive sign, but it needs to be accompanied by the development of robust intergovernmental relations. The state formation process is fragile and fraught.[13] Robust mechanisms for intergovernmental cooperation and coordination are vital to sustaining the process. The Provisional Constitution envisages that the constitutional review process defines intergovernmental relationships, but it is yet to play a role in emerging intergovernmental negotiations. The Constitutional Review Commission has been formed, but it has not been able to operate effectively because of resource and capacity limitations. There has been little discussion of the intergovernmental system that defines the interactions between the FMSs and the federal government. If the state formation process proceeds faster than the development of intergovernmental institutional arrangements, it may reinforce the division of functional responsibilities and revenue bases along geographic lines rather than across levels of government.

Fiscal arrangements lie at the heart of the federal project. Somalia's 2012 Provisional Constitution does not specify how functions and resources will be distributed between levels of government, except in relation to four specific areas.[14] Assignment of functions, and the distribution of resources to finance them, may be among the most contentious provisions to be debated as the final constitution is agreed.

The intergovernmental fiscal system should be based on principles, but they should reflect Somalia's unique social, historical, and political context. Dialogue on these issues is developing in an ad hoc way, usually through serial bipartisan interactions rather than a plural negotiation among the entities that will make up the federal state. There are no hard and fast rules about what a federal system should look like (see Box 6.1), so a wide range of options are open to Somalia's constitutional designers. Sharper focus on key decisions is needed, underpinned by more robust

13 The fragility of the current system of government is evidenced by the fact that the Puntland Government has announced the severing of its relationship with the FGS twice since 2012, resulting in a parallel political process to resolve disputes. Similarly, only months after the interim Southwest administration was formed, it set up customs posts between the Benadir region and the new state. The action resulted in a dispute between the Benadir region, the interim Southwest, and the FGS. Early in 2015, the Federal Parliament voted to disapprove the composition of the newly constituted Interim Jubba Administration (IJA). In response, the IJA announced that it would sever its ties with the FGS. The Interim Administration of South West State (ISWA) also took issue with the composition of the IJA regional assembly. Frictions have also arisen between Puntland and the FGS over the formation of the Galmudug Interim Administration. Such examples highlight the need for mechanisms to resolve government to government disputes.

14 Article 54 of the Provincial Constitution grants the Federal Government powers over foreign affairs, national defence, immigration and citizenship, and monetary policy. All other powers are to be negotiated by the Federal Government and FMSs.

evidence base to inform them. The discussion in this section aims to support this debate by framing a basis for understanding the choices and options, focusing on technical issues rather than the larger political aspects of forming a federal system. The analysis suggests five principles that, in addition to those already articulated in the Provisional Constitution, might provide guidance to Somalia's leaders. Agreement on these principles, followed by a process of unbundling constituent elements of the fiscal architecture, may provide a more productive starting point than framing the debate in terms of models.

Principle 1: The approach should be dynamic, organic, and grounded in cooperative intergovernmental institutions

Current arrangements will shape what is possible in the short term, but fiscal arrangements often evolve substantially from their initial design. To the extent that newly established states exercise the expenditure and revenue powers of existing states, the current decentralized arrangements may become difficult to change, except over time.[15] In Somalia this evolutionary process is made necessary by the uneven and sometimes fragile relations between the center and regions and the history of interclan rivalries. Although some aspects of a constitution can be expressed as aspirational goals, fiscal arrangements should be realistic and capable of immediate implementation. If the intergovernmental financing arrangements to be included in the Constitution are not capable of immediate implementation, some transitional arrangements should be included in the Constitution. When de facto fiscal arrangements are different from the de jure ones for too long, the risk increases that they may never be fully implemented. Given the dynamic conditions in Somalia, a useful approach may be to allow fiscal arrangements to evolve through successive agreements rather than try to strike a grand constitutional bargain at the outset.

The immediate focus should be on nurturing intergovernmental mechanisms through which fiscal arrangements can be negotiated on an ongoing basis. The Constitution should be clear on the institutional arrangements through which fiscal arrangements will evolve, even after it has been finally negotiated. Several provisions of the Provisional Constitution specify a cooperative form of federalism. The Constitution also provides for an institutional intergovernmental framework, including the Interstate Commission, to become operational once the state-formation process is complete. It seems reasonable that fiscal arrangements should be agreed on through negotiation and discussion rather than by the decision of the Federal Government, but the Intrastate Commission may not necessarily serve the purpose of intergovernmental negotiation, if it cannot bind states' leaders to the decisions it reaches. The process by which these intergovernmental agreements could be reached is yet to be fully spelled out.

Principle 2: Intergovernmental financing arrangements work best as coherent wholes

Decisions about the design of one element of the intergovernmental financing architecture limits the options for the design of other elements. The idea that "funding follows function" is one of the most basic concepts in intergovernmental fiscal design. Having more than one level of government means that both functions and funding must be divided between them, and logic suggests they should match. Resources can be allocated in two ways: by assigning tax bases to different levels of government or by transferring funds from one level of government to another. International best practice, which is to assign functions first and then allocate funding accordingly, may not be practical, since many functions and tax bases are de facto assigned already. Indeed, arrangements may be dynamic for a period of time in Somalia. Nevertheless, as

[15] In this Special Focus, "state" or federal member state (FMS) is used to describe the sub-national units that have formed or are forming. Federal Government of Somalia (FGS) or "federal government" is used to describe the national level of government. "Federal State" or "state of Somalia" is used to describe the whole governance framework for Somalia, including both the federal and state government entities.

decisions are made about individual components (for example, assigning responsibility for particular function, or allocating a tax base), regard should be paid to how those changes affect balance within the system as a whole.

Principle 3: Fiscal arrangements should support a strong and unified economic space

As a small country with low GDP, Somalia can ill afford to balkanize its economic space. To increase economic efficiency throughout the federal territory, goods, money, and people should be highly mobile. Federal fiscal arrangements should be configured to promote a common domestic economic space to encourage direct investment and an enabling business environment.

States should be discouraged from erecting economic barriers to the free flow of goods and commerce within Somalia or complicating the investment environment in other ways. A practice to avoid is the levying of taxes on the domestic movement of goods across states' borders (as is happening in Kenya). Somalia needs to attract the kind of domestic and international investment that will make a sustainable contribution to the economy. Coherent regimes for investment are central to creating this enabling environment. Center-state "tax jungles" or tax competition among states is to be avoided.[16]

Principle 4: Equity and inclusion lie at the heart of intergovernmental fiscal arrangements

Resource competition and unequal access to limited resources have often been a cause of conflict in Somalia. If they are well designed, fiscal arrangements can help address inequities and engender solidarity. Beyond issues of conflict, inequitable distribution also has economic consequences. Highly unequal fiscal outcomes might trigger movements of population to better-endowed states (a right Article 21 of the Provisional Constitution grants to individuals), putting pressures on services and potentially raising tensions within or between states regarding access to services by residents of one region who migrate to another. Equal access to services and fairness in the distribution of resources are already enshrined in the Provisional Constitution, but it is not clear how this objective will be achieved.

Addressing inequity will require some arrangement to share resources among states. If the revenue-raising capacity of individual states is uneven, some form of fiscal equalization will be needed. Somalia's tax room (the fiscal space to collect taxes from different bases) is currently divided across levels of government largely on a geographic basis. The FGS controls revenues from the highly urbanized geographic region around Mogadishu; other states control revenues that can be readily captured within their jurisdictions. As customs revenue collected at ports is currently the most significant single source of revenue, it is likely that some states will be relatively poorly endowed with revenue, because the ports within their jurisdiction are small. A system for sharing resources will need to address this inequality. Equalization could be achieved either by having richer states share their revenues directly with states that have less revenue or by having all states send a larger share of their revenues to the federal government, which would then transfer funds to the states that need them most.

Principle 5: The assignment of functions should be efficient and consistent

International experience suggests a number of principles to guide the assignment of expenditure responsibilities between levels of government, but some principles are in tension with others. On the one hand, services should be as decentralized as possible, to ensure that they are most responsive to local needs. On the other hand, capacity limitations, economies of scale, and the need to limit administrative duplication

16 In theory, competition between states can be healthy driver of efficiency in more mature federal systems – since states will seek to strike the most attractive balance between levels of taxation and the services that can be provided. However, Somalia's public sector is still extremely under-developed and it will be some time before tax competition is likely to be healthy rather than harmful to the economy.

suggest more centralized approaches. The capacity of different FMSs is currently uneven: Puntland, for example, has had a functioning administration since 1998, whereas some yet-to-be formed states in central Somalia face the challenge (or opportunity) of building systems from scratch. An important question for Somalia's constitutional architects to consider is whether all states should exercise the same expenditure responsibilities immediately or whether some asymmetry should be allowed.

The Provisional Constitution prescribes that revenues will be collected and services delivered by the level of government that is able to do so most effectively. How these principles should be operationalized has not yet been negotiated. In general, goods and services that are highly mobile are best and most easily taxed at the federal level. In other countries, the central government almost always sets customs tariffs, which have international trade implications. The administration of a wide range of taxes by multiple separate revenue collection entities is particularly inefficient given Somalia's limited human capacity and the small size of the economy. Tax administration is a complex bureaucratic function that requires relatively strong capacity to realize the potential of tax bases; it can be inefficient to have multiple organizations attempting to develop the same capacity. The model of tax administration is a separate issue from how to divide the revenues that have been collected. However, considerable trust is usually required before one level of government is willing to hand over responsibility for collecting its taxes to another. Achieving it may be an intermediate rather than an immediate aim.

7. From Unitary to Federal Government

Somalia's journey from a unitary state to a nascent federal system of governance has been long and difficult. The term *federal* did not appear in a Somali constitution until 2004, but in many respects Somalia has been on a journey to federalism for more than 30 years. In 1995, a report by two respected scholars of Somalia recommended four models of decentralized government, including federation, confederation, and a consociational power-sharing arrangement (Lewis and Mayall, 1995).[17] Understanding the complicated journey to today's provisional federal constitution is important if one is to appreciate the influences that will shape the emerging state and the decisions Somalia's constitutional architects will face in designing the fiscal arrangements (Box 7.1).

7.1 The Long Road to the Provisional Constitution

The period from 1960 to 1969 was one of hope, high expectations, and democratic experiment in Somalia. On July 1, 1960, the former British Protectorate of Somaliland, which had gained independence from the United Kingdom five days earlier, came together voluntarily with the former Italian colony Somaliland to form the Republic of Somalia, under a centralized, parliamentary, and unitary system of government. A democratic system with a directly elected national parliament prevailed until 1969. During this period, there were two peaceful transfers of power.

>> Box 7.1: Constitutional provisions chart the gradual emergence of a federal state

1960 Constitution:

Article 1: The Republic

Somalia is an independent and fully sovereign State. It is a representative, democratic, and unitary Republic. The Somali people is one and indivisible.

2004 Transitional Federal Charter:

Article 1: Establishment of the Transitional Federal Government

There shall be a Transitional Federal Government of the Somali Republic based on the sovereign will of the Somali people.

Article 11:

The Transitional Federal Government of the Somali Republic shall have a decentralized system of administration based on federalism.

2012 Provisional Constitution:

Article 1, Section 1

Somalia is a federal, sovereign, and democratic republic founded on inclusive representation of the people and a multiparty system and social justice.

[17] A confederation is an association of independent sovereign units that join together for certain purposes. The federal level of government is often nominated by the members of the confederation, rather than directly elected. United Arab Emirates and Bosnia and Herzegovina are examples of confederal systems. Consociational power sharing involves non-territorial power sharing among all the important communities within a state, regardless of where they live. State institutions are designed to accommodate proportional representation of these communities, and veto power for minorities. Executive institutions like the cabinet are designed to ensure representation of all groups. Within this framework, the individual communities are self-government. Belgium and Lebanon are two examples of consociational government. The fourth model proposed by the report was a unitary decentralized democracy.

