Building Cooperative Fiscal Federalism in Somalia

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FOREWORD

One of the principal tasks of the National Economic Council is to commission the preparation of objective and fact-based studies that are presented at the Consultative Policy Forums so as to avail relevant stakeholders the opportunities to discuss and debate policies that promote sustainable economic growth, high employment and poverty reduction. The policy papers are then subjected to rigorous peer reviews and are the basis of policy briefs that are submitted to the National Council members for consideration and national policy uptake.

The NEC of Somalia is indebted to many national, regional and international partners in undertaking the primary studies, those that have participated in the consultative policy forums, the researchers that conduct the peer reviews, and the agencies that provided financial support for the studies and the Policy dialogue processes.

On behalf of the NEC, I wish to extend my thanks to all the contributors to these studies. We commend the contributions of officials of the Office of the President, the Prime Minister, and the Ministry of Planning, Investment and Economic Development and other Economic Ministries for their participation in the policy forums with diverse stakeholders. The NEC studies were enriched by the contributions of the academics, and civil society and private sector participants at these Forums.

In particular I thank the organizations and individuals that supported this study “Building Cooperative Fiscal Federalism in Somalia” A most sincere appreciation goes to the research team comprising the NEC members and associate scholars, as well as the staff of the Economic Policy Analysis Unit for their invaluable support and assistant.

The facilitation and financial assistance of “UNDP Somalia mission” in the process of implementation of the policy forums is much appreciated. They have been a reliable and invaluable partner to the research teams from inception to the completion of the studies.

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Building cooperative fiscal federalism in Somalia

1. Introduction and Background

The 2012 Provisional Constitution (PC) established a federal system of government in Somalia but left the details related to the powers and governance of fiscal federalism to be agreed between the Federal Government of Somalia (FGS) and the Federal Member States (FMS). So far little progress has been made in negotiating the relevant provisions of the PC regarding the assignment of expenditure and functions. The issues are now being addressed under the ongoing constitutional review process (CRP).

Multiple public organs are driving the CRP process, which includes the National Security Council (NSC) comprising the executive leadership of FGS and FMS, the Parliamentary Constitutional Implementation and Oversight Committee, the Ministry of Constitutional Affairs, and the Independent National Review Commission, among others. A Council of Ministers Inclusive Forum has been set up to review models and best practices in fiscal federalism to recommend an appropriate model for Somalia. On operational aspects, an Inter-Governmental Finance Ministers Forum (IFMF) comprising finance ministers of the FGS and FMS has been established to provide a platform for consultations on fiscal federalism, including harmonization of taxes and management of natural resources and infrastructure, and revenue sharing. Other areas of cooperation are the automation of the collection of inland revenues and implementation of a standard information technology (IT) system in all the ports in Somalia. The two levels of government have also held consultations on national revenue legislation before submission to Parliament. Also, a federal National Technical Committee (FNTC) was established in July 2018 to provide technical support and enable the Executive leadership of the FGS and FMS to negotiate issues of fiscal federalism.

Since the current CRP was launched in May 2018, the process has been slow and would need to be accelerated for the constitution to be promulgated before the next elections. Some of the relevant issues the CRP should address are the number of

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Somalia’s Current Fiscal Federalism

2.1 The Current Institutional Structure

Whether Somalia has a working fiscal federal system remains a valid question. After informal interviews, surveys, and dialogue with relevant stakeholders ranging from government officials, technocrats, and civil society, it can be concluded that in practice, fiscal federalism is at its infancy in Somalia. Both the federal...
government and the federal member states operate under fiscal federalism based on a centralized fiscal system inherited from the unitary regime that collapsed in 1991. However, recent efforts have been made to establish institutions to develop workable fiscal federalism.

There is an Inter-Governmental Finance Ministers’ forum of the FGS and FMS, serviced by an ad-hoc Fiscal Forum Technical Committee (FFTC) of officials from the two levels of governments. The objectives of the organs are to devise mechanisms that would facilitate discussions and agreements on the sharing of shared resources, expenditure raising powers, public finance management, and harmonization of revenues and taxes. Since its establishment, the FFTC has held nine meetings, but the Staff Monitored Program (SMP) values are visible in the dominant narrative. It is also important to note that the FFTC lacks institutional legitimacy and legislative power. Political disagreements between the federal government and the federal member states negatively affect the work of the institution. Current efforts are focused on how to get the work FFTC to move forward.

Another objective of FNMC is to create a platform to enable negotiations on issues of fiscal federalism between the federal government and the federal member states. The FNMC has engaged in the necessary discourse regarding points of contention that required political consensus and developed options that should provide the basis for political settlements of the critical issues. It also sought to deliberate on a working power and resources sharing mechanisms that could provide viable options for Somalia.

The FNMC sought advice from reputable experts who presented case studies and best practices of different countries where the framework had been applied. Although the tenure of the committee was short-lived, it established an open dialogue concerning essential aspects of fiscal federalism, which included primary points of contention, especially sharing of oil and gas resources and fishing revenues arrangements. The FNMC also scratched the surface of essential power-sharing arrangements and federal governance including a justice model and security architecture.

2.2 Overview of Fiscal Federalism in Somalia

The Provisional Constitution assigns a few functional responsibilities to the Federal Government. However, its assertion that functions should be assigned to the level where they are most likely to be exercised, meaning delivery of essential services such as education, health, water and sanitation and social protection should be assigned to FMS or the third tier of government, such as Local Governments (LG) recognized by the PC. Functional assignments to all levels of governments should thus be clarified. Currently, basic services are mostly provided by the private sector or Non-Governmental Organizations (NGOs) through donor funding as humanitarian and development assistance. Under this scenario, the FMS would need substantial financial resources to take over the delivery of these services.

The PC also does not assign specific revenue powers to the FGS and FMS. These two levels of government largely levy similar taxes and the FMS retain all the tax revenues in their jurisdictions. There is also an imbalance in tax efforts among the existing five (5) FMS, with some states collecting substantial revenues while others hardly collect any revenues.

Somalia currently has no institutional structures to manage intergovernmental transfers. However, FGS has been making revenue transfers on an ad-hoc basis to FMS and regularly to the Banadir Regional Administration. The FMS should not depend on the goodwill of FGS for fiscal transfers. The need for institutional mechanisms to manage revenue transfers to sub-national governments is necessary for reasons well-grounded in economic theory. The transfers should include vertical and horizontal transfers, in some cases, fiscal equalization transfers, which are all critical for the promotion of social equity. It is therefore imperative that a legal framework that provides for fiscal transfers and a mechanism to manage the intergovernmental transfers should be developed.

Lack of an intergovernmental fiscal transfer mechanism in Somalia has led to the distribution of budgetary support without a formula and structure that is supposed to ensure principles of accountability, equity, and efficiency. Three

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1 FNMC was composed of representatives of five federal member states (5), the Office of the Prime Minister, the Office of the President, and the Banadir region. Political meddling and mistrust, led to its loss of credibility, even though its creation enabled necessary discourse.
state governments of Galmudug, Hirshabeele, and South West are examples as they do not receive consistent and equitable budgetary support from the federal government. Puntland and Jubaland raise more revenue than these states but receive higher fiscal transfers. Similarly, the federal government occasionally facilitates sharing of external donor support to FMS, based on a mechanism that lacks transparency and pre-agreed formula. This method of fiscal transfers does not consider the relevant distinctions between the federal member states, including population size and financial needs for service delivery and security, among others.