A bloodless coup put an end to democracy. In October 1969, following the assassination of President Abdirashid Ali Sharmarke, the army took power. A period of centralized government followed, under which the Supreme Revolutionary Council, led by General Mohamed Siad Barre, made all major government decisions. As part of its move toward "scientific socialism," the government nationalized economic production and services. Somalia's economic fortunes changed after the 1977–78 war with Ethiopia, when the Soviet Union withdrew its support. The ideological stance of the leadership softened and patrimonial tendencies appeared to take hold, resulting in increased opposition from armed groups.

Armed resistance to the regime culminated in the effective collapse of the state in 1991. The period just before the fall of the regime was marked by increased armed clan-based opposition to the government and the reduction of effective state control in many parts of the country. Some of the leaders who engaged in this conflict later emerged as powerful political actors. In January 1991, General Said Barre fled the country. After the collapse of the regime, various opposition groups fought one another for control of Mogadishu, resulting within a short period of time in civil war, and, by 1991, the disintegration of the state. The civil war continued for the next 10 years, despite efforts and armed interventions from international actors, including the United Nations and the United States.

Soon after the collapse of the state, regions in North-Western Somalia (which included the former British Somaliland) unilaterally declared independence from the rest of the country. Within a short time, the self-declared state of Somaliland was able to establish and maintain peace and democracy within its borders and to focus on building the apparatus of a functioning, if weak, state. In 1998 the regions in the north eastern part of the country, Puntland, declared their autonomy, although its leaders have expressed its willingness to be part of a unified Somalia. Puntland managed to avoid the violence that engulfed the rest of the country, first by establishing security forces and later by focusing on building administrative structures and a system of self-government. Meanwhile, armed militias controlled the rest of the country, with the acquiescence of local populations. The resulting chaos fueled ongoing mistrust among various clans.

After a number of unsuccessful efforts, a peace agreement was finally achieved in Djibouti in 2000. The conference led to the formation of a civilian Transitional National Government, which excluded participation of leaders of armed groups. During its four years in existence, the Transitional National Government controlled little beyond Mogadishu, with the blessing of the militia groups that controlled that part of the city. Armed groups that controlled most of southern Somalia rejected the legitimacy of the new government. This period also saw the rise of the Islamic Courts Union (ICU), which took control of much of southern Somalia. Its presence provided the impetus for increased international and regional interventions, further complicating the state-building process.

Some Somalis who remained in the country and others in the diaspora had been advocating for federalism since the mid-1990s. They argued that political reconciliation could not be achieved under the hegemony of any one community and that a predatory, centralized state administration was one of the root causes of the civil war. The federal approach found favor with the international community during the decade that followed, as well as with many in the constitutional negotiation process.

Following a protracted reconciliation conference in Kenya, a second government formed in 2004. It incorporated militia leaders in leadership roles and decided for the first time on a federal system of government. While the Federal Transition Charter contained an explicit list of the few areas of responsibility for the federal level and of the many areas to be left to the states, there was little space for debate or agreement on what type of federal system would be most appropriate. The charter therefore empowered the Transitional Federal Government and the Federal Transitional Parliament to complete the process of giving birth to a new federal state through negotiations. It was expected that by 2008 a federal constitution would have been written that would define the type of federal system Somalis wanted to have, but the Transitional Federal Government made little progress during its first four-year term. During most of this period, it operated effectively as a government in exile outside Mogadishu, as the ICU gained effective control of many areas in the country. The ICU established itself as an alternative public authority to the internationally backed Transitional Federal Government in southern Somaliaand was viewed by some observers as a worrisome sign of the increasing role of radical groups in Somali politics. In 2006 Ethiopia intervened to expel the various groups aligned with the ICU. The ICU was defeated, but it left behind radical elements of the movement—among them, Al Shabaab, the youth wing of the ICU.

In 2008 another transitional government incorporating some of the moderate members of the ICU was formed to complete the federal project. It made little headway, as deteriorating security conditions have frustrated attempts at state building for much of the past decade, after Al-Shabaab gained control of significant parts of the country. In 2007 the United Nations established AMISOM, which has helped increase security by expanding the space within which government forces may provide services. Al-Shabaab forces that had controlled most of southern Somalia gradually lost territory. The process of dislodging them has accelerated since 2011, as a result of intense pressure by AMISOM forces and the Somali national army. Al-Shabaab has now been removed from all major urban centers, depriving it of key sources of revenue and safe havens, although it still retains the capacity to instigate terror attacks against government and international targets. The resulting peace, albeit fragile, has allowed the process of rebuilding government in Somalia to begin in earnest. The preliminary design of governance is reflected in the 2012 Provisional Constitution. Section 7.3 below takes up discussion of the he state formation process which has followed in more detail.

7.2 Municipal and District Governance

Governance arrangements in Somalia have always incorporated elements of deconcentration and decentralization to regions, districts, and municipalities. Under the original system of parliamentary government established after Independence, the central government appointed governors of administrative regions and most other regional and local administrators, as well as all public sector employees: Everyone from the janitor of a village school to the minister, including village police officers, elementary school teachers, and village elders, was a government employee. A deconcentrated system continued to operate during the succeeding period of centralized military rule, except that mayors and members of city councils, who had previously been elected for three-year terms, were appointed along with all other officials. A national law allowed municipalities to raise revenue from some minor fees and taxes and from the sale of some city services to partially fund some of their basic municipal services, but all other taxes and expenditures were handled at the central government level. In 2013 the Federal Parliament adopted the District and Regional Administration Establishment Act. The implementation status of the law is unclear, but it is anticipated that it will be overtaken by the final constitutional arrangements (Samuels and Otieno 2014).

Some cities, towns, and villages developed their own systems of government and revenue administrations during the period of state collapse. In the absence of an effective regional or central government, communities and authorities appointed by successive government developed their own independent administrations, disconnected from higher-level governments.

These authorities collect revenues and provide basic municipal services. Revenue is raised largely from taxes on businesses, fees, fines, and charges collected at border checkpoints. Some major urban centers have established revenue administrations that independently collect revenue to supplement their share. The government of the region in which Mogadishu is located receives 15 percent of the Mogadishu port revenues collected by the Federal Government, which it uses to deliver services (these revenues are not shared with other levels of government). Municipal governments in Somalia may be more effective and accountable than higher levels of government, as they are elsewhere in the world (Menkhaus 2014).

A rudimentary system of fiscal decentralization to the local level is in place in Puntland and Somaliland, which have had functioning governments for many years. Governments give back some of the revenues collected by districts and municipalities in Puntland and Somaliland, which also retain whatever local revenues they collect. As a result, some municipalities, especially ones located near ports, are richer than others and provide better services to their citizens. In Somaliland the Regions and Districts (Self-Management) Law (Law No: 23/2002), as extensively amended in 2007, defines the services that municipalities deliver and the revenue sources they are allowed to collect.[18] It delegates the delivery of health services, education (elementary and middle school), security, animal health, water, electricity, and the environment to the local level and allows municipal governments to collect a wide variety of taxes, including property taxes, fines, sales tax, and license and permit fees. Puntland's equivalent law, the Local Government Act No. 7, was partly modelled on the Somaliland law. It defines the roles and responsibilities of lower-level governments in delivering services, identifies the revenues they are allowed to raise, and provides for a revenue-sharing mechanism. The law also gives the minister of local government and rural development the power to oversee municipal affairs.

The capacity to deliver services and collect revenues varies widely across Somalia. In both Puntland and Somaliland, assigning functions to local governments with very little capacity to deliver them means little in practice to citizens, and many social services are provided by nonstate actors. The United Nations Joint Program on Local Governance and Decentralized Services (known as JPLG) is encouraging development of local capacity to deliver services, by funding municipalities in Puntland and Somaliland that met eligibility criteria, including elected councils.

7.3 Formation of the Federal State

A Provisional Federal Constitution was adopted on August 1, 2012, with significant technical and financial support from the international community and following consultations with numerous stakeholders. The Constitution is provisional because it is incomplete and leaves many key issues to be resolved, through a process laid out in the document. It seems highly likely that the arrangement of government adopted in the final constitution will be a federal one. The independence being exercised by interim state administrations suggests that a unitary system of governance would be difficult to implement in the short term. It should be noted, however, that some commentators still believe federalism may be inappropriate, or infeasible, in Somalia. They fear that in the absence of a strong central state, clan rivalry may undermine state legitimacy.[19]

Many decisions will determine what kind of federal state is adopted as part of a more permanent constitution (See Box 7.2 for an explanation of how the terminology is used in the following discussion). The concept of federalism embraces a wide variety of models. At one end of the spectrum are centralized federations, in which the federal government is responsible for formulating policy and subnational governments are responsible for implementing it. At the other end, in more decentralized federations, states

18 This law, which consists of 105 articles, defines in detail how regions and municipalities should govern themselves. It also spells out the roles and responsibilities assigned to lower-level governments and the role of the Somaliland Government (Ministry of Interior) in overseeing the administration of these governments. Because of capacity limitations, implementation of the law is lagging, and the ability of municipalities to discharge their responsibilities is limited.

19 See Elmi (2015) for a discussion of various arguments for and against federalism.

are more powerful, and federal government powers are limited to a few defined functions. Under a decentralized model, the powers of the federal government are often circumscribed, and states exercise all residual powers. Figure 7.1 depicts one way of viewing these options, along a continuum from a highly unitary centralized state to ungoverned anarchy. Over the past 54 years, governance in Somalia has swung between these two extremes. The work of defining where Somalia's federal state will come to rest along this continuum is yet to begin in earnest; a great deal of work remains to be done.

>> Box 7.2: A note on terminology

FGS (Federal Government of Somalia) refers to the federal (national) level of government only. FMS (Federal Member States) refers to the subnational entities under the provisional constitution and for the time being refers to the interim state administrations that have been established. The Federal State of Somalia refers to all governments covered by the Provisional Constitution (the FGS, the FMS, and any third-tier governments).

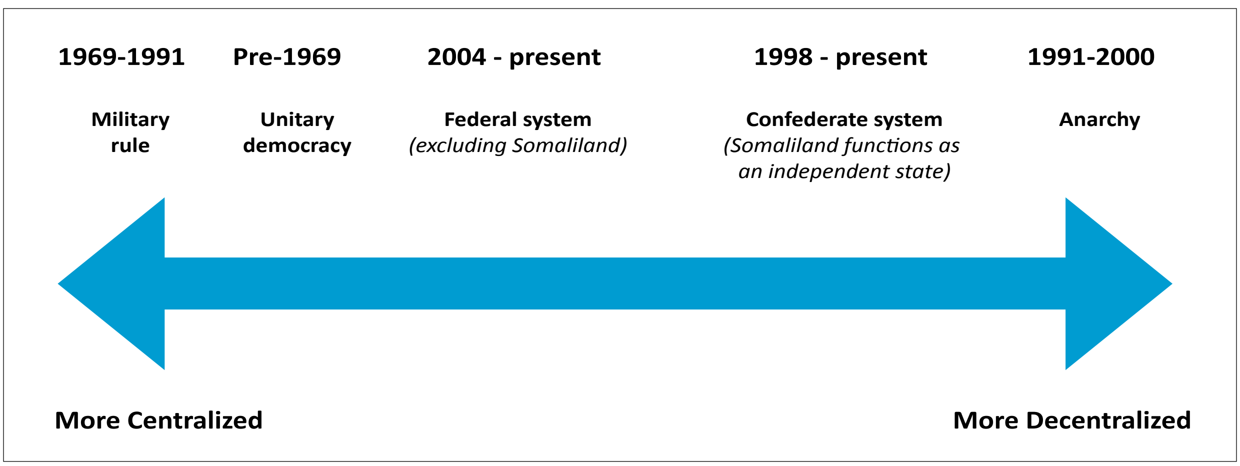
Article 50 of the Provisional Constitution lays out seven principles that will form the foundation of Somalia's federal system. These principles envision cooperative federalism, equity in access to services and resources, and efficiency in revenue collection and service delivery (see Annex A for detail of all seven principles in Article 50 of the Constitution). The institutions and mechanisms required to build and operate a durable federalism in Somalia are yet to be created.