Public Finance Management (PFM) system is an essential tool for good governance under fiscal federalism. Application of the system is centralized, and both the federal government and the federal member states are bound to implement. Public finance management should be broadened to encompass relevant fiscal federalism legal frameworks and processes. It should include the establishment of crucial PFM institutions at federal, state, and local levels; and application of national auditing, accounting, reporting procedures at all levels of government.

It has to be said that some progress has been made in several areas of fiscal federalism. The NSC approved a natural resource (minerals and oil) sharing agreement at a meeting held in Baidoa in June 2018, and the Federal Parliament of Somalia passed the Petroleum Bill on 18 May 2019. A fisheries revenue-sharing agreement was reached in March 2019. Similarly, legislative bills on harmonization of revenues and revenue administration have been tabled in Parliament.

2.3 Challenges to Constitutional Fiscal Federalism

Agreements in any federation must be anchored in the constitution and other laws. In order to promote non-centralized decision-making process, enhanced democratic participation, and efficient accommodation of diverse interests or preferences, it is essential to legally entrench involvement of the public in decision making at all levels of governments. A balanced approach to development should ensure the participation of all communities in the formulation and implementation of government policies, projects and programmes.

The following principles should guide the institutional approaches to development. First, federalism should bring government closer to the people so that public goods are delivered to meet the various needs of residents. The constitutional division of power between the federal and regional governments and decentralization of power from the regional to local level are all meant to enhance citizens’ abilities to express their preferences and influence public decisions. Secondly, to improve outcomes of devolution and promote active civic participation, appropriate institutions must be built and strengthened at the sub-national level. Although some changes have been observed in FMS, significant administrative, financial and human resource capacity constraints remain. These constraints must be removed if the constitutional obligations of fiscal federalism are to be met.

In designing fiscal federalism, specific functions must be allocated to each level of government or assigned as shared responsibilities, and revenues to finance these functions must also be assigned to each level of government. Importantly, less endowed regions should be allocated additional support through intergovernmental transfers to ensure delivery of comparable services at all levels. Institutions to manage the design and implementation of these principle elements of devolution must also be established.

In summary, the following are challenges which face the implementation of fiscal federalism in Somalia:

There are no distinctive constitutional responsibility assignments for the different levels of government, including separation of powers between the executive, legislative, and judicial branches of government. The roles and responsibilities of federal and state governments are merely outlined in the PC and lack detailed implementation and enforcement mechanisms.

There are no federally mandated minimum national standards for the provision of public goods.

Both levels of Somali governments have limited capacity in the provision of public goods and services, except for the inadequate provision of security
services. It applies particularly to the provision of primary education, healthcare services and infrastructure development.

There are no predictable, transparent and accountable mechanisms and institutions for equitable distribution of revenues, both horizontally and vertically.

There is a lack of credible and fair dispute resolution mechanisms, to address disputes either among state governments or between the federal government and state governments. It may require the establishment of a constitutional court that would be impartial in settling disputes and clarifying constitutionality matters.

3. Functional and Revenue Assignments

3.1 Assignment of expenditure responsibilities

In federations, the division of expenditure responsibilities is primarily provided for in negotiated federal constitutions. Together with revenue assignments, expenditure assignments are the most contentious elements of fiscal federalism and therefore consist the main provisions of federal constitutions. However, it is generally agreed that expenditure assignments should be governed by the principle of subsidiarity which asserts that in the sharing of functional powers, functions should be assigned to the lowest decentralized competent authority, thus discouraging centralization of functions. As noted above, the PC subscribes to this principle, but only assigns a few functions FGS, leaving the rest of the assignments, including those FMS for further negotiations.

In negotiating assignment of expenditure powers, any of three alternatives can be chosen (World Bank, 2015). Assignments to the federal government could be specified, while sub-national governments are left with residual expenditure powers, as is the case in the USA and Australia. On the other hand, the opposite could apply where expenditure powers of subnational governments are specified, and the federal government is left with residual powers as practised in Canada. Lastly, functional assignments to both levels of government could clearly be defined in the constitution as practised in Kenya and South Africa. It would appear that the choice of any of the alternatives depends on the initial conditions. For example, in the USA, the States preceded the federal government. It, therefore, surrendered some powers to the federal government, leaving them with residual powers which are more than those assigned to the federal government. For the Kenya and South Africa example, the national governments ceded some functions, mostly service delivery functions, to the new sub-national governments. Somalia is unique in that both levels of government are responsible for more or less the same functions. It will complicate the negotiations, and both sides will have to be ready for compromises.

The collapse of the central government of Somalia led to the rise of ‘sub-national governments’ starting with Somaliland in 1991 and Puntland in 1998, followed by the other 4 FMS, which were more or less fully established by 2015. The origins of the federal system of governance in Somalia is the Transitional Federal Charter of 2004, which was confirmed with the adoption of the PC in 2012. Expenditure responsibilities under the Charter, as listed in Table 1, followed the classic assignment of functions under fiscal federalism. The federal government was responsible for the delivery of public goods- foreign affairs, naturalization and immigration, defence, money (currency), and national infrastructure. In contrast, the delivery of public goods and services was mostly assigned to the federal member states. Local governments in FMS, the District Councils and Municipalities, were also assigned responsibilities for delivery of public goods and services, as exemplified by the case of Puntland shown in Table A1. It should be noted that assignment of functions outlined by the charter is far more elaborate than those provided by the PC, which only lists a few functions assigned as private functions of the Federal Government.

Although the PC calls for the allocation of powers and resources to be negotiated between the two levels of government, Table A2 shows that both the FGS and FMS currently carry out similar functions. More importantly, the principle of subsidiarity does not apply. This duplication of functions is costly and leads to inefficient delivery of services and underlines the necessity of providing for assignment of functions in the constitution. It may include the functions assigned to local governments.
Expenditure assignments must be agreed before revenue assignments are discussed and agreed, and what is agreed must be anchored in the constitution. The process and some specific elements of assignment of functions are elaborated below.

(i) The Federal Government should be responsible for policy formulation and setting of national standards. The FMS would then pass legislation to implement the policies but within the confines of the constitution. FGS may also pass legislation on concurrent functions, and as guided by the constitution. Examples include PFM and procurement legislation which apply to both levels of government. Generally, the constitution will provide for legislation required to effect critical provisions of the constitution. In the case of standards, legislation must apply to all levels of government to protect public health and safety, and for security reasons. The FMS may, however, pass legislation on PFM and standards applicable in their jurisdictions as long as they do not contravene national legislation.

(ii) The principle of subsidiarity should govern the allocation of functions. As discussed earlier, (Table A3) FGS and FMS have similar expenditure functions. In a federal system, this would be costly and ineffective. Without getting into detailed recommendations, the following should be considered in the process of functional assignments in Somalia:

- FGS should remain with the functions assigned by the PC, namely: Foreign Affairs, National Defense; Citizenship and Immigration, and Monetary policy. Other areas which should be assigned to FGS are Internal Security (Interior), Air Transport and Aviation and Ports and Marine Transport for security reasons. Other than these functions, the Federal Government should be assigned those functions which are more efficiently delivered at the national level or subject to economies of scale.

- FMS should be allocated those functions related to service delivery, namely: education, health, agriculture and livestock, water, housing, sports, environmental protection, local roads, local security, public works, town planning etc. The Constitution may also require FMS to delegate certain functions to local governments. This will require unbundling of functions into the most basic elements to provide guidance on which aspects of the functions should be assigned to the local governments, and in some cases to the federal government.