7.4 The State of State Formation

The Provisional Constitution prescribes a process for the formation of Federal Member States (FMS). Before 1990 Somalia's government included a deconcentrated administration consisting of 18 regions (including the capital region of Benadir). The Provisional Constitution recognizes these regions as the basis of forming an FMS but requires two or more regions to voluntarily agree to form one. Once agreement has been reached, the Boundaries and Federation Commission is expected to determine the boundaries of the new state, after which Parliament declares the state's formation.

Although the state formation process is well underway, it is not necessarily following the steps envisaged in the Constitution. As a result, some stakeholders have challenged the legitimacy of the process. A contributing factor is that the Boundaries and Federation Commission was established only very recently. It is expected that a more formal process of ratifying state formation will begin soon. Deciding on a process of bringing the informal formation of state administrations into line with the constitutional prescriptions is likely to have its own challenges. A recent report by Conflict Dynamics evaluates several possible options (Samuels and Otieno 2014).

Figure 7.1: Somalia has experienced a full range of government systems since Independence



Source: Oates Continuum of Government Systems, adapted from Dafflon 2014.

Puntland, the only state that existed when the Provisional Constitution was adopted, has a special status.[20] It has been self-governing under its own constitution since 1998 and is considered a de facto FMS. Puntland includes two and half of the pre-1990 regions (Bari, Nugaal, and half of Mudug, although these boundaries are not agreed to by all). It also claims two additional regions, Sool and Sanaag, and part of Togdheer.[21] An informal process of forming states has been adopted, to ensure that conflicts over state boundaries and the composition of the interim administration are minimized. Not all the newly formed FMSs have followed this process (Table 7.1).

Three new interim states have been created since 2013, and a fourth is expected to form by the end of 2015. The Interim Jubba Administration was created in August 2013, as a result of agreement between the FGS and delegations from Jubba.[22] In November 2014, the Interim South West Administration was created, through a process supported by the FGS. The process of creating legislative assemblies and functioning regional governments is currently underway. In July 2015 the process of creating the Interim Galmudug Administration was completed. The state formation process has now moved to the final state, which is expected to cover Hiiraan and Middle Shebelle. Once this process is completed, every citizen in Somalia will live in an FMS, in the Benadir region (the capital region), or in Somaliland, which remains a self-declared independent state.[23] Serious discussion of how the FGS and the FMSs will work together is just beginning.

Table 7.1: State of state formation

State/entity	Regions	Comments
Somaliland	Awdal, North West, Sool, Sanag, and part of Togdheer (Cayn). Puntland and the new aspiring FMS of Khatumo also claim Sool, Sanag, and parts of Togdheer (Ayn).	On May 18, 1991, the people of northern Somalia (former British Somaliland) unilaterally declared independence from Somalia, calling their state Somaliland. Somaliland has enjoyed peace for much of the period since its creation. It has established the apparatus of an independent state, holding both parliamentary and presidential elections that have been considered fair and transparent. Creating an internationally recognized independent country has been the central objective of all Somaliland governments since 1991. It is not anticipated that Somaliland will be part of the process of finalizing the Constitution of Somalia.
Puntland	Bari, Nugal, and half of Mudug (North Mudug). Puntland also claims Sool, Sanag, and parts of Togdheer (Ayn), regions that are also claimed by Somaliland as well as the new aspiring FMS of Khatumo.	Puntland declared itself an autonomous region within Somalia in 1998. It has since set up a functioning administration and held three presidential elections, in which power was peacefully transferred. Puntland considers itself part of Somalia and is willing to be part of the federation.It is a de facto FMS, as it preceded the Provisional Constitution and signed it. Although it meets the requirement of becoming an FMS as prescribed by the Provisional Constitution, the formal process of recognition through the Federalism Commission is yet to occur. Given the absence of a functioning central government for many years, Puntland's government assumed all the functions and powers of an independent state. The FGS delivers no services in and collects no revenue from this region, including customs tariffs from the Bosaso port. Puntland is still issuing visas to international visitors. The borders of Puntland State are not yet clear and may have to await the determination of the newly formed Boundaries and Federation Commission and the Federal Parliament. In addition to the long standing dispute between Somaliland and Puntland in the north, new border tensions have emerged following the constitution of the newly formed Interim Galmudug Administration.

20 Article 142 of the Constitution on Existing Federal Member States in Somalia includes a provision that "(1) Until such time that all the Federal Member States of Somalia are established and the adopted Federal Member State Constitutions are harmonized with the Somali Federal Constitution, the Federal Member States existing prior to the provisional adoption of this Provisional Constitution by a National Constituent Assembly shall retain and exercise powers endowed by their own State Constitution." In theory, the provisions of the Constitution on preexisting states also apply to Somaliland, but in practice this is not relevant since Somaliland does not consider itself part of the federal state system.

21 Somaliland also claims Sool, Sanaag, and Ayn (part of Togdheer).

22 Following the agreement, the process of forming a viable state has been ongoing; the final step of constituting a parliament was completed in May 2015, although a reconciliation process to bring along unhappy clans still needs to continue.

23 Somaliland is not part of the state-formation process, as it does not consider itself part of Somalia. However, separate tentative discussions of the status of Somaliland and its future as a separate state or part of Somalia are underway.

State/entity	Regions	Comments
Interim Jubba Administration	Gedo, Lower Jubba, and Middle Jubba	On August 28, 2013, the FGS and representatives of the de facto administration of Kismayo (the capital city of this region) signed an agreement to create an Interim Jubba Administration (Jubbaland) for two years. The new administration has established government structures and inaugurated a regional assembly on May 7 2015. On May 19, 2015, 40 members of Parliament tabled a motion in the Federal Parliament opposing the inauguration of the IJA Regional Assembly. Their actions prompted protests in several towns in Lower Jubba. The process of completing the formation of this potential FMS is under way.
Interim South West Administration	Bay, Bakool, and Lower Shabelle	After protracted negotiations supported and at times mediated by the FGS, on November 8, 2014 representative of these regions agreed to form a new interim FMS. A state formation conference was due to be held in June, but was postponed because of disagreement on contentious clauses in the provisional state constitution that had been adopted in 2014.A conference in Baidoa to select assembly members was meant to begin in late May 2015, but at October the formation of the Interim South West Parliament was still pending.
Interim Galmudug Administration	South Mudug and Galgaduud	An agreement was signed in July 2014 to begin the process of forming an interim administration for central Somalia.On April 16, 2015, the conference to form an interim Central State opened in Adaado, in the presence of the president of Somalia.The process of forming an interim administration for this state wascompleted in July 2015, with the adoption of a new state constitution (following a consultation process and revisions by a Technical Committee), selection of members of Parliament, and the election of a president and a vice president. The newly elected president indicated his willingness to discuss concerns expressed by Puntland relating to the borders of the new FMS.
Hiiran and Middle Shebelle	Hiiraan and Middle Shabelle	A reconciliation conference was held at Beledweyne, at which a peace agreement was reached on May 6, 2015, following intense fighting between clans in the region. The reconciliation conference was extended in mid-June to accommodate grievances by some groups. A state consisting of Hiiraan and Middle Shebelle is expected to be formed before the end of 2015.
Benadir Region	Capital city	The Provisional Constitution directs that the status of the capital city be determined by the constitutional review process and a special law enacted by the two houses of Somalia's Federal Parliament. Discussion is also underway regarding whether the Benadir region, regardless of its status as the capital city, should be treated as a region like any of the 18 other pre-1991 regions. If this view prevails, the region could potentially join neighboring regions to form part of a new FMS. This argument considers the location of the capital city as separate from the fate of the Benadir region. For now, the FGS appoints the governor and all senior officials of this region as well as all district commissioners. This arrangement many change once the legal status of the city is determined.

Note: Information is current as ofmid-October 2015.

A number of important steps in the process of forming the FGS cannot be completed until all FMSs have been formed. All FMSs need to be in place before constitutional negotiations can begin, because they are the counterparts to the FGS in the constitutional negotiations as representatives of the wishes and aspiration of the people they represent. The Upper Chamber of Parliament (Senate) cannot be established until the states have formed, as this chamber is expected to represent the interests of the states. The Senate plays a central role in amending and ratifying the Provisional Constitution. States are also needed to form several constitutionally required commissions, membership of which is constituted by state-appointed representatives. One of these commissions is the Interstate Commission, which has a mandate to promote cooperative federalism by coordinating activities and resolving disputes between the FGS and the FMSs.

Nascent and sometimes difficult relations between new entities will make the federal project challenging. Many years without an effective and legitimate state have undermined trust in the concept of central government. However, the creation of a well-functioning federal system will also confront the challenge of accommodating minority interests within FMSs that may be dominated by members of one community. Most FMSs are likely to include communities with a history of rivalry. Development of inclusive forms of governance within each state will be as crucial for lasting peace as the development of the relationship among levels of government.

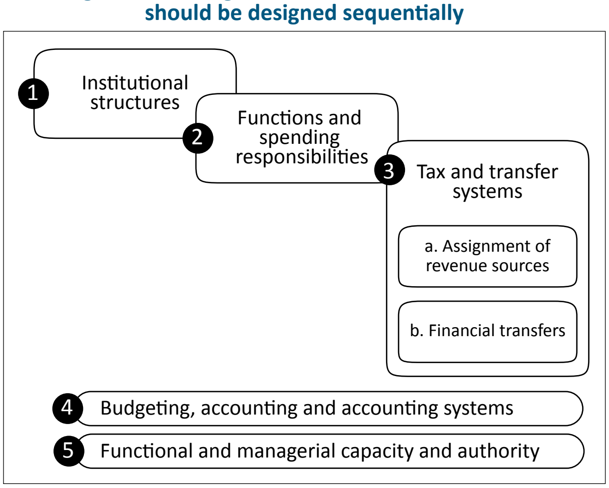
As FMSs are forming, they are establishing interim systems of revenue generation and service provision, even though the design of these arrangements is intended to be part of the constitutional negotiations. In Puntland's case, these arrangements have been in place since 1998. On the one hand, deferring negotiation of the federal state until the states have formed is fair, as it prevents states that form earliest from exerting unfair influence over the design process. On the other hand, the longer the state-formation process takes, the more entrenched systems of de facto intergovernmental fiscal relations are likely to become. The next section examines the facto arrangements that are emerging and how they are likely to influence the options available to Somali constitutional architects.

8. Designing Intergovernmental Financing Arrangements for Somalia

All intergovernmental financing systems incorporate two basic components: the distribution of spending responsibilities and the tax and transfer system that finances them.[24] These components rest on a foundation of institutional arrangements (the political and power relationships inherent in the design of government structures). They are implemented through budgeting and accounting arrangements and the functional and managerial capacity of public servants at all levels of government.

In an ideal world, these components would be designed in sequence, so that "funding can follow function." Figure 8.1 depicts the sequence of designing these components. Of course, the real world rarely presents the opportunity to design these arrangements sequentially, but the ideal sequencing helps reinforce an important principle that the distribution of spending responsibilities (also referred to as "expenditure assignments") and the design of the tax and transfer system are two halves of a system that must function as efficiently as possible in order to deliver services effectively. These components need to be designed, or retrofitted, to operate as a single system.