(iii) Justice

Both the FGS and FMS list justice as one of their functions. The judiciary should be independent of the control of both levels of government as provided for in Article 106(1) of the PC. However, both levels of government can have a Ministry of Justice, for example, to promote human rights, advising the government on legal and judicial matters, etc.. Still, the mandate of that Ministry should not include any powers constitutionally allocated to the Judiciary.

(iv) Unbundling of Functions

This is a process that analyses and breaks down functions into their basic components. Take the example levels of education which can be categorized as University and other tertiary, high school, primary school and pre-primary school. Based on subsidiarity, each of the unbundled functions could be allocated as follows:

- University education: Federal Government
- Secondary and Primary education: Federal Member States
- Pre-primary education: local governments

Functions can be further unbundled to clarify responsibilities; for example, for secondary and primary education, further unbundling leads to the following functions and responsibilities:

- Policy on universal access to education: FGS and FMS
- Policy on transition, literacy and numeracy rates: FGS and FMS.
- Accreditation of teachers: FGS
- Employment and payment of teachers: FMS and LG.
- Building and maintenance of school facilities: FMS and LG.
- The setting of performance targets for teachers: FMS and LG
Monitoring and evaluation of teacher performance: FMS and LG.

The unbundling process should be applied especially to concurrent functions (functions assigned to more than one level of government) and is also useful in the costing of functions for the purpose of budgeting.

(v) Transfer of Functions

Once expenditure assignments have been agreed, the process of transferring functions to the relevant government should start. This is usually the most difficult part in the devolution of powers because governments responsible for the functions to be transferred loathe to lose them. The process will be doubly hard in Somalia because both levels of government are responsible for many concurrent functions; which will force one level of government to stop or scale back on performing certain functions.

There are two approaches to transferring functions: gradual and immediate (the so-called “big bang”). Many observers favour the gradual approach because it allows for the spread of risks and costs of reforms and the building of capacity, which is considered important for the success of reforms. Those who support the “big bang” approach argue that gradualism may lead to distortion and even reversal of agreed reforms and that immediate implementation of reforms forces governments to take hard decisions and move on.

In the case of Somalia, it is recommended that both approaches are applied. For example, service delivery related functions proposed for transfer to FMS could be done immediately, while rationalization of the armed forces and the police, for example, could be undertaken gradually. Successful and effective implementation of the transfers would require the establishment of an institutional structure whose main mandate will be to determine readiness to receive functions by any level of government and to monitor the transfer of functions, including assets and staff.

3.2 Assignment of revenue-raising powers

The 2012 Provisional Constitution does not assign any revenue powers to either the federal government or the member states. Instead, it stipulates that “the allocation of powers and resources shall be negotiated and agreed upon by the Federal Government and the Federal Member States” (Art. 54). This is yet to be done, but must be addressed in the context of the ongoing constitutional review process. The PC (Article 50(f)) also provides that “revenue-raising responsibilities should be given to the level of government that can exercise that responsibility most effectively.” Meaning that allocation of revenue powers should take into account the expenditure assignments of each level of government, the costs of providing services related to the assignments, and the source of finances. The bottom line is that revenue assignments should be linked to the assignment of functions (the “revenue follow function” principle) to ensure that levied taxes relate to benefits. It also means that any re-assignment of the current functions of FGS and FMS will require a reassessment of the current revenue assignments.

In the absence of revenue assignments by the Provisional Constitution, the FGS and FMS levy similar taxes (Table A3). The FMS levy and collect taxes, and spend all the revenues within their geographical boundaries, while the FGS collects taxes from Mogadishu and share a large proportion of the revenues with the Banadir Region. In recent years the FGS has begun to make modest transfers to the member states. It should be noted that municipalities also collect, though insignificant, revenues from service charge, property rates, licenses, rent and market taxes. While taxes levied by the FGS and FMS are similar, the rates are not harmonized, but the anomaly is now being addressed through the IGFF.

Revenue performance of the FGS and the FMS, shown in Figure 1, indicates that the member states of South West, Guledug and Hirshabelle hardly collect any revenue. However, revenue performance has improved with time, in terms of revenue collected and the number of jurisdictions collecting revenues. It is noteworthy that until recently, Somaliland has been raising more revenue than the FGS. It is also evident that FGS, Somaliland and Puntland, which have operational ports collect more revenues. The main source of revenues in all these jurisdictions are trade taxes (collected mainly in ports), non-tax revenues and taxes on goods and services.
Revenues from income and corporates taxes are negligible, signifying weak tax authorities and tax evasion.

Following the assignment of expenditures, and because “finance-follow-functions”, agreement on assignment of revenues should follow. Revenue assignments should also be subject to the subsidiarity principle, and in line with the principles of taxation. In particular, an ideal tax system should promote efficiency, equity and economic stabilization; and should ensure achievement of economies of scale and avoidance of tax competition. Such a system will favour the national government over subnational governments.

Taking the above principles into account, the FGS should collect the so-called mobile taxes, such as corporate and personal income taxes, consumption taxes (VAT), trade taxes and taxes on natural resources. On the other hand, FMS and local governments would rely on taxes on immobile tax bases such as land, property and user charges. However, these jurisdictions may impose specified sales taxes and excise and surcharges on national income taxes and payroll taxes.

In this respect, FMS would lose control of important tax bases and the associated tax (“own”) revenues. This issue is critical because any sub-national government that does not control sources of its revenue will not be truly independent. This challenge would need to be addressed through the provisions of the Constitution, which guarantee that FMS own revenues are complemented by revenue transfers from FGS which are sufficient to finance the delivery of services associated with their functions.

In light of the above discussions, the following specific recommendations are advanced:

• A National Revenue Authority should collect national taxes, and the FMS should have the choice of contracting the authority that collects some of their revenue.

• Assignment of tax bases agreed through a constitutional process could be as follows: personal incomes taxes, corporate income taxes for national companies, all trade taxes, visa and passport fees, airport and harbour fees could be assigned to the FGS. FMS should be assigned business taxes, some sales taxes and property taxes. Taxes on telecommunications and natural resources could be shared between FGS and FMS.

• Consideration should be given for FMS to tax their employees, based on tax rates set by the recommendation of the revenue authority and approved by Parliament.

• Since FGS will take up major tax bases, FMS should receive an equitable share of FGS revenue. Sharing of revenues should be based on a formula specified in the Constitution, provided in law, and applied by an Independent Commission for revenue allocation with the concurrence of Parliament.

• Since FGS will take up major tax bases, FMS should receive equitable share of FGS revenue; and FMS with the least revenue collections (Galmudug, South West, Hirshabelle) should receive additional revenue transfers in the form of equalization funds to bridge the gap between revenues, including equitable transfers and the required funding to meet the needs of their residents. Sharing of revenues should be based on a formula specified in the Constitution and applied by a Commission.
4. Natural Resources Revenue Sharing

The access and distribution of resources are one of the most contentious causes of conflict in the world. Unequal access and distribution of shared resources in addition to weak governance are one of the common root causes of conflict historically. However, this problem is also attributable to broad insecurity, the inadequacy of the rule of law, and lack of clearly defined and enforced property rights. Without a legal framework, institutional structures, and strong and efficient governance there will not be an effective mechanism for allocating resources toward critical public and private investments; including education, health, infrastructure, and legal systems and institutions.

The assignment of tax powers and raising revenue from natural resources is a critical point of contention. Natural resource revenues are different from other revenue because they can be a significant source of income in a federal state, and because they are often unevenly distributed among the constituents. Important natural resources in this regard are oil and natural gas, and other minerals, which are significant in some federations. Therefore, the key issues related to the control, administration, ownership and sharing of revenue between the federal government and the producing or non-producing member states needs to be clarified. The issues imply the importance of not only equitable sharing of natural resource revenues but also financial transparency and accountability. Neglecting to consider these issues carefully increases the probability of exacerbating existing protracted conflict in Somalia.

Thus, it is paramount to design a model for natural resource revenue sharing that is based on the rule of law, and institutions where economic resources, be they national or communal are managed, distributed, and safeguarded. Somalia’s narrative for the past three decades has been riddled with conflict, violence, and destruction of public and private wealth. To rebuild livelihoods, regain national identity, and eradicate prevalent poverty, Somalia must ensure that its resources are used in an effective, efficient, and most importantly, impartial manner. The deeply embedded weaknesses may hinder such an outcome of natural resource revenue allocation in the institutional frameworks of the country. A post-conflict economic reconstruction strategy for Somalia must be one that uniquely addresses its fragile socio-political situation and pervasive trust deficit.

The balance of this section addresses natural resource revenue sharing schemes in Somalia and provides a roadmap for establishing accountable and transparent revenue sharing mechanisms for distributing natural resource revenues. The ownership of natural resources is generally stipulated in the national constitution, and processes of natural resource revenue sharing plans in many federations are kept separate from questions of resource control and management.

For instance, the revenue from oil and gas can be captured in different forms like royalties, licenses and fees, export taxes, excise taxes, environmental taxes, special corporate income taxes, payments from state-owned companies etc. The sharing of such revenues are a subset of the broader design of the resource sharing and transfer of grants. Political negotiations will be important when deciding how much to allocate to producing regions, and how much is to be managed by the federal government on behalf of the nation.

Equally important in major natural resource taxation are stabilization funds and savings, transparency and accountability. Although the experiences of federations are not uniform when deciding the allocation of natural resource revenues favour allocation to the federal government based on the following considerations. The overall significance of the revenues for the economy and their corresponding macro-economic impact. The volatile and non-renewable nature of natural resources revenues and the impact of those characteristics on sub-national governments fiscal management.

The power to legislate and manage natural resources does not necessarily imply that the level of government with such power will exclusively appropriate the revenue from the resources. Concerns for economic efficiency and capacity often guide the rationale of decisions concerning resource management. At the same time, the sharing of revenue is mainly a result of the desire for a political settlement and the equitable distribution of revenue. Like other revenues, natural resource revenue sharing must consider the expenditure responsibility of the federal government and federal member states of Somalia.
The Foundation of Successful Natural Resource Revenue Sharing

Effective, efficient, equitable and natural resource sharing schemes are contingent upon the following:

- Well developed institutional and legal frameworks
- Highly developed and well-designed constitutionally based equalization mechanisms, and ownership and control
- The diversification of the economy across all sectors
- Political consensus and participatory democracy, and
- Information sharing.

The condition of these factors in any country serves as a significant determinant of the impact of natural resource sharing on sustainable and shared economic growth. Capitalizing off natural resource revenue sharing inevitably leads to sustainable economic development and the minimization of conflict. This will likely catalyze the inception of a new era of peace and prosperity in Somalia. This hypothesis is evidenced by the experiences of Botswana, Australia, the United States, the Netherlands and Norway.

Well-developed institutional and legal framework

Good governance is contingent upon the clarity and legislative power of the institutions. The provision of law and order; property rights, contracts and criminal laws; proper regulations and antitrust laws should be explicitly stated, implemented, and enforced. It is a significant prerequisite that should not be overlooked because Somali citizens have a right to equal access to shared resources (natural, national, or foreign aid). The aftermath of the prolonged civil war and polarization based on social phenomenon emphasize the necessity of this. This is deeply critical in Somalia’s effort to reinstate itself as a viable sovereign state that does not revert to conflict.

Constitutionally based equalization mechanisms, ownership and management control

The distribution and management of natural resource revenue sharing are particularly important in a country like Somalia, where the distribution of natural resources is uneven across the regions. It potential also constitutes a large portion of the national economy. The competing ownership claims include private, communal, customary land rights and state ownership. The federal government of Somalia must ensure that earnings from natural resources are equitably distributed among the federal government and the federal member states to attain natural resource management and control. Also, equitable sharing of revenue from natural resources would bring forth uniform provision of public services and coordinated development across the country.

Following a prolonged civil war where institutions - both fiscal and legal - are weakened, establishing a fiscal rule and a distributional formula based in law on how the revenues from natural resources are owned, managed and shared should be prioritized. Ownership of natural resources has no bearing on how efficiently resources are managed and controlled. In some countries, the federal government owns the natural resources and devises equalization mechanisms and transfer formulas to constituent units. In other countries, the member states own the resources, but the federal government also devises the equalization mechanisms and transfer formulas.

The goal is to provide comparable services at comparable tax rates. If the federal government manages the revenues from the natural resources, they might generate huge revenues to provide equitable services for all. Whether the producing regions and local authorities should be given a special share (and at what level) is also an important consideration. On the contrary, the revenue from natural resources could be accumulated in a common pool where legally mandated distributional rules would be devised. Ownership, management, and control are critical because different countries have different equalization mechanisms. The constitution in Somalia does not contain a clear blueprint for this process:

“The provisional Constitution of Somalia does not regulate the ownership, management and sharing of revenue from natural resources. It rather leaves the ‘allocation’ of natural resources of Somalia for future negotiations between the federal government and federal member states (articles 44 and 54). The principle of fairness will guide the distribution of
resources (articles 50 (e)). The constitution further guarantees the right of everyone to have a share of the natural resources of the country (articles 25(2)). In addition, article 45(2) imposes a duty on everyone to participate in the development, execution, management, conservation and protection of natural resources and the environment. The constitution also requires the federal government to conserve the environment and prevent activities that damage the natural resources and the environment of the nation (article 45 (3))."

This excerpt from the provisional constitution is vague and does not outline how resources should be distributed between the different levels of government in a definitive manner. Somalia’s unique social, political, historical, and economic landscape should be carefully considered when devising these natural resources sharing mechanisms. Although ownership of natural resources is political in nature, the management and control should be based on economic efficiency and equity, in addition to accountable and transparent processes.

As a result of all federal member states in Somalia not being equally endowed in natural resources, the income from such sources can create a significant horizontal imbalance among the states. It bears the potential of exacerbating existing conflicts. The federal republic of Somalia must ensure that earnings from natural resources are equitably distributed among and between the federal government and the member states. Equitable sharing of revenue from natural resources would bring forth uniform provision of public services and coordinated development across the country.

The underlying issues with Somalia’s provisional constitution dealing with natural resources are its lack of specificity. Therefore, one would look at the constitution and see the absence of satisfactory regulation, legislation or special laws addressing these gaps. Good governance is predicted by the ability of the constitution and the legislative power to provide clear mechanisms of natural resources ownership, control and management.

It would restore the trust in institutional capacity and promote shared wealth and inclusive growth, which could potentially contribute to the resolution of the on-going conflict in Somalia. The constitution-making process should include and elaborate on clear cut guidelines of fiscal tools, and formulas with clear objectives and directives. Moreover, legislative based independent commissions and oversight structures must be established to promote resource sharing arrangements that are rule-based and not at the discretion of the short-term political interest of the politicians.