Figure 8.1: Intergovernmental fiscal architecture should be designed sequentially



Source: Adapted from Dafflon, 2014

In fragile and conflict-affected states, the design of intergovernmental fiscal relations rarely, if ever, follows a linear path. A recent study of intergovernmental fiscal relations in post conflict states summarizes insights from international experience (Frank, Elin, and Vaillan court 2014). It suggests there are several decision-making areas in which different intergovernmental stakeholders will likely continue to struggle for ownership. On the expenditure side, they mainly concern human resources and public investment. On the revenue side, they relate to taxes, transfers, and natural resources. Any of these areas can be a starting point from which to build and strengthen intergovernmental relations. While decisions on revenue might precede assignment of responsibilities, over time the aim should be to bring these different areas of decision making into line. Fiscal conflict is a feature of any multilevel government system; the mechanisms for intergovernmental fiscal coordination need to be robust enough to prevent new conflicts from emerging. It is also likely that the interests, incentives, and power of stakeholders will change over time. Fiscal arrangements are more likely to evolve in line with these changes if designed with flexibility. Robust intergovernmental negotiation mechanisms are therefore critical.

Unpacking these components into their constitutent elements can help focus stakeholders on options and their implications. At the same time, Somalia's intergovernmental fiscal arrangements will build on what is already in place. This section examines the choices involved in designing the distribution of functions and spending responsibilities and the design of the tax and transfer system. It then explores how a de facto architecture of functional and revenue assignments is emerging as FMSs form. Although these arrangements are not part of a formal bargain

[24] The terms intergovernmental fiscal relations, intergovernmental financing arrangements, and fiscal architecture are used interchangeably in the following discussion.

among stakeholders, they very likely affect what it is possible to negotiate, given that any change from the status quo will involve winners and losers. The scope for accommodating different interests is then explored through a case study of functional assignment and revenue sharing in the oil and gas sector, an area of special interest to Somali stakeholders. This section concludes with a discussion of two considerations that are likely to shape the choices open to Somali stakeholders as they turn to the detailed design of their new system.

8.1 Functions and Spending Responsibilities: The Theory

Federal constitutions typically specify the distribution of law-making power among levels of government. In countries where subnational autonomy is highly valued (such as Australia and the United States), the powers of the center are specified and residual powers lie with the states. In other systems (such as Canada), the powers of the states are specified and residual powers lie with the federal government. A third model (which Kenya and South Africa have adopted)is to list the powers of each level, including areas in which both levels can make laws. An important question is whether the central government will have the power to spend money in areas where it does not have constitutional authority to make laws. Provisions of this kind, known as "spending power," provide a legal anchor for spending in areas not constitutionally delegated to the federal government.

Beyond law-making power, different levels of government must reach agreement on the assignment of spending responsibilities—who does what—usually at a much finer level of detail. "Unbundling" can be a useful way to reach agreement on the assignment of spending responsibilities. It involves disaggregating a function according to its component parts, covering, for example, the setting of policy; the imposition of regulations or standards in the sector; the actual production of the service (staff, operational funding); the provision of capital infrastructure; and monitoring and evaluation. Even before the Constitution is finalized, it may be useful to establish technical sector committees to begin unbundling functions (see Box 8.1 for suggested terms of reference).

>> Box 8.1: A technical committee could help unbundle shared functions using the following terms of reference

1. Analyze how functions are currently being performed.
2. Explore how those arrangements might change under a more efficient and effective set of delivery arrangements.
3. Identify areas where ongoing coordination between levels of government will be needed and what processes and procedures should be put in place to ensure it happens.
4. Identify the budgetary implications of different models of function assignment.
5. Isolate any contentious areas that should be referred to the political level for debate and decision.

There is no one correct assignment of functions, but some functions are almost always assigned to the national level. They include defense, foreign affairs, and management of the economy, which Somalia's Provisional Constitution assigns to the federal level (see Annex A). A small number of functions (such as garbage collection) are almost always local. In between lies a wide range of variation, with both states and federal governments playing some role in most functions. It is increasingly common for responsibilities to be shared across all levels of government. Table 8.1 shows the assignments for three federal countries (Brazil, Mexico, and Canada) and two constitutionally decentralized unitary states (Kenya and South Africa).

Table 8.1: Assignment of Responsibilities in Five Countries

Responsibility	Brazil	Mexico	Canada	South Africa	Kenya
Defense, foreign affairs, trade	F	F	F	F	F
Post and telecommunications	F	F		F	F
Monetary policy, currency, banking, fiscal policy	F	F	F	F	F
Water resource management and airports	F, S, L	F, S, L	F,S,L	F	F
Pensions and social security payments	F	F	F, S	F, S	F
Immigration	F	F	F, S	F	F
Environment	—	—	F, S, L	F, S	F, S
Land use planning, licensing of building construction, residential occupancy permits, local markets	F, S, L	F, S	S, L	F, S, L	S
Primary education	L	F, S	S, L	F, S	F, S
Secondary education	S	F, S	S, L	F, S	F
Health, dispensaries, local hospitals	F, S, L	F, S	S, L	F, S	S
Community fire protection	—	—	S	L	S
Water supply and distribution	F, S, L	S, L	—	L	S
Interstate roads	F, S	F, S	—	F	F
Local roads	S, L	FS, L	—	S, L	S

Source: Adapted from Bergman, Ebel, and Frank 2013. Information on Kenya and South Africa comes from their constitutions.
Note: F = federal, S = state, L = local/municipal. — = Not available.
a. Kenya has only two levels of government.

The "subsidiarity principle" informs decisions about which level of government should perform what function. It holds that the lowest level of government that is capable of performing a function should carry it out. Subsidiarity helps increase responsiveness and accountability to local citizens and enables government to better reflect local preferences. Article 50 of the Provisional Constitution recognizes this principle (see Annex A).

Other considerations suggest that functions should be carried out at the central level. They include externalities (a situation in which the activities of one state affect citizens in another), economies of scale, efficiency, and weak subnational capacity. Table 8.2 shows a theoretical assignment of responsibilities for education. The functions it identifies can be assigned in many different ways; what works best differs across countries. The point of this example is to show how unbundling works, not to suggest what components should be vested in a specific level of government.

Table 8.2: Unbundling the education function: Theoretical assignment of responsibilities across levels of Government

Area	Selection of function "components"	National	State/local
Policy making	Universal access	✓	✓
	Retention of women and girls	✓	✓
	Hours of schooling	✓	✓
	Design of school buildings		✓
	Religious education		✓
	Use of vernacular in early grades		
Standard setting	Curriculum and qualifications	✓	✓
	Accounting standards for schools		
Regulation	Teacher accreditation	✓	✓
	School governance arrangements		
Service delivery	Payment of teachers	✓	✓
	Administration of school operating grants	✓	✓
	Supervision and inspection	✓	✓
	Support and training for facility committees		✓
	Execution of capital projects		
Procurement	Purchase of school books	✓	✓
	Capital investment (classrooms)		✓
Monitoring	Setting of performance standards	✓	✓
	Accountability for use of funds	✓	
	Education information systems	✓	

Source: World Bank staff analysis.

8.2 Functions and Spending Responsibilities: Current Practice in Somalia

De facto expenditure assignments in Somalia are characterized by concurrency—that is, both levels of government perform the same functions but in relation to different regions. In some respects these expenditure responsibilities are aspirational rather than real, as limited fiscal capacity means that most government entities exercise only some of their potential spending responsibilities.

In many countries, the assignment of functions is dynamic. Functions often shift between levels of government depending on the changing balance between demands for autonomy and responsiveness and the desire of central government for nationally consistent policy or in response to concerns about state government capacity to deliver. While the Constitution will need to specify how law-making powers are distributed between levels of government, it could be less specific about functional responsibilities. Law-making powers do not always coincide with service delivery responsibilities, but a particular government passing laws on an issue is usually a good indication that it controls policy on the area as well.

Actual practice does not yet reflect that the Constitution reserves four functions to the federal government (foreign affairs, national defense, citizenship and immigration, and monetary policy). The government of Puntland still issues visas to foreigners travelling from abroad, however, even if they hold a visa issued by the FGS.

Two aspects of functional assignment—efficiency and duplication—merit consideration in the constitutional design process. Somalia is a small country with very low GDP. It cannot afford to assign functions in a way that involves duplication of effort by multiple governments. Somalia's emerging FMSs are at very different stages of development. Administrations that are just forming in areas previously not under government control will be in a very different position to deliver services than Puntland, which has a longer history of administration than the federal government. Some form of asymmetry—where some states have more functions than others—may be appropriate at first. In Kenya the transitional 2010 Constitution provided for functions to be assigned only once counties developed the capacity to manage them. However, the distribution of revenue bases may determine whether an asymmetric arrangement is feasible. Unless the FGS controls significant revenues and can provide transfers to states that have more functions, an asymmetric distribution of functions will not be feasible.

It makes sense to concentrate first on the functions that cost the most. In this respect, the function that deserves the greatest attention is the security sector. Almost 30 percent of total expenditure in Somalia goes to the security sector, a larger share than in any other fragile state other than Afghanistan. Assignment of security sector expenditures should therefore form a starting point for considering how to assign tax bases, in order to ensure that the level of government which is responsible for security expenditures has the fiscal capacity to meet them. Conversely, it is unlikely that any of the existing tax bases can be reallocated to another level of government without transferring some or all of this important cost responsibility.

8.3 Assignment of Revenues: The Theory

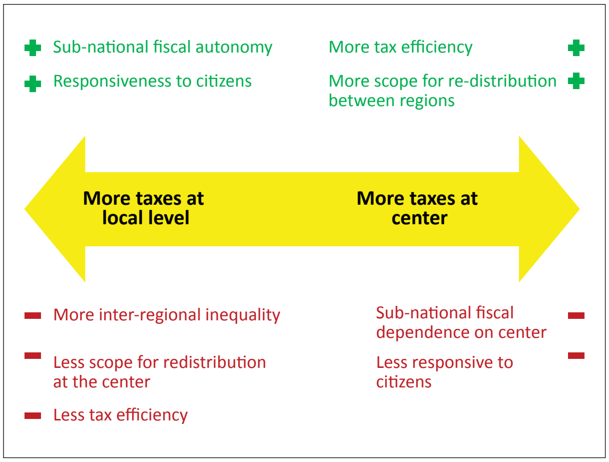
When designing a tax and transfer system, the first question to consider is how tax bases should be assigned to each level of government. Some federal constitutions empower both levels of government to tax the same bases (concurrent taxing power). Others assign tax bases to different levels. A third, less common, option is to assign tax bases according to the type of taxpayer (Ethiopia uses this system).[25] The policy decisions that follow depend on which option is selected. If both levels of government share taxing powers, decisions must be made about what proportion of the available tax room each level will collect. If taxing powers are divided, the main questions are about which tax bases should be given to which level of government. Some economic and efficiency considerations inform allocation of taxing powers among levels of government. But it is also important to ensure that subcentral governments have control over a substantial portion of their revenues, to promote accountability to citizens/taxpayers and discourage wasteful spending. And unless the central government has substantial revenue powers, there will be limited capacity to equalize differences across regions through central to state transfers.

Who administers taxes is a separate question from who controls revenues. Tax administration options include (a) having national agencies collect some or all taxes on behalf of subnational governments (as Canada, Germany, and Uganda do), an approach that is particularly useful where two levels of government share a specific tax base;[26] (b) having separate tax administrations (which may be inefficient, costly, and often not workable where local capacity is low); and (c) having subnational governments collect some national taxes collected for the center. Different approaches could conceivably be adopted for different FMSs. All revenue assignment decisions involve trade-offs (Figure 8.2).

25 Ethiopia divides taxes based on the nature of the taxpayer. Because the private sector is relatively small, much of its tax revenues come from taxing public servants and publicly owned enterprises. Federal public servants and companies pay tax to the federal government, while taxes on state employees and companies go to state governments.

26 The federal government of Canada collects personal income tax on behalf of all provinces and territories except Quebec and corporate income tax on behalf of all provinces and territories except Quebec and Alberta.