Diversification of the economy across all sectors

The discovery of natural resources tends to skew against some of the productive sectors of the economy, like agriculture and manufacturing. Economists elaborate on how sometimes natural resource discovery can become a curse due to what is known as Dutch Disease, which leads to an appreciation of the local currency exchange rate. As a result, the cost of production of other sectors rises without an increase in their productivity. Furthermore, it makes imports of goods and services cheaper and more affordable relative to domestic production. This imbalance attributable to the discovery of natural resources and ensuing currency appreciation renders domestic manufacturing and agriculture uncompetitive.

Increasing the capacity of the Somali economy to grow must come from the sectors where it has a comparative advantage, such as agriculture. This will increase the quantity and quality of the agriculture sector and will not only feed its people but increase the rate of economic growth. This will also be a boom for job creation in the rural economy that suffered for the past three decades. Also, the state-of-the-art manufacturing sector will increase employment, the supply of capital goods, and ultimately bring about technical innovation necessary for long term sustainable economic development. To enhance sustainability, the exploration of natural resources should not turn into a curse, and the nation should avoid becoming solely dependent on that one source of income.

Post-conflict economic reconstruction for Somalia entails that the sharing of the potential natural resource revenue should be in line with national development priorities and should be a source of peace, development, inclusive and shared growth. Natural resource revenue can also be used to complement other valuable sectors of the economy.
such as infrastructure, social development, economic development as well as advancement in agriculture, manufacturing, livestock, fisheries, frankincense etc.

Reliable and accurate information on extractive companies, Governments and Citizens The disparity in knowledge and information accessibility between different groups can impede the flow of reliable and accurate information. This is especially critical in Somalia, where citizens are already suffering from a trust deficit. Informational asymmetries can arise between the government and extractive companies, or between the federal government, federal member states, and local governments.

Historically, natural resource extractive companies tend to be more opaque in their information. They have found many ingenious ways to be more secretive regarding the number of natural resources on a country’s ground or off-shore. They are also non-transparent about their tax systems, profits and sometimes they are the only ones who have full knowledge of aerial surveys. It is important to mitigate these informational asymmetries through transparent, competitive processes, and well-defined laws. This should be enforced by inspection and penalties that can govern the extractive companies’ activities. Government, on the other hand, can provide a transparent and competitive process of discovery rights, how profits and royalties are measured, managed and shared to benefit all. It is equally important that reliable data should be compiled and made publicly available for all to observe. This facilitates making informed decisions as to how the wealth of the nations are appropriated, managed and shared.

Information sharing is as important as natural resource revenues sharing, as it promotes transparency and builds trust among people and creates a critical mass of informed citizens. Issues of moral hazard should be addressed seriously. Moral hazard is the tendency of one party of a contract to alter their behaviour after the contract is signed in ways that could be costly to the other party. These structural and informational problems can surely exist between the extractive companies and the Somali government. They can also exist among the federal government, federal member states and local governments and should be addressed with government regulation and law.

Informational asymmetry can be minimized when the government builds the local capacity through technical training such as accounting, taxation, geology, survey-taking for many Somalis to create employment. But also to provide the technical know-how, so the government is not at the mercy of what extractive companies reveal and their operations relating to the exploration process, the quantity of the resources they extract as well as their taxable corporate income. Incentive-compatible mechanisms should be established regarding the process, the quantity of the resources they extract, issues related to environmental damage, as well as their taxable corporate income.

**Political consensus and participatory democracy:**

Promoting participatory democracy and an actively engaged civil society allows for increased transparency that equips citizens with the power to hold the government accountable for their policies. The relationship between government and citizens becomes strong when the government derives its revenue source from general taxation. This is because citizens usually demand services for the taxes they pay to the government and become concerned when tax revenues are used for other purposes. However, abundant natural resource revenues can sometimes break the link between citizens and their government.

It is because a natural resource can provide an alternative income that dissuades unwelcome public scrutiny over the misutilization of tax revenues.

**Models of natural resource management**

For Somalia to successfully benefit from its potential natural resources and provide guidelines for equitable and efficient natural revenue sharing, it’s important to analyze the experiences of countries that have successfully benefited from proper management of these resources. It is equally important to analyze the experiences of countries that failed in the management of their natural resources’ revenue-sharing mechanisms.

**Norwegian natural resources model**

Norway first discovered its natural resources in the 1970s, a time when they were a low-income country in comparison to other Western economies. The discovery of oil has become a huge advantage and blessing, presently ranking Norway as one of the richest countries in the world. Some factors contributed to Norway’s extraordinary success. Although the government has direct ownership stakes in the oil revenue, mechanisms and laws were codified to ensure that money was going to government coffers and not into private hands.
In addition, the revenue from oil has produced shared growth among all Norwegians in the form of advancement of infrastructure and improved public services like health, education, environment etc. A few important revenue management mechanisms offer lessons on effective management and control the revenue. One specific factor for its success has been the approach they have utilized in pooling their natural resource revenues into the Sovereign Wealth Fund. Another important mechanism is that Norway managed to restrict the use of the Fund's principal, which is reserved for saving and investment. They only used the rate of return on the fund to be allocated as government expenditure. Another striking feature in regard to Norway’s prudent fiscal management is the separation of expenditure and revenue as well as the creation of the fiscal rule. Fiscal rule constitutes that 4% of the return of the Sovereign Wealth Fund is to be remitted to the government coffers.

The government avoided becoming oil-dependent by investing and promoting other sectors of the economy. Norway is considered to possess one of the most highly developed and robust manufacturing sectors in the world today. In addition, they created a legally enforceable fiscal rule guiding the annual transfer from the fund to the government budget. The combination of a Sovereign Wealth Fund and fiscal rule created a strong legal and financial framework that guided the distribution of the petroleum revenue that turned Norway's petroleum and oil sector into a blessing. Today, Norway has the lowest income inequality in the OECD. They possess 1.3 trillion USD that is not only enough for the current generation, but also for generations to come. Somalia can learn from Norway’s legal and institutional frameworks to capitalize and establish fiscal rules for the management of its potential natural resources.

Botswana’s natural resource case

Botswana has not been without constraints in its quest for development. Still, the country has turned its abundant supply of natural resources into a blessing by the following five important pillars. These pillars ranked Botswana as Africa’s highest human development index and is a high middle-income economy with a multi-party democratic system. Botswana promoted a transparent fiscal and legal restraint, effective state management that emphasized strategic state-led growth-promoting policies. It also mobilized savings to withstand natural resources price fluctuations and used these savings to build other sectors of the economy. Their government practised a leadership style that sought political dialogue and consensus-building that has held the country together.

Botswana’s legal framework - transparent and accountable policy and law-abiding government - has led the country onto a sustainable economic path. Natural resource revenues are utilized to advance investment in social development such as health and education as well as improvement in infrastructure. The government adopted prudent fiscal policy and saving schemes which have stabilized the economy. Botswana's good policies attracted foreign investments and support that helped the country build needed infrastructure. Diversifying the country’s local economy coupled with the accumulation of substantial financial reserves, help the country withstand the severity of exchange fluctuations that are commonly known within a natural resource-based economy. Moreover, Botswana succeeded in combating corruption and conflict owing to good governance.

As deduced by preliminary exploration results, Somalia could have abundant natural resources that can generate massive revenue for the government. The constitution and other clear regulations should determine the ownership and management of these resources. and the model of natural resource sharing should have the following features:

- Following prolonged insecurity where institutions have been weakened, establishing fiscal rule and a law based distributional formula should be designed on how the revenues from natural resources are owned, managed and shared.
- An accountable, transparent, flexible and straightforward formula should be codified, implemented and enforced.
- Highly developed and well-designed constitutionally based equalization mechanisms for ownership, management, and control should be put in place.
- Constitutionally based separation of expenditure and revenue is recommended. The establishment of a Somali Revenue authority will enhance transparency and accountability.
- Establishment of Somali Stabilization Fund and fiscal rule that determine the percentage of natural resource revenue that be allocated to the
• Political consensus and open dialogue are critical in minimizing and resolving conflict.

• Diversifying the country’s local economy along with investing in critical infrastructure and institutions, can relieve pervasive unemployment and poverty.

• Revenue harmonization, appropriate intergovernmental transfers, and the design of fiscal tools are necessary to establish standardized fiscal instruments.

5. Intergovernmental Fiscal Transfers

Intergovernmental transfers refer to the transfer of money from the central government to lower levels of government, or from subnational governments to local government units. In most of the developing countries, intergovernmental transfers are essential components in financing subnational governments. The term transfer refers to various kinds of public financing instruments such as grants, subsidies, as well as tax sharing arrangements. A country would likely use multiple types of transfers to local governments and the right choice for the country depends on the objectives to be achieved.

In Somalia, because of the collapse of the government institutions and the difficulties associated with the national security situation, the ability to generate revenues, both at the federal government and member state levels is minimal. Hence, there is a significant reliance on foreign grants, and there is no mechanism nor institutions to manage intergovernmental transfers. Somalia is moving from a centralized government system to a federal system, and the public finance management system of the country has to reflect this transition. Hence, it is essential to revisit the intergovernmental transfer system.

In this context, the following sections of the paper provide decision-makers with a basic knowledge of essential elements and relevant policies of intergovernmental transfers.

Fiscal federalism involves both political and administrative aspects, and in Somalia, the focus has been thus far on the political element almost exclusively, including the establishment of sub-national governments (Member States). However, the administrative, fiscal aspect that deals with how the federal government and member states work together and who performs what government function has not received much attention. This could be in the form of devolution, delegation, or decentration. The established Federal Member States now and need the funds necessary for them to perform their functions. This could be done by either raising their funds or receiving sustainable intergovernmental fiscal transfers.

Understanding intergovernmental transfers require several questions to be answered:

• How are intergovernmental transfers linked within the legal framework of the country?

• What are the objectives of the transfers?

• How does the federal government decide on the total transfer pool?

• How is the transfer pool distributed to the federal member states?

• What are the types of transfers? and

• How should the transfers be administered?

5.1 Intergovernmental transfers legal framework

The first step in understanding intergovernmental transfers in a country is to examine how the principles of transfers are anchored within the legal and regulatory framework. In most countries, broad parameters are set up within the constitution, and in all cases, specific fiscal legislation and regulations provide further details.

As noted above, the assignment of powers and functions to the different levels of government in Somalia, which is the basis of intergovernmental transfers, has not yet been established. Article 54 of the PC states “the allocation of powers and resources shall be negotiated and agreed upon by the Federal Government and the Federal Member States. Further, the PC states in Article 50(d) that "every part of the Federal Republic of Somalia shall enjoy similar levels of services and a similar level of support from the government." This requires that responsibilities need to be assigned first, for the size and distribution of the transfer pool among the FMS.
to be determined. And as the legal framework is a work in progress, it would not be possible to make federalism work without it for Somalia.

Objectives of intergovernmental transfers
There are many different forms of intergovernmental transfers, and the right choice for a country depends on the objectives to be achieved. Intergovernmental transfers are introduced by governments mainly for one of four reasons: to address a vertical imbalance, horizontal imbalance/equalization, externalities, and national priorities.

Vertical imbalance occurs when there is an imbalance between the expenditure responsibilities and revenues of the federal government and the subnational governments (Shah, 2007). The federal government usually collects revenue either from tax or foreign aid and borrowing. This will create a vertical fiscal imbalance when the revenue of the federal government is compared with the revenue of the sub-national governments, which do not have substantial taxing power and borrowing capacity (Masaki, 2018).

Almost no local government has enough revenues to cover all their costs. Thus, in designing intergovernmental transfers for the vertical balance objective, one faces the issue of how to measure the total transfer pool, which depends on the difference between the revenues and the expenditure needs of subnational governments. The fact that the expenditure needs are almost limitless makes this exercise subjective at best. Most countries who use the vertical balance approach determine a “minimum service level”, and fill the gap with transfers. In some cases, the amount of transfer is determined by central budget constraint rather than by a “minimum requirements” approach (Bordignon et al., 2013).

The horizontal imbalance is another justification for intergovernmental transfers. In most Federal countries, non-comparability between revenue-raising and expenditure responsibilities of sub-national governments contribute to horizontal fiscal imbalance. Hence, equalization is quite often one of the most important objectives of such transfers. The horizontal fiscal imbalance could involve variations of revenue capacities of different sub-national entities so that they are not able to provide their citizens with services at the same level. A local government in a wealthy urban area may collect much more revenues than a government in a poor rural area. The imbalance also could involve expenditure needs of different sub-national entities because of variations in socio-demographic characteristics of their populations (population dispersion, urbanization, age structure, etc.); and the cost of providing services is affected by such factors as the scale of public administration and the physical and economic environment.

To assess equalization as a justification for intergovernmental transfers, we must consider three questions. How are intergovernmental transfers financed (i.e., what taxes support the transfers)? What services do subnational governments deliver? And what distribution formula is used to allocate resources among the local governments?

Externalities: Another justification for the use of intergovernmental transfers is to offset externalities (also known as spill-overs). That is, left to make their own decisions, local governments may underspend on services where there are substantial external benefits. For example, sub-national governments may underspend on education and health services relative to that desired by the nation as a whole. In this case, theory tells us that a grant conditional on spending for the service in question could stimulate spending on that service (Bordignon et al., 2013).

The design of a transfer system to address externalities raises two important issues that must be addressed by policymakers (Anderson et al., 2004). The first is the size of the grant required. That is, how much of a subsidy is needed, and how much expenditure response will be required by the local government? This is a subjective question that must be answered by the central government. The second issue has to do with three-level fiscal federalism. If the grant is made to the federal member state government, it may not reach the government that is responsible for the underspending. Related to this is the issue of how the intermediate level will allocate its resources to the local level government.

5.2 Designing a transfer system
Roughly, transfers can be divided into general-purpose transfers and conditional transfers. General-purpose transfers allow for local discretion, and this is very much in line with the devolution model. Either it is completely discretionary or form of block grants in which funds have to be spent on a specific area such as health and education. Conditional grants are for particular purposes,
and they are usually linked to specific guidelines as well as inputs or certain outputs to be achieved by local governments. Conditional transfers can have a matching component where the local government needs to match transfer with their funds. In designing a transfer system, one or more of these types of transfer will be used.

**Determination of the size of the transfer pool**

The vertical pool constitutes the total amount of money to be distributed among the sub-national governments. There are three common approaches to determining the size of the total transfer pool. It could be a fixed percentage of some federal government revenue source, it may be determined on an ad-hoc basis by the federal government, or it may be based on sub-national government expenditure to be reimbursed. What should be kept in mind is that how the transfer pool is decided has implications for sub-national government budget predictability. For example, if the transfer pool is determined using an ad-hoc decision, it may result in fluctuations from year to year, which may create problems for the subnational governments planning for the long term.