Figure 8.2: Assignment of revenue powers to different levels of government involves trade-offs



Source: World Bank staff

8.4 Assignment of Revenues: Current Practice in Somalia

The Provisional Constitution does not assign revenue bases to different levels of government. Article 50(f) stipulates that revenue-raising responsibilities should be given to the level of government that can exercise that responsibility most effectively. In the spirit of cooperative federalism, this division is to be determined through negotiations. The Provincial Constitution also invests the Federal Parliament with responsibility for establishing national treasury laws that, among other things, "determine legitimate revenue collection and expenditure disbursement relating to institutions at all levels within the Federal Republic of Somalia." (Relevant articles of the Provisional Constitution are in Annex A).

The tax bases in use are divided across levels of government on a geographic basis, with the FGS collecting taxes from the Mogadishu region (and sharing a proportion with the Benadir capital region) and Puntland and Somaliland collecting taxes within their geographic boundaries (Table 8.3). The newer states are still developing their revenue raising capacity, but it seems likely that they will follow the same pattern. Some taxes are not yet being collected by any level of government, and some tax bases are with municipal governments (Table 8.3).

Table 8.3: Distribution of tax bases in Somalia[27]

Type of tax	Federal Government of Somalia (Mogadishu)	Somaliland	Puntland
Customs duty	✓	✓	✓
Sales tax		✓	✓
Telecoms charges	✓	✓	✓
Corporate income tax	✓	✓	✓
Turnover tax	✓	✓	✓
Personal income tax (public sector)	✓	✓	✓
Personal income tax (private sector)	✓		✓
Land/property taxes		✓	✓
Stamp duty	✓	✓	✓
Vehicle taxes	✓	✓	✓
Business taxes			
Departure/ visa fees	✓	✓	✓
Airport/harbor fees and charges	✓	✓	✓
Administrative fees	✓	✓	✓

Note: For Somaliland and Puntland, lower levels of government are included.

27 The table sets out a presumed allocation based on the types of taxes currently being raised, or planned to be raised. In practice no level of government is fully exercising these tax bases presently.

Both the FGS and the FMSs are heavily dependent on taxes on trade levied at ports. In 2013, 68 percent of Puntland's revenues came from customs and related taxes, 90 percent of which were export and import taxes.[28] Eighty-three percent of its revenue was generated in the region of Bari, where the port city of Bosaso is located. In the FGS, customs duties and related international taxes generated from the Mogadishu port and airport generated 78 percent of total revenue in 2013.

The heavy reliance on taxes levied at a border point is not unusual for a tax system that is at an early stage of development, as these taxes readily lend themselves to collection at physical checkpoints. Other taxes, such as income tax, require more sophisticated systems and much greater voluntary cooperation by taxpayers. Neither level of government in Somalia has been successful in exploiting other core taxes, such as personal or corporate income tax. The FGS, for example, collects personal income tax only from public servants. Personal income tax generates less than 4 percent of total income tax in Puntland (see Annex B). In the first ever budget of Interim Jubba Administration, which covers the six months from June to December 2014, port revenues account for 76 percent of domestic revenues and 48 percent of total revenues.

8.5 Transfers: The Theory

The second dimension of designing a tax and transfer system is addressing fiscal imbalances between among levels of government and subnational units. Depending on how tax revenues are assigned, one or another level of government will have more (or less) resources than needed to meet its assigned spending responsibilities. In both developing and developed countries, tax revenues are generally skewed toward the central government, giving rise to vertical fiscal imbalance (the central government has more revenues than it needs). In most countries, revenues are inequitably distributed across regions (horizontal fiscal imbalance).

Inequity in the distribution of resources across regions is a primary cause of conflict; addressing inequity is a central concern of intergovernmental fiscal relations. There are two broad models through which equity can be improved. Under the first model, the federal government is assigned sufficient tax bases so that it has excess revenue, which it uses to subsidize states with lower fiscal capacity using intergovernmental transfers. Under the second approach, states with more resources share them with less well-off states. This approach, which is less common than the first, is described as a "fraternal" system, because transfers are horizontal (among states) rather than from the top down (although the central government still plays a strong role in administering transfers). Box 8.2 describes some examples of fraternal transfer systems.

Design of a classic top-down transfer mechanism involves two sets of decisions. The first is how much revenue should be shared between levels of government. Sharing between among levels of government can take the form of a percentage of all or most national revenues (Kenya, Nigeria, the Philippines) or the allocation of specific types of revenue (Australia, Indonesia, India). Some systems combine both approaches. In more centralized countries, the central parliament may determine how intergovernmental transfers are made on an ad hoc way basis, sometimes with the advice of an independent body. The second decision is how to share revenues among states, regions, or provinces. This step addresses the problem of horizontal fiscal imbalance. One approach is to share revenues on a derivation basis, which means that revenues go back to the region or state that generated them. A derivation approach is often used for sharing a proportion of natural resource revenues with the producing region. Derivation-based sharing does not address horizontal fiscal imbalance, however—in fact, it often makes the problem worse. States with more robust tax bases receive more revenue than states with weak revenue bases. A second approach is to distribute grants or revenue shares

[28] Total revenues do not include off-budget revenues and surcharges that are not appropriated.

>> Box 8.2: Chile and Germany have fraternal intergovernmental transfer systems

In fraternal intergovernmental transfer systems, better-off subnational governments share resources with governments that are less well-off. Fraternal systems are supposed to promote national unity, because citizens whose governments receive transfers can see that citizens from other regions have given something up to help them. They can be difficult to enforce, however, and in the situations described below the inter-regional transfers are enforced through strong discipline from central government.

Chile's Municipal Common Fund

Municipalities are the third level of decentralized government in Chile. Because of the tax bases assigned to them, they have more fiscal autonomy than provinces. There is a wide disparity between rich and poor municipalities. Three-quarters of municipalities rely on transfers for more than 80 percent of their revenue.

To reduce disparities, the government created a system in which municipalities contribute 60 percent of their property taxes (65 percent in the four richest municipalities) and 50 percent of their vehicle taxes (most of which come from the wealthier municipalities) to the Fondo Común Municipal (Municipal Common Fund). The four wealthiest municipalities also contribute a proportion of the commercial taxes they raise. The proceeds of the fund are distributed according to a formula that is based on equal shares, poverty, tax-exempt land in the municipal area, and per capita revenues from other sources.

Germany's Solidarity Pacts

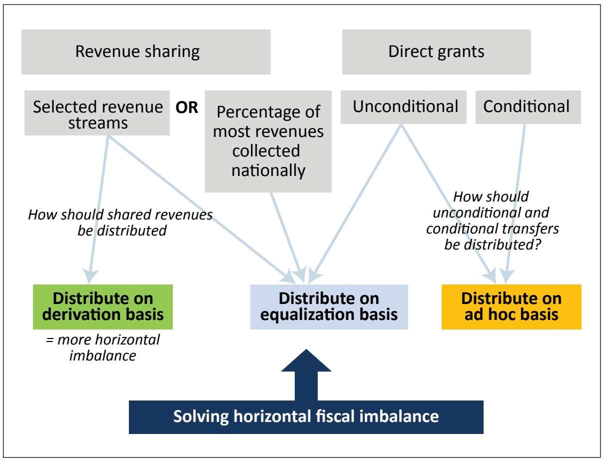
Following the reunification of East and West Germany, the six newly incorporated states in eastern Germany had significantly lower revenue-raising capacity than western Germany. Because Germany's constitution mandates the sharing of taxes, there was limited capacity to address this inequality through top-down fiscal transfers. Instead, the presidents of the states (*lander*) and the federal government agreed on a "solidarity pact."

The first pact was negotiated in 1995; the second came into force in 2005. Both pacts provide for states with the greatest fiscal capacity to share some of their revenue from tax sharing with the poorer states. The states contribute to the equalization pool on a graduated scale, with states most above the national average contributing the most. The federal government also contributes to the fiscal equalization pool and provides support to the economies of poorer states in a variety of ways.

Source: Boadway and Shah 2007; OECD 2008.

on an equalization basis. The objective of this method is to give all subnational governments an equivalent fiscal capacity to deliver a similar level of public services. A third approach is to allocate grants on a variety of other bases. Under this approach grants can reflect sector-specific needs, be determined by Parliament, reflect performance, match an amount contributed by a subnational government, or be based on other methods not clearly related to either equalization or derivation (Figure 8.3).

Figure 8.3: Allocation across sub-national units can help solve inequity between them, or make it worse



Source: World Bank staff

[30] Since natural resources are often located in remove regions, derivation-based sharing of natural resource revenues may have immediate appeal as a way of compensating for the economic disadvantage otherwise experienced by that region. International experience, for example in Indonesia (Papua and West Papua) and Papua New Guinea (Southern Highlands) is that these regions end up with far more discretionary resources than the rest of the country, but much less capacity to spend it effectively.

8.6 Addressing Interregional Inequity Through Transfers: Scope to Apply theory to Practice in Somalia

Dependence on port revenues means that in the near term, the emerging fiscal architecture of Somalia is likely to be highly inequitable, because not all states have significant ports. Puntland has the port of Bosaso, and Jubbaland captures revenue from the port of Kismayo. FGS revenues come mainly from the Mogadishu port; 15 percent of these revenues is shared with Benadir, the capital region.[30] In contrast, the newly established Interim South West Administration and Interim Galmudug Administration, along with the as yet undetermined state in Hiiraan and Shebelle, lack access to an established port.

Even once other tax bases are more effectively mobilized, the revenue-raising capacity of states is likely to differ widely. Interregional fiscal inequity resulting from uneven endowments of economic geography is a feature of many countries. Few have had much success in overcoming these natural limitations through interregional economic convergence. Urbanization is another factor that is likely to influence revenue potential. In addition to the capital city region of Benadir, Puntland is already quite urbanized, whereas Jubbaland and South West State remain mainly rural (Table 8.4). For this reason, addressing interregional inequity through a system of horizontal fiscal equalization will be a key objectives for the intergovernmental financing system in Somalia, as it is in most countries.

The most obvious solution to interregional inequity—transfers from the federal government to the poorer states—would require more tax bases to be assigned to the federal level. In most federal systems, tax bases are divided between levels of government either by virtue of the Constitution or by agreement.[31] Customs revenue is almost always a national-level tax. The simultaneous dependence on customs revenue by both federal and state governments in Somalia not only skews resource availability between regions, it also restricts the capacity of the federal government to equalize these imbalances through transfers to poorer states.

Under current fiscal arrangements, the FGS has no capacity to finance transfers to states with lower revenue capacity, because its own revenues are insufficient. The FGS cannot meet the basic operations of government and salaries of employees from its current revenues. In 2013 it spent $106 million on civil service wages and government operations, well in excess of its own-source revenues. Without international grants, the government would not have been able to cover these basic expenditures.

In the short term, the most likely way for the FGS to fund transfers would be for the states to hand over some of the revenue bases they control to the center, which would then redistribute them. Increasing FGS revenue by reducing revenue leakage, better mobilizing the bases, and using more effective tax instruments (such as ad valorem customs duties) will take time, and such measures are unlikely to yield the kind of revenue increases that are needed to fund an intergovernmental transfer system. Another option would be for FGS to be assigned emerging new revenue bases. For example, the telecoms sector is generally regulated by the centre in many federations including the highly devolved federal system of the United Arab Emirates. However, it will be challenging for the states to cede revenue bases to the FGS unless they can also hand off some expenditures. The only state for which there is a reasonable time series of data is Puntland.[32] As of December 2014, it had accumulated $24.9 million in arrears, more than 60 percent of its annual revenue in 2013.

30 Residents of other states, who pay higher prices for the goods they consume, bear part of the burden of these taxes.
31 In some countries, two levels of government share larger tax bases, such as income tax or VAT, but this mechanism involves complex negotiations to ensure that the overall level of tax is appropriate and does not discourage economic activity.
32 The first budget of the Interim Jubba Administration, which covered the last six months of 2014, did not include revenue from the port of Kismayo.