**The shared taxes:** In this case, the federal government allocates a share of national collections of some tax to the subnational governments. This raises two design questions: what kind of taxes should be shared and the percentage of the tax collections to be shared. There is a wide variation among federal countries in the kind and the per cent of the tax shared.

**Ad hoc transfers:** In this approach, the federal government decides on the number of transfers on a discretionary basis. That is, each year, the federal government decides on an allocation to subnational governments; and there are considerable drawbacks to this approach (Masaki, 2018).

- This approach denies the link between expenditure responsibilities and revenue resources. While the central government cuts or increases the local revenue share each year, they are less likely to change the expenditure functions assigned to local governments and a revenue shortfall can produce harmful effects on the level of public services provided.
- Subnational governments are likely to be discouraged from increasing efficiency and from becoming self-reliant if all grants are made on an ad hoc basis. Local officials will feel less in control of their budgets, and less accountable to their voters for the level of services provided. It will be very convenient to blame any service delivery shortfalls on the inadequate support offered by the centre.

On the other hand, the ad hoc approach also has some advantages.

- For the federal government, it provides maximum flexibility. The government can implement a fiscal stabilization program with minimum regard for a fixed committed share to the local government sector.
- Another advantage is that this approach will enable the federal government to change spending priorities without changing expenditure assignments. For example, subnational governments are more likely to spend on consumption than for infrastructure purposes. An ad-hoc grant will allow the centre to reduce the flow of revenues to the local sector and use the funds for infrastructure.

In sum, the ad-hoc approach that determines the size of the distributable pool is the most centralizing approach in designing an intergovernmental transfer system.

**Cost reimbursement**

The cost reimbursement approach works as follows:

- The central government defines a service for which it will guarantee to cover the cost incurred by the local government in delivering this service.
- The transfer to cover these costs may be open-ended, i.e., the central government stands ready to cover the cost of all expenditure incurred by the local government. More often, the transfer is close-ended, i.e., the central government...
Cost reimbursement grants often carry conditions.

- Cost reimbursement grants have some significant advantages (Wang & Herd, 2013). First, they can be used to direct investment to high priority national needs. Local governments, left to their own devices, will underspend on services with regional and national benefits. Conditional grants based on costs incurred for specified purposes will redirect these funds toward the priority areas. Cost reimbursement transfers may also be used to ensure uniformity of standards across the country.

The disadvantages of cost reimbursement grants are that they compromise local choice and can retard true fiscal decentralization. The requirement of uniformity set by the federal government also discourages innovation by local governments. Finally, cost reimbursement grants impose an administrative cost on the central government, which must monitor the program and a compliance cost on the local governments who must do significant reporting on their use of funds and their adherence to standards.

Cost reimbursement grants are widely used as a method of determining the total flow of funds to subnational governments. It gives the central government control over the amount of funds allocated to the local government sector, and it provides the centre with some say in how the funds will be spent.

Horizontal balance: how to distribute the pool of resources?
No matter how the total grant pool is determined, the distribution of this pool among eligible local governments is a separate question. The impact of a grant system, however, depends on both dimensions of grant design. In what follows, we discuss the relevant design options for horizontal balance.

The derivation approach
Under this approach, the total grant pool is determined as a share of a national tax, and each local government receives an amount based on collections of that tax within their geographic boundaries ((Wang & Herd, 2013). For example, 25 per cent of value-added taxes in a hypothetical country is allocated to the subnational government sector, and the allocation is made according to amounts collected inside the boundaries of each regional government. This approach requires that the type of tax to be shared is determined.

Formula grants
A second common approach to the allocation of intergovernmental transfers among local governments is the formula grant, which uses some objective, quantitative criteria to allocate the pool of revenues among the eligible local government units. The most common reason why governments move to formulae based distribution is to gain transparency and certainty in the distribution of grants. This creates a sense of fairness in that all know the exact criteria by which distributions are made, and the flexibility in distributions may change as the needs for public expenditures change. In short, formulas are meant to remove judgment (Banful, 2007).

The four important considerations for designing formula grants are: (i) the elements of the formula, (ii) the data necessary to implement the formula, (iii) the costs associated with administering the grant program, and (iv) conditionalities. The design of the formula is arguably the most challenging issue because it calls into question the purposes of the grant. The formula should reflect the objectives of the grant program. The first objective is to allocate grant funds to reflect regional differences in expenditure needs. The second is income or fiscal capacity equalization, which attempts to provide more money to those jurisdictions with the weaker capacity to raise taxes. The third is to include a tax effort provision directly in the formula, to provide some positive incentives to increase the overall level of revenue mobilization. The fourth could reflect the balance between revenue-raising capacity and expenditure needs.

Conditional, cost reimbursement grants
Another grant type is the conditional grant that is based on reimbursement of costs of specified services. Under such schemes, the centre agrees to reimburse the locality for all or a portion of the cost of an activity (if it is a portion, a matching share from the locality is required). Grants to reimburse costs are typically tied to a particular expenditure.

5.3 Institution for intergovernmental transfers
The expenditure and revenue assignments change over time, and intergovernmental transfer is subject political, economic and financial demands that
require the trust and confidence of the general public and the relevant levels of governments in a country. In this context, this necessitates the need to establish institutions and procedures that manage the intergovernmental transfers’ allocations and effective and efficient administration of aggregate revenue and their distribution. These institutions may perform the following functions: compute transfer allocations to sub-national governments and decide about disbursements; provide a forum for dialogue between levels of government, and make policy recommendations about specific aspects of intergovernmental finances. The foundation of such institutions could be at the National legislative model (senate or upper house); a Government agency model; or independent national commission.

5.4 Revenue administration under fiscal federalism

Adequate institutional capacity is a precondition for sound public policymaking in any country’s economic and social development. Effective institutions are required for markets to function efficiently and for the private sector to thrive; to ensure proper management of a country’s domestic resources and external assistance, and to implement home-grown economic policies and reforms. With the exception of security and national reconciliation, the most critical task facing Somalia is the restoration of effective good governance and building public trust in Government. This fact is perhaps actual of most countries recovering from conflict. Without good governance, and firm adherence to the rule of law and delivery of justice, security, political stability and economic recovery are endangered.

The experience of Somalia since 1991 demonstrates clear evidence that ad hoc interventions and uncoordinated and un-sustained external assistance is insufficient in restoring domestic institutional capacities for good governance and economic recovery. Domestic resource generation has remained inadequate and constrained. The FGS has made some efforts, but mobilizing domestic tax revenues under the existing tax laws and strengthening tax policy and tax administration has a long way to go. Lack of a clear legal framework on tax legislations, inadequate harmonization of rates at the different level of government, and limited administrative capacity to enforce revenue collections resulted in little progress in mobilizing significant domestic resources in the country—at all levels of governments.

A critical near-term challenge of the recovery and reconstruction of Somalia is the need to improve the management of revenue mobilization, intergovernmental transfers, and resource sharing at the federal government and constituent member states. In this context, the resources mobilization and domestic revenue management must be revamped and reformed at the FGS and the FMS, which confront similar and most likely equally severe challenges of administering public resources.

Based on the country’s current experience and inability to mobilize adequate domestic revenue as carried out by line departments of Ministries of Finance at both the FGS and member states, it is essential to separate the functions of revenue administration and expenditure management. As a result of limited institutional and human capacities, the government ministries have failed in both the policies and administration of taxes and non-tax revenues at all levels. There are general concerns, and underlying circumstances have led almost all countries practising fiscal devolution and decentralization in Africa and this sub-region in particular to establish Autonomous Revenue Authorities, including the following:

(i) Governments have been much dissatisfied with the performance of revenue collection, with chronic inefficiencies that exist with tax administration by the ministries of finance.

(ii) There have been perceptions of widespread corruption and tax evasion, combined with limited compliance that contributed to calls for reforms of tax administration.

(iii) The revenue authority model is designed partly to limit direct political interference in day-to-day operations and somewhat to permit the recruitment and retention of high-calibre human resources by providing incentives for better job performance.

The experiences of many of the countries that established autonomous revenue authorities are that this step has been critical in the enhancement of domestic revenue generation and administration. The envisaged improvements in revenue mobilization will not occur unless competent management with unquestioned integrity is put in charge. The governance of an autonomous revenue authority is particularly critical under the fiscal federalism circumstances, whereby the federal government and the member states have to establish a sound and
effective governance structure cooperatively. Under shared power, the transparency and accountability of the operations and activities of the autonomous revenue authority ought to assure the separation of resources and expenditure management and insulate intergovernmental transfers from the political influence of one kind or another.

Policymakers need to understand that the establishment of the legal and administrative frameworks to guide intergovernmental transfers is essential. The objectives of the transfers, the way it is distributed and the type of transfers should be linked. Furthermore, an effective administrative institution to manage such transfers should be established to ensure accountability, transparency and autonomy from political intervention to build the essential trust for all stakeholders.

6. Findings and Recommendations

The following summary of findings and policy recommendations have been compiled from the analysis undertaken in this study, and the current status of implementation of cooperative fiscal federalism in Somalia to improve the prospects of realizing successful fiscal federalism in the ongoing constitutional reform making and its effective implementation in the country.

Assignment of expenditure responsibilities.

The PC subscribes to the principle of subsidiarity in the assignment of expenditure responsibilities. Still, it only assigns a few functions to the FGS, leaving the rest of the assignments, including those to FMS for further negotiations. However, the FGS and FMS currently carry out similar functions. This duplication of functions is costly and leads to inefficient delivery of services. In this regard, it is recommended that:

• The Federal Government should be responsible for policy formulation and setting of national standards. The FMS would then pass legislation to implement the policies but within the confines of the constitution. FGS may also pass legislation on concurrent functions, such as PFM, procurement and standards which apply to both levels of government.

• FGS should continue with the functions assigned by the PC, namely: Foreign Affairs, National Defense; Citizenship and Immigration, and Monetary policy. Other areas for consideration are Air Transport and Aviation and Ports and Marine Transport for security reasons; Internal Security (Interior), etc. Other than these functions, the Federal Government should be assigned those functions that are more efficiently delivered at the national level or are subject to economies of scale. Further negotiations should lead to additional assignments to the FGS.

• FMS should be allocated those functions related to service delivery, namely: education, health, agriculture and livestock, water, housing, sports, environmental protection, local roads, local security, public works, town planning etc. The Constitution may also require FMS to delegate certain functions to local governments.

Both the FGS and FMS list justice as one of their functions, therefore the judiciary should be independent of the control of both levels of government as provided for in Article 106(1) of the PC.

Assignment of a tax authority.

The 2012 Provisional Constitution does not assign any revenue powers to either the federal government or the member states. This has led to a situation where FGS and FMS levy similar taxes. The FMS spend all the revenues within their jurisdictions. At the same time, the FGS collects taxes from Mogadishu area and shares a proportion with Banadir Region and has recently made modest transfers to select member states. It is therefore recommended that:

• A National Revenue Authority should collect national taxes, and the FMS should have the choice of contracting the authority that collects some of their revenue.

• Assignment of tax basis agreed through a constitutional process could be as follows: personal incomes taxes, corporate income taxes for national companies, all trade taxes, visa and passport fees, airport and harbour fees could be assigned to the FGS. FMS should be assigned business taxes for non-national companies, some sales taxes and property taxes. Taxes on telecommunications and natural resources could be shared between FGS and FMS.

• Consideration should be given for FMS to tax their employees, based on tax rates set by the
recommendation of the revenue authority and approved by Parliament.

- Since FGS will take up major tax bases, FMS should receive an equitable share of FGS revenue. Sharing of revenues should be based on a formula specified in the Constitution, provided in law, and applied by an Independent Commission for revenue allocation with the concurrence of Parliament.

**Natural resource revenue.**

- The management of revenues from the natural resource is different from other sources because of their significance to the economy and potential disparity in impact among the different levels of government. Sharing of the revenues between natural resources producing or non-producing areas is also of interest. Revenue from natural resources are mostly collected by the federal government and shared with the constituent units, although there is no uniformity in the experiences of federations.

- Addressing the environmental and socio-economic impacts on the producing regions, or communities, and establishing autonomous institutions to manage and allocate the sharing of the revenues are of utmost importance. Even where the FGS has direct ownership of natural resource revenue, it should be shared with FMS through a formula that specifies relevant details. However, the establishment of an institution to manage the natural resource-based revenues, such a Somali Sovereign Wealth Fund, should be codified into the law. The use of the Fund’s principal should be reserved for saving, and investment and the returns on the fund should be allocated as government expenditure, which is subjected to a fiscal rule provided by law. Successful expenditure natural resource revenue depends on the separation of expenditure and revenue. The National Revenue Authority should collect the revenue while the ministry of finance would be responsible for expenditures at the federal level.

- It is therefore recommended that an enforceable fiscal rule guiding the annual transfer from the Sovereign Fund to the government budget should be established through legislation. The combination of Sovereign Wealth Fund and the fiscal rule would create a robust legal and financial framework that can guide the distribution of the natural resource revenue for current and future generations. The Somali government, however, should avoid becoming over-dependent on natural resource revenues by increasing investments and promoting other sectors of the economy.

**Intergovernmental transfers.**

- Intergovernmental transfers refer to the transfer of money from the central government to lower levels of government, and from sub-national governments to local government units. In most of the developing and transition countries, intergovernmental transfers are essential components in financing a sub-national government. However, Somalia has no mechanism for managing intergovernmental transfers.

- Somalia is transitioning from a centralized system of government to a federal system. It is, therefore, important to develop accountable and transparent systems and mechanisms for revenue mobilization, administration, and intergovernmental fiscal transfers. The framework for ensuring equitable and responsible transfers should, at the same time, respect sub-national autonomy. Under shared power, the transparency and accountability of the operations and activities of an autonomous Revenue Authority ought to assure the separation of resources and expenditure management and insulate intergovernmental transfers from the political influence of one kind or another.

- A critical near-term challenge of the recovery and reconstruction of Somalia is the need to improve the management of revenue mobilization, intergovernmental transfers, and natural resources revenue sharing at the federal government and constituent member states. This requires clear constitutional principles to guide the process of intergovernmental transfers, and establishment of institutions which guarantee transparency, equity and accountability either through the participation of both levels government or through an independent constitutional commission. For example, formula-based fiscal transfers are appropriate for a federal system of governance. It
is therefore recommended that this framework be considered during the current CRP and incorporated in Somalia’s Constitution.

References


## Annexes

### Table A1: Expenditure Assignments

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Sources:  
1/ The Transitional Federal Charter of the Somali Republic, February 2004  
2/ Local Government Act, No. 7, Puntland State
### Table A2: Ministries of FGS and FMS

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