Table 8.4: Population and economic base of Somalia's Regions

Regions	Population estimates	Economic Base
Somaliland	Estimated population is 2.6–3.5 million. About 50–60 percent live in urban areas, 25–35 percent are nomadic, 10–15 live in settled rural areas, and less than 3 percent are internally displaced persons (IDPs).	Trade and livestock are the two dominant sectors of the economy. Fisheries and agriculture make smaller contributions. Hargeisa is a government town with a large number of public servants. Berbera, the second largest port in Somalia, is the business and trade center. Trade with Ethiopia and Djibouti is an important economic driver and source of revenue.
Puntland	Estimated population is 1.6–2.3 million. About 50 percent live in urban areas, 30–40 percent are nomadic, 10 percent live in settled rural areas, and 5 percent are IDPs. (These population estimates do not reflect the border disputes in the north and south of Puntland.)	The traditional economic bases of Puntland are livestock and fisheries (primarily for exports). Some commercial agriculture, mostly rain-fed farming, exists, but it is very minor. During the civil war years, trade through the port of Bosaso and the inland town of Galkayo, including with southern Somalia and the Somali region of Ethiopia, flourished.
Jubbaland (Interim Jubba Administration) Regions: Gedo, Lower Jubba, and Middle Jubba	Estimated population is about 1.3–1.4 million. About 35 percent live in settled rural areas, 30 percent are nomadic, 25 percent live in urban areas, and about 10 percent are IDPs.	Livestock is the most important sector of Gedo, which also has some agriculture. Agricultural areas are under the control of Al-Shabaab. Gedo has boundaries with both Ethiopia and Kenya and is an important trade transit point between Kenya and Somalia. In Lower Jubba crop production along the banks of the Jubba River is the main driver of economy. Al-Shabaab controls some of agricultural areas of this region, which limits the potential of commercial farming. The two major rivers in Somalia meet in Middle Jubba and join the sea in Lower Jubba. The Jubba river traverses all three regions of Jubbaland. Livestock plays an important role in the economies of all three regions that constitute Jubbaland. Fisheries was an important sector in the past. Both the Middle and Lower Jubba have long coasts. Kismayo, the capital of the Lower Jubbaregion, has a large international port. Charcoal trade, which is currently banned, has been a source of revenue for various groups, including Al-Shabaab, that at one time or another controlled the region.
South West State(Interim South West Administration):Bay, Bakool, and Lower Shebelle	Estimated population is about 2.3–2.4 million. About 60 percent live in settled rural areas, 20 percent are nomadic, 15 percent live inurban areas, and 10 percent are IDPs.	Bay depends mainly on subsistence rain-fed farming and livestock. Bakool's economy depends largely on livestock. Historically, Lower Shebelle was part of the breadbasket belt of Somalia and a major contributor of export crops. Crop production declined significantly because large export-oriented firms and irrigation systems are no longer operational, however, as a result of prolonged conflict have displaced farming communities who were generally unarmed. Crop production and some fisheries now drive the economy.

Regions	Population estimates	Economic Base
Interim Galmudug Administratio): Galgaduud and half of Mudug , IWhether Mudug region as a whole or and only half will form part of Galmudug is yet to be settled.	Estimated population is just under 1 million. Almost 40 percentlive in urban areas, about a third are nomadic,15 percent are IDPs, and about 10 percent live in settled rural areas. (These population estimates do not include the areas that are disputed with Puntland.)	The economy is based largely on livestock. Potential exists for artisan fisheries potential in both regions, Galgaduud and at least half of Mudug, together constitute Galmudug State but without a good port the contribution by the fisheries sector in the economy is limited. Lower Shebelle borders Mogadishu, the seat of the federal government and the commercial capital of the country, where 13% of Somalia's population lives. This gives the region easy access to a large market.
Undetermined (Hiiraan, Middle Shebelle)	Estimated population is about 1 million. About 35 percent live in settled rural areas, almost 35 percent are nomadic, just under 20 percent live in urban areas, and 10 percent are IDPs.	Crop production is the most important driver of the economy. The Shebelle River (one of two major rivers in Somalia) cuts across both regions. Middle Shebelle has access to the sea while Hiiraan is land locked. Middle Shebelle also borders Mogadishu.
Benadir Region: Capital city	Estimated population is 1.4 -1.6 million, more than two-thirds of whom live in urban areas. A little more than 20 percent are IDPs. About one-third of Somalia's IDP population lives in Mogadishu.	Mogadishu is the commercial and service capital of Somalia and the country's largest port. The largest businesses and traders are based in the capital. Despite insecurity, Mogadishu has retained its dominance. Mogadishu used to be industrial base of Somalia, but almost all industrial infrastructure has been destroyed.

Source: Data from UNFPA 2014.
Note: Population figures should be treated with caution, as doubts have been expressed about the validity of aggregate numbers given the implied annual growth rate.

A number of recent political decisions may result in the handover of expenditures to the FGS without the accompanying handover of revenues. The FGS is already under severe fiscal stress, with estimated arrears in excess of $45 million and a structural budget deficit, according to IMF estimates.[33] Despite this situation, on May 12, 2015, Somalia's president launched the Commission on Regional Militia Integration, whose terms of reference indicate that it "shall ask the Ministry of Defense for any fund and need based on the laid down plan and the allocated budget." The roles and responsibilities of the Ministry of Finance need to be clarified. Decisions regarding the integration of the militia are already being made at a political level.[34] For these agreements to be meaningful and to hold, affordability questions need to be discussed in relation to revenue assignments.

Agreements about the transfer of functions should be meaningful, and followed through by implementation. Questions of affordability should be central in these negotiations, to ensure the deals are fiscally feasible. It does not serve much purpose for the federal government to agree to assume responsibility for functions if it cannot afford to pay for them in the long run. A number of intergovernmental agreements about the sharing of functions and funding have been agreed but not implemented. Reaching agreements but not honoring them if they are not implementable will do more harm than good. Following through on agreements is crucial in the current context, since the development of trust between intergovernmental stakeholders will be fundamental to successful evolution of the fiscal arrangements.

33 The stock of arrears has grown significantly since 1 January 2015 when it was estimated by the IMF.

34 One example is the agreement in May 2015 at the Garowe Leadership Forum to accommodate 3,000 additional forces from Puntland into the Somali National Army (RBC Radio 2015).

In the absence of support from fiscal transfers, emerging states may erect domestic trade barriers as a way of capturing revenue as goods cross their borders. Domestic trade taxes (called octroi in Ethiopia and India) are an attractive tax base for subnational governments, because they are relatively easy to levy at checkpoints. These taxes have two important drawbacks, however. One is that they are prone to leakage, because payments are often collected in cash. An equally important concern is that they erect domestic barriers to trade. Somalia cannot afford to create disincentives to economic activity. However, unless a solution can be found—most likely in the form of equalizing transfers—it seems inevitable that fiscally challenged emerging states will seek to exploit whatever tax bases they can. Neighboring South Sudan experienced a similar problem of managing the emergence of informal subnational taxation through checkpoints and taxes on goods. Its experience may prove useful for Somalia.

If a top-down transfer system is not fiscally feasible in the short term, fraternal (state-to-state) transfers may be an option.[35] If states are not willing to give up revenue bases, at least initially, a system in which better-off states transfer some of their resources to states with less access to revenue may make sense (see Box 8.2). The success of such a system depends on strong trust and goodwill among the emerging FMSs.

8.7 Case Study of Oil and Gas

Management of oil and gas raises an important and immediate question of functional assignment and revenue that puts the framework set out above in a practical context. Currently, multiple levels of government in Somalia claim the right to regulate oil and gas concessions, creating an environment of confusion. Lack of agreement over who is in control heightens the risk that oil and gas revenues may stimulate interregional conflict and reduce the potential revenues extractable from these resources.

Internationally, there are many different variations in the ways in which ownership, control, and revenue entitlement are configured—but very few examples of joint management by two levels of government. Among developing countries that produce oil, there are no examples of subnational control and management. Although joint management is not out of the question, it raises considerations that need careful thought, including the risks and inefficiencies associated with politicized or complicated multilevel negotiation and approval processes. Issues of revenue sharing could be separated from questions of control and management. Management of the resource does not necessarily carry an entitlement to the revenues accruing from it.

Revenue arrangements for oil, gas, and other natural resources are a subset of the broader design of the tax and transfer system. Decisions concern how much to allocate to producing regions and how much to allow the central government to manage on behalf of the country as a whole. Oil and gas revenues in Somalia are likely to be at least 10–15 years away, but a decision on revenue sharing should be made before commercial discoveries are made, to minimize the risk of violent conflict over disputed resources. The level of government that manages the resource need not capture all the revenues.

Several factors should be considered in determining the allocation of revenues. They include the significance of the revenues for the economy and for government revenue, the volatile and nonrenewable nature of natural resource revenues and the impact of those characteristics on subnational governments' fiscal management, and the potential to create significant interregional inequity if revenues are unevenly distributed. Oil revenues often come from regions that are poorly developed; derivation-based transfers can significantly change the fiscal balance. In Nigeria, for example, the region with the highest per capita transfers receives more than 10 times the per capita

35 Another option, not discussed here, is a donor-funded, government-implemented transfer scheme.

revenues of the poorest region. For this reason, arrangements for sharing resource revenues should be considered as part of the overall design of revenue-sharing arrangements.

A further question is whether producing states should reap a net fiscal benefit if some revenues are shared with producing states. Revenue from oil and gas can be captured in different forms, including royalties, payments from state-owned oil companies, license and land use fees, export taxes, and special corporate income taxes. If the formula for allocating equalization transfers reduces the amount a particular government receives based on its revenues from other sources, then any revenues from oil and gas will be "netted off," so that the net fiscal benefit may be zero. Oil, gas, and mining revenues are treated this way in a number of countries, including Australia, Canada, and Indonesia.

8.8 Conclusion: Choices and Options

The emerging de facto fiscal architecture is likely to be important in shaping what is possible in the design of the new system. Providing access to similar levels to services across the country will be possible only if there is pooling of some significant revenue sources—either by putting revenues in the hands of the federal government or by striking an intergovernmental bargain among the states to share revenues. Where a country starts from exerts a powerful influence over what options are feasible or realistic in the short term. The fiscal arrangements embedded in the Final Constitution should be designed so that it is clear how the current de facto architecture will change to make way for the new constitutional arrangements. If the changes from current to new arrangements are substantial, a phased approach may be needed.

These constraints are important to keep in mind when considering how best to draw on experience in other countries. Some of the models adopted by developed countries are unlikely to be practical in Somalia. The fiscal architecture of mature federal countries rests on conditions—well-developed industrial economies, robust government revenues, a high level of social trust, well-developed capacity, sophisticated data collection systems—that are not in place in Somalia. The early experience of developed federations may still be useful, however, as examples of how countries faced with similar situations managed to achieve agreement on fiscal issues, especially in the context of conflict. Federalism has been a common choice for countries that emerged from interregional conflict over the past 200 years. Developing countries that decolonized in the past 60 years do not necessarily offer better models, because many of them started with highly centralized systems inherited from the colonial period. Their story is more about the center relinquishing power and resources to the periphery. Where federal or quasi-federal systems have emerged, they have been more about holding together than coming together. There may be as much to learn from bad experiences as good ones, but Somalia's circumstances are very different from those of most other countries. The two international examples described have features that may resonate with Somali stakeholders.

It may not be possible to achieve more than an interim solution. Intergovernmental fiscal arrangements should remain flexible, in order to manage fiscal conflicts as circumstances and the interests of different stakeholders change over time (Frank, Elin, and Vaillan court 2014). The most feasible approach may be a sequence of incremental steps phased in over a specified time period, potentially with a sunset clause that expires after a fixed period. The Australian Constitution, adopted in 1901, provided fiscal arrangements only for the first 10 years, for example. Australia's fiscal landscape 100 years ago bears many similarities to that of Somalia today: Its six states operated as fiscally independent entities, dependence on customs duties was high, and fiscal capacity varied widely across regions, with the average tax to GDP ratio only about 6 percent. Two central problems made finding common ground particularly difficult during the constitutional negotiations. First, transferring customs duty to the federal government would have left the states without enough revenue to function. Second, the transfer of customs duties would have affected different states in different ways. In the end, the Australian Constitution provided for the transfer of customs and excise powers to the federal government, with at least 75 percent returned to the states. The distribution provisions covered only the first 10 years of federation, after which arrangements evolved substantially and in ways not envisaged by the constitutional architects as the result of ongoing intergovernmental negotiation (see Box 8.3). Today Australia is one of the most fiscally centralized federal countries.

>> Box 8.3: Australia's fiscal architecture has evolved

The formation of the federal Commonwealth of Australia in 1901 brought together six previously self-governing colonies, each with its own fiscal arrangements. The Constitution, negotiated over a decade leading up to federation, was fundamentally a bargain struck by the six constituent units. Retaining state autonomy was an important goal of the negotiations. Accordingly, the powers of the federal government were limited, and states were given residual powers.

The most important revenue sources for the colonies at federation were customs and excise duties. The six colonies had operated as independent economic units, taxing the movement of one another's goods across their borders. As in Somalia, each state levied customs duty at different rates, taxing the taxed movement of goods across state borders. One aim of federation was to form an economic union. State perspectives on economic union varied considerably, however, with some states promoting free trade and others wanting to protect their local industries. Two colonies had begun diversifying their revenue base by imposing land and income taxes; other, less developed states were unable to do so, because their populations were itinerant. Underdeveloped states were consequently more reliant on customs revenue. Because the fiscal circumstances of the states varied greatly, the fiscal provisions of the Constitution proved very difficult to negotiate.

The final constitutional settlement gave the federal government exclusive control over the most important tax base but subject to revenue sharing with states. Customs and excise duties were transferred to the Commonwealth government as exclusively federal taxes, with a uniform tariff to be imposed within two years. The federal government was also given four key spending responsibilities: defense, foreign affairs, pensions, and post and telecommunications. It proved very difficult to accommodate the very different fiscal circumstances of each state, because tariff harmonization affected each of them differently. In the end, it was agreed that Western Australia could continue to levy duties on goods from other states on a diminishing basis for a period of five years, as the redistribution effected by the uniform tariff took effect.

The question of how to distribute the surplus customs revenue back to the states proved the most difficult to negotiate. In the end, the Constitution included a temporary solution, known as the Braddon clause. For a period of 10 years, the Commonwealth was permitted to use one-quarter of customs revenue for its own expenditure needs. Surplus revenues from customs duty would be returned to the states. Until uniform tariffs were imposed, each state's "share" of customs duties was calculated based on how much revenue had been raised in that state; for a period of five years following the imposition of uniform duties, duties accrued to the state in which the goods were consumed. For the purpose of calculating the surplus, Commonwealth expenditures were charged against states on a per capita basis. It was envisaged that return of the surplus on a derivation basis would give way to a system of federal transfers to the states, which the Commonwealth Parliament would legislate once the Braddon clause expired.

Australia's fiscal architecture changed radically after federation, in ways that the constitutional architects had not envisaged. What was essentially a derivation-based system in which states received the surplus generated in that state, gradually gave way to a system of intergovernmental transfers based on need. The federal government, which had started at federation with only customs and excise revenue, gradually assumed other tax bases. A federal income tax was introduced to finance participation in World War I. Later the federal government made access to intergovernmental transfers conditional on states not imposing state income taxes, effectively crowding states out of this tax base. Over the first 100 years of federation, Australia went from having a highly decentralized tax and transfer system to having one of the most fiscally centralized federal systems in the world.

Source: Hancock and Smith 2001; Spahn and Shah 1995.

Experience suggests that flexibility will be key, so that fiscal arrangements can evolve as trust builds. Bosnia and Herzegovina had a rocky entry into nationhood following its civil conflict. Immediately after the Dayton Accords in 1995, which ended the civil war, the country became an independent nation, but the level of trust among the constituent entities was low. In many respects the country was a confederation. Virtually no revenue-raising powers were vested in the central government at the start. Fiscal integration occurred only gradually, first with harmonization of customs duty rates, then with the establishment of a common tax administration, and later with the introduction of a national VAT distributed based on a formula (Box 8.4). It is likely that Somalia's intergovernmental financing arrangements will build on what is already in place, in a series of incremental stages rather than through a grand design. Identifying the first step may be the most that is possible in the short term.

>> Box 8.4: Bosnia and Herzegovina gradually achieved fiscal integration through tax reform

Following the comprehensive peace agreement initiated at Dayton Ohio in 1995, Bosnia and Herzegovina was established as a single sovereign state made up of two entities: the Serb Republic, including about 60 municipalities, and the Federation of Bosnia and Herzegovina. The new country had two subnational tiers, consisting of 10 cantons and about 80 municipalities.

The design of the fiscal architecture drew on the fiscal legacy of Yugoslavia, in which most revenues were raised and retained by the republics, which then made bottom-up transfers to fund the federal government. This arrangement created considerable budgetary vulnerability at the federal government level, because its functioning was dependent on transfers from the better-off republics.

The accord reached in Dayton gave the sovereign state of Bosnia and Herzegovina limited responsibilities—for foreign affairs, trade, and immigration; customs policy; monetary policy; and regulation of communications, transport, and law enforcement (but not defense). All powers not allocated to the federal government, including the right to raise an army, were reserved to the entities. The federal government was provided with no independent tax sources. For more than 10 years, its activities were financed entirely from transfers from the entities. The Federation of Bosnia and Herzegovina provided two-thirds of the federal budget, and the Serb Republic provided one-third. Indirect taxes accounted for about 70 percent of all revenues in both entities; they were owned by the entity where they were raised, with shares to canton and municipal level in the case of sales tax. Cantons and municipalities were heavily dependent on sales tax revenue, which accounted for 70 percent of cantonal revenue in the federation and 50 percent of municipal revenue in the republic. Distribution on the basis of origin generated substantial interregional inequity.

With support from international actors, the two entities reached agreement on the harmonization of indirect taxes. A harmonized customs law was adopted in 1998, followed by harmonized excise taxes in 2000 and sales tax in 2001. Integration of tax administration proved more difficult, partly because of a policy in the federation to share all sales tax revenues with the canton level.

Agreement on the introduction of a VAT was finally reached in the mid-2000s and implemented on 1 January 2006. It was agreed to establish a state-level Indirect Tax Authority and pool all taxes in a single account. The single account provided state government for the first time with a revenue source to supports it functions. It was first applied to fund the state budget and service Bosnia and Herzegovina's debt, with the balance shared between the entities. Because of the difficulty in attributing VAT revenue to a particularly location, a new basis for distributing the balance had to be found. The parties agreed to share VAT revenue on the basis of a formula that guaranteed the respective shares of entity, cantons, and municipalities within the federation and of the entity and the municipalities within the Serb Republic. To ensure support for the changes, municipalities were given at least as much revenue as they had received from the sales tax, with the new formula phased in over six years.

The introduction of VAT not only succeeded in introducing a single national tax administration system and giving the national government a revenue stream to support its functions, it also increased interregional equity. Disparities in per capital income at the cantonal level fell from 4: 1 to 2: 1, and municipal-level differences fell from 200: 1 to 35: 1.

Source: Fox and Wallich, 1997; Fox , 2003; Fox, 2007; Levitas, 2007; Wallich and Zhang, 2013.

9. Institutions and Processes

Designing institutions and processes through which the fiscal architecture of a government can evolve may be just as important as designing the architecture itself. This section examines the mechanisms through which evolution can be managed in an orderly way that minimizes the risk of conflict escalating. Four categories of institutions are potentially important for managing the ongoing negotiation of resource and revenue sharing and spending responsibilities. The most important of these in Somalia's current context is the institutions that are needed to take the next step of negotiating a workable, even if interim, fiscal bargain for the federal state. Box 9.1 describes the other three types of institutions that have proved useful in other countries.

Much of the evolving intergovernmental architecture in federal countries is determined through intergovernmental agreements that are renewed and amended periodically. The two (or three) levels of government usually meet to discuss issues. Meetings take place at both the political and technical levels. At the highest level are heads-of-government meetings, at which the most politically significant agreements are negotiated and ratified. Standing committees of finance ministers and ministers of various sectoral ministries meet more frequently, often to reach preliminary agreement before referring contentious issues to heads of government. Meetings at the political level are supported by more frequent and more detailed meetings at the technical level, where the day-

>> Box 9.1: Three types of institutions can support dynamic and responsive intergovernmental fiscal relations

Finance Commissions

A number of countries have formal (often constitutional) finance commissions that provide advice on revenue-sharing arrangements. In some cases they advise on the overall division of resources among levels of government; in other cases their mandate is confined to advising on sharing among levels of government. They help take the heat from political debates about resource sharing, particularly if they provide a technically expert and credible evidence base to inform these decisions. Three key policy choices must be made in designing these commissions: (a) whether membership is technical (as in Australia, India, and South Africa) or political (as in Nigeria and Pakistan); (b) whether the body sits on a permanent basis (as in Australia, Kenya, and South Africa) or periodically (as in India); and (c) whether the commission's mandate is limited to horizontal sharing between states (as in Australia and Nigeria) or extends to sharing between levels as well (as in Kenya and South Africa).

Upper Houses of Parliament

Upper houses can function as forums for intergovernmental relations. Their impact depends on how they are constituted. In South Africa, the Council of Provinces is made up of the premiers of the provinces, who provide a direct voice for state governments in the national Parliament. In Australia and Kenya, senators are elected by the voters of the state. Because they are elected separately from the state government, rather than being chosen by them, they do not necessarily represent the interests of the state government; sometimes they are actively in competition with it. They do however represent the interests of voters in their state. Composition of the upper house will depend on whether it is intended to represent state governments or the citizens who reside in states. If these houses have intergovernmental relations functions, they usually have limited mandates, related to vetoing legislation affecting states; they may have no powers with respect to the budget or exclusively federal concerns. Somalia's Provisional Constitution provides for an upper house with 54 directly elected members representing the FMSs and an equal numbers of senators based on the 18 regions that existed before 1991 (Article 72).

Dispute Resolution Bodies

Dispute-resolution institutions include constitutional courts and other mechanisms. The court is almost always the final arbiter of constitutional disputes, including disputesrelating to financial provisions, although its jurisdiction is sometimes limited. In South Africa, parties are required to exhaust other options before resorting to courts. In Papua New Guinea, interpretation of certain constitutional provisions is non-justiciable (meaning they cannot be challenged in court) or justiciable only at the instigation of one or other government, not private individuals. Somalia's Provisional Constitution establishes a constitutional court consisting of five judges, nominated by the Judicial Services Commission and approved by the lower house of Parliament (Article 109B).

to-day work of intergovernmental coordination is done. The Provisional Constitution provides for regular meetings across levels of government, including meetings on issues that affect water, agriculture, health, and education (see Article 52 in Annex A). The same article envisages that FMSs may enter into cooperative agreements with other federal states or the federal government.

The Provisional Constitution envisions creating an interstate commission once all FMSs are fully formed. It will consist of members appointed by the prime minister and the FMSs. The federal parliament will determine its powers. The commission has a role to play in facilitating intergovernmental coordination and cooperation between the FSG and the FMSs and resolving administrative, political, and jurisdictional disputes. It thus has the potential to fulfill more than one of the institutional functions outlined above. Whether its membership is appropriate to negotiate intergovernmental fiscal arrangements on behalf of states and the FSG remains to be seen. It may be that a dispute-resolution role (which should be at arm's length from the parties to a dispute) may not be consistent with an intergovernmental negotiation role, which should more properly rest with elected representatives of the FMSs, most obviously the ministers for finance and constitutional affairs at each level.The overlapping roles of the Constitutional Court and the interstate commission also need to be clarified.

The formal processes of negotiating the Constitution cannot begin until all FMSs are formed, but a great deal could be done to lay a solid foundation for that process. An intergovernmental committee of ministers, including ministers of finance, constitution, and federalism, could be formed to distill the issues that will need negotiating. It would work most effectively if backed up by a committee of technical officials. Part of distilling the issues would involve creating a common platform of information to inform joint decision making by both levels. The technical committee of officials could play an important role in information gathering and joint analysis. It could analyze the economic base and revenue potential of different regions, map the revenue sources of potential FMSs, and develop a simulation model to explore the fiscal implications of different options for the design of the tax and transfer system.

Regular and purposeful meetings help build trust, particularly if they are focused on resolving practical problems rather than debating competing political perspectives. Although it may be too early to reach final agreement on issues, it is never too early to begin forming a common basis for understanding the issues. Even before the Constitution is finalized, it may be useful to establish technical sectoral committees to begin unbundling functions. The function of such committees would be to(a)assess how functions are currently being performed, (b) explore how those arrangements might change under a more efficient and effective set of service delivery arrangements, (c) identify the budgetary implications of different models of function assignment, and (d) isolate any contentious areas that should be referred to the political level for debate and decision.

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ANNEXES

Annex A: Excerpts of relevant articles from the provisional constitution

Article 21: Freedom of Movement and Residence

(1) Every person lawfully residing within the territory of the Federal Republic of Somalia has the right to freedom of movement, freedom to choose their residence, and freedom to leave the country.

(2) Every citizen has the right to enter and to remain in the country, and has the right to a passport.

Article 48: The Structure of Government

(2) No single region can stand alone. Until such time as a region merges with another region(s) to form a new Federal Member State, a region shall be directly administered by the Federal Government for a maximum period of two years.

Article 49: The Number and Boundaries of the Federal Member States and Districts

(1) The number and boundaries of the Federal Member States shall be determined by the House of the People of the Federal Parliament.

(2) The House of the People of the Federal Parliament, before determining the number and boundaries of the Federal Member States, shall nominate a national commission which shall study the issue, and submit a report of its findings with recommendations to the House of the People of the Federal Parliament.

(3) The nomination of the commission referred to in Clause two shall be preceded by the enactment of a law by the House of the People of the Federal Parliament, which shall define:

- (a) The responsibilities and powers of the commission.
- (b) The parameters and conditions it shall use for the establishment of the Federal Member States.
- (c) The number of the commissioners, requirements of membership, nomination methods, office tenure, and their remuneration.

(4) The number and the boundaries of the districts in a Federal Member State shall be determined by a law enacted by the parliament of the Federal Member State, which must be approved by the House of the People of the Federal Parliament.

(5) Federal Member State boundaries shall be based on the boundaries of the administrative regions as they existed before 1991.

(6) Based on a voluntary decision, two or more regions may merge to form a Federal Member State.

Article 50: Federalism Principles of the Federal Republic of Somalia

The various levels of government, in all interactions between themselves and in the exercise of their legislative functions and other powers, shall observe the principles of federalism, which are:

- (a) Every level of government shall enjoy the confidence and support of the people.
- (b) Power is given to the level of government where it is likely to be most effectively exercised.
- (c) The existence and sustainability of a relationship of mutual cooperation and support between the governments of the Federal Member States, and between the governments of the Federal Member States and the Federal Government, in the spirit of national unity.
- (d) Every part of the Federal Republic of Somalia shall enjoy similar levels of services and a similar level of support from government.
- (e) Fair distribution of resources.
- (f) The responsibility for the raising of revenue shall be given to the level of government where it is likely to be most effective exercised.
- (g) The resolution of disputes through dialogue and reconciliation.

Article 51: Collaborative Relationships Between the Various Levels of Government in the Federal Republic of Somalia

(1) Every government shall strive for a cooperative relationship with other governments, whether at the same level or at another level of government.

(2) Every government shall respect and protect the limits of its powers and the powers of other governments, and shall:

   (a) Have effective brotherly relationships with other levels of government in order to promote the unity of the citizenry.

   (b) Inform governments of other levels of policies and activities it implements within its boundaries which may have an impact on the areas of other levels.

   (c) Have policies that facilitate the planning and implementation of joint development projects.

(3) In order to ensure the existence and development of cooperative federal relations, an annual conference of Executive heads of the Federal Government and the Federal Member State governments shall regularly be convened, so as to discuss and agree on:

   (a) Strengthening national unity.

   (b) Security and peace of the country.

   (c) National socioeconomic development, and common market policies of the country.

   (d) Promotion of the wealth of the people.

   (e) Information sharing.

(4) All levels of government must comply with the national Constitution, without any government assuming more powers than the Constitution allocates.

(5) A law passed by the Federal Parliament shall regulate:

   (a) The establishment of institutions and guidelines that shall facilitate interaction between the various levels of government.

   (b) The establishment of guidelines that will facilitate the resolution of disputes between the various levels of government without resorting to court.

Article 52: Cooperative Relationships Between the Various Federal Member State Governments

(1) The Federal Government and Federal Member State governments shall ensure that meetings between the Presidents of the Federal Member States and high ranking officials be held regularly to discuss issues that affect their territories, including:

   (a) Water sources.

   (b) Agriculture.

   (c) Animal husbandry.

   (d) Pasture and forestry.

   (e) The prevention of erosion and the protection of the environment.

   (f) Health.

   (g) Education.

   (h) Relations and dialogue amongst traditional leaders, and the protection and development of traditional law

   (i) Relations among religious scholars and

   (j) Youth.

(2) Federal Member States may enter cooperative agreements amongst themselves or with the Federal Government, which may not be legally binding or contradict the national constitution and the constitutions of the Federal Member States.

Article 72: The Number of Members of the Upper House of the Federal Parliament

The members of the Upper House of the Federal Parliament shall be elected through a direct, secret and free ballot by the people of the Federal Member States, and their number shall be no more than 54 members based on the eighteen (18) regions that existed in Somalia before 1991, and on the following:

(a) The number of Federal Member States of the Federal Republic of Somalia.

(b) That all Federal Member States should have an equal number of representatives in the Upper House of the Federal Parliament.

(c) That the members of the Upper House of the Federal Parliament should be representative of all communities of the Federal Republic of Somalia.

Article 109B: The Formation of the Constitutional Court

(1) This Constitution establishes the Constitutional Court which is composed of five Judges including the Chief Judge and the Deputy Chief Judge.

(2) The Judicial Service Commission shall nominate as judge of the Constitutional Court only persons of high integrity, with appropriate qualifications in law and Sharia, and who is highly competent in Constitutional matters.

(3) The Judicial Service Commission shall propose to the House of the People the person they want to be appointed as a Constitutional judge.

(4) If the House of the People of the Federal Parliament approves the name proposed in accordance with Clause 3 of this Article, the President of the Federal Republic shall appoint that Person as a judge of the Constitutional Court.

(5) From amongst their members, the Constitutional Court judges shall appoint the Chief Judge and Deputy Chief Judge.

Article 125: The National Treasury

(1) A law enacted by the Federal Parliament shall establish a national treasury. That law shall also determine legitimate revenue collection and expenditure disbursement relating to institutions at all levels within the Federal Republic of Somalia. That law shall be based on an accountability system that has been tested worldwide and is known to have standards related to financial reserve and expenditure that can equally be implemented in every part of the Federal Republic of Somalia

Article 142: Existing Federal Member States in Somalia

(1) Until such time that all the Federal Member States of Somalia are established and the adopted Federal Member State Constitutions are harmonized with the Somali Federal Constitution, the Federal Member States existing before the provisional adoption of this Provisional Constitution by a National Constituent Assembly shall retain and exercise powers endowed by their own State Constitution.

(2) Existing Federal Member States must be consulted in the decision-making process regarding the federal system, and security arrangements.

Annex B: Revenues of the FGS and the Puntland federal member state, 2013

Entity/source of revenue	Revenues (US Dollars)	Percent of domestic revenue
Federal Government of Somalia		
Domestic revenues and external assistance	117,440,899	
Total domestic revenues	7,5769,408	100.00
Tax revenue	65,051,205	85.85
Tax on income, profit, and capital gains	688,887	0.91
Of which:		
Wages and salaries (public sector payees)	688,887	0.91
Excise tax	0	0.00
Sales tax	0	0.00
Turnover tax on services (presumptive tax)	1,627,000	2.15
Telecommunications tax	1,627,000	2.15
Stamp sales and duty	4,006,907	5.29
Taxes on international trade and transactions	58,728,410	77.51
Of which:		
Customs tax on imports	57,985,308	76.53
Custom taxes on export goods	743,102	0.98
Non-Tax Revenue	10,718,203	14.14
Revenue from government services and assets	4,108,203	5.42
Of which:		
Administrative charges	325,653	0.43
Airport and harbor fees	1,021,335	1.35
Visa and passports fee	2,761,215	3.64
Domestic loans and grants	6,610,000	8.72
Foreign grants	41,671,492	
Bilateral	41,671,492	
Multilateral	0	
Puntland Government		
Domestic revenues and external assistance	38,351,800	
Total domestic revenues	38,351,800	100.00
Tax revenue	32,374,450	84.40
Tax on income, profit, and capital gains	1,299,213	3.39
Of which:		
Wages and salaries (public sector payees)	849,924	2.22
Wages and salaries (private sector payees)	449,289	1.17
Excise tax		
Sales tax	1,863,495	4.86
Turnover tax on services (presumptive tax)		0.00
Telecommunications tax		0.00
Stamp sales and duty	1,633,635	4.26
Taxes on international trade and transactions	25,653,118	66.89

Entity/source of revenue	Revenues (US Dollars)	Percent of domestic revenue
Of which:		
Customs tax on imports	23,140,837	60.34
Custom taxes on export goods	314,070	0.82
Non-Tax Revenue	5,977,350	15.59
Revenue from government services and assets	2,906,640	7.53
Of which:		
Administrative charges	1,018,858	2.7
Airport and harbor fees (Landing permits)	346,343	0.01
Visa and passports fee		
Revenue from government assets	938,936	2.4
Domestic loans and grants		
Transfers, debts and contributions	3,070,710	8.01
Foreign grants	0	0.00
Bilateral	0	0.00
Multilateral	0	0.00

Transition amid Risks

with a special focus on Intergovernmental Fiscal Relations

The Somali economy has remained resilient, driven by the private sector despite two decades of conflict. The private sector helped the economy mitigate the devastating consequences of war and drought. Somali entrepreneurs adapted well and even flourished in a stateless conflict-ridden economy. There has been significant private sector investment growth in trade, money transfer services, transport and telecommunications, funded by remittances from the diaspora. The IMF and the World Bank estimate Somalia's GDP at around US$5.7 billion in current dollar terms in 2014. This puts Somalia's GDP per capita at US$435 making it the 5th poorest country in the world.

The Federal Government of Somalia is faced with a daunting task of creating a peaceful and secure environment, building strong institutions of governance, and delivering key public services to a weary population after decades of war. These challenges can only be overcome if the FGS takes a leading role to sustain economic reconstruction by creating a stable macroeconomic environment that would underpin rapid economic growth, job creation, and poverty reduction. This can only happen when the Federal government has the resources from both the public and donors.

The special focus of this Update examines intergovernmental fiscal relations in Somalia and highlights the challenges and lessons drawn from theory and international experience to provide an analysis of what this means for Somalia given the de facto architecture of fiscal arrangements that is currently emerging. One of the recommendation from this work is that Somalia's new fiscal arrangements should be designed to work as a coherent system, preserving a strong common economic space across the country, and provide scope to address inequities between regions. As political bargains are struck, regard should be given to the balance between functional responsibilities, and the availability of revenue to fund them. Another recommendation is that Somali stakeholders should be prepared to develop a sustainable fiscal bargain incrementally, renegotiating as fiscal circumstances and the interests of states and federal government change over time. It may not be possible to find a permanent fiscal bargain immediately. The focus now should be developing robust intergovernmental institutions to facilitate ongoing negotiation, and on negotiating a way forward rather than a final fiscal arrangement.

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