MANAGING THE TAXATION OF THE INFORMAL BUSINESS SECTOR IN MOGADISHU

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Abstract

Somalia has been experiencing civil unrest since 1991. This has resulted in social, economic, and political instability, as well as the destruction of systems of governance, including the taxation culture. During this period of fragility, businesses of different sizes have, in general, grown informally and no public bodies have asked them to pay tax. The new government, which was established in 2012, has officially resumed tax collection operations in the capital city, Mogadishu. This is the country's largest city. It hosts most of the informal business activities in the country and is the only fiscal space in which the Federal Government of Somalia (FGS) operates.

In this study, we use administrative data from the revenue department, together with information gained from interviews with experts and business owners, with the aim of showing how the revenue department managed to tax the informal business sector in Mogadishu (the FGS's only revenue source) after re-establishing the tax system. It also considers the challenges associated with this and recommends several technical solutions. The findings show that, in Mogadishu, informality is common amongst small and medium-sized enterprises (SMEs). Although the government has increased taxpayer registration rates, begun to tax the sector indirectly, and improved licensing, the study shows that the nature of Somalia's economy, the existence of undertaxed sectors, the limited administrative capacity, the high costs involved in enforcing compliance and formalizing businesses, and a historical weakness in terms of engaging with the business community continue to hinder the proper management of the taxation of the sector in Mogadishu.

We provide recommendations for both the federal revenue authority and revenue officers in the Mogadishu Municipality to help them to develop better administrative and enforcement measures. These measures could enable them to reduce the number of business activities that are taking place outside of the tax net. We also highlight the importance of sequencing the reforms, creating a promising environment for SMEs, simplifying the tax system, and providing taxpayer education.

Keywords: Informal Sector, Taxation, Mogadishu, Municipality, Banadir, Somalia, SMEs.

1. INTRODUCTION

Informality is common in developing economies and the situation is worse in war-torn countries. The tax administrations of countries such as Zimbabwe (Dube & Casale, 2019),

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South Africa (Ryan, 2014), Zambia (Phiri & Nakamba-Kabaso, 2012), and Nigeria (Udoh, 2015), as well as Somalia, have struggled to manage informal businesses and force them to pay tax. In addition, the informal economies of Somalia's neighboring countries, Ethiopia, Djibouti, and Kenya exceed, on average, 40 percent of their gross domestic products (GDPs) (Schneider, 2005). The issue of the taxation of the informal business sector in transition countries has received increasing attention in recent years. According to Joshi et al. (2013) and Keen (2012), taxing the informal business sector is difficult due to: the limited revenue potential involved: their regressive nature, as small informal businesses are often owned by the poor; the high costs involved in collection; and the potential opportunities for corruption and perverse impacts on small businesses. At the same time, the benefits of taxing the sector are: the government becomes accountable to more of its people; economic growth; the development of an important source of local government revenue; and improvements in governance, tax compliance, and taxpaying culture (Joshi et al., 2013).

Since its first appearance in the early 1960s, the term "informal business sector" has become so popular in government systems that it now has different meanings in various circumstances. According to Chambwera et al. (2011):

> On first hearing the phrase 'informal economy' (IE), most people think of illegal activities, such as trading in drugs or prostitution, paying bribes or avoiding taxes. As such, it is often regarded as something that should be eliminated in pursuit of a formal economy (FE). Without much analysis, one can even assume that the IE is a transitional route to formality as economies grow and regulation becomes stronger (p. 1).

Hence, the total economy is divided into two sectors: the informal and formal. According to the Organisation for Economic Co-operation and Development (OECD, 2002), "the informal business sector is broadly characterised as consisting of units engaged in the production of goods or services, with the primary objective of generating employment and incomes to the persons concerned" (p. 217). Meanwhile, Smith (1994), as cited in Schneider (2009, p. 1080), defines the shadow economy as the "market-based production of goods and services, whether legal or illegal, that escapes detection in the official estimates of GDP". Although Somalia's economy largely depends on imports, and the agriculture and service sectors, administrative challenges seem to make it difficult for the tax authorities to detect non-compliance at both the national and sub-national levels. Hassan et al. (2018) argue that informal business does not just take place at domestic market levels, but also occurs during the import and export of commodities. For example, it is illegal to export female animals (livestock), scrap metal, and charcoal, but the informal export of these items is widespread. For the purpose of this study, we focus on income and consumption taxes, and assess the management of the collection of such taxes from informal businesses in Mogadishu, the only city that the FGS manages to tax. The tax systems of all other Somalian cities are managed by their respective Federal Member States and this situation will continue until a nationwide fiscal decentralization agreement is reached.

The country's prolonged economic and political instability has caused the taxation culture to disappear and the number of untaxed businesses operating to increase (Mohamud & Isak, 2019). In fact, trade taxes have dominated the revenue base throughout Somalia's taxation history—which began in the Italian and British colonial eras—due to the lack of a conventional economy and the absence of widely taxable formal markets in the country (Jamal, 1988). Although most businesses and services were provided by European companies, their governorates aggressively taxed trade using strong fiscal policies which no one could challenge. In addition, during the early stage of the military regime, most businesses were state-owned and there were fewer monopolistic private companies in certain sectors (Mubarak, 1996). This situation continued until 1991, when civil war broke out (Mubarak, 1996). Since then, there has been a dramatic increase in the number of informal businesses in operation, and no strong tax regime or regulatory bodies in place (Mohamed et al., 2019; Mubarak, 1996). During this period, the private sector has undergone extensive development at micro, small, medium, and large-scale levels. These businesses have shown resistance and the sector has been a key driver of the economy. Although financial services—including banks and money transfer businesses, telecommunications firms, and trade, transport, and construction service providers—were contributing to the GDP (International Monetary Fund, 2019) and paid scant amounts of tax (Isak, 2018), small-scale businesses and the entire agriculture, livestock, and fishery sectors, which are relieved by statute, paid taxes neither to the federal government nor to the Mogadishu Municipality.

On the other hand, as noted by Tellander and Hassan (2016), Somalia's other Federal Member States are also experiencing issues. For example:

> Somaliland does not have a formal coherent tax policy and Somaliland's duty and tax collection is a patchwork that is lacking proper legal and institutional support. The tax base is small because of the large informal economic sector, the low economic growth, and the fact that the largest corporations do not pay tax according to their earnings. In recent years the face of tax collection has begun to shift, from informal systems to more professional and automated systems of collecting taxes (Tellander & Hassan, 2016, p. 2).

During the civil war, large private sector operators enjoyed more power than the weak transitional governments that were in place prior to 2012. When the government that came into power in 2012 re-established domestic revenue collections after a break of two decades, it faced widespread resistance and evasion activity from the city's business communities (World Bank, 2017b) and from those politicians who were business shareholders or stakeholders at the time. Mohamed et al. (2015) argue that, in Somalia, small businesses provide livelihoods to the wider urban population while companies in the rural, livestock, and agricultural sectors sustain the rural community on a day-to-day basis, but all of these business types are associated with unpaid taxes.

The current tax administration in Somalia (Raballand & Knebelmann, 2020; World Bank, 2015) hinders revenue collection in many ways, such as by failing to manage the collection of tax from informal businesses and SMEs or to enforce compliance within the informal sector effectively. This has ultimately resulted in the existence of a huge tax gap (Raballand & Knebelmann, 2020; World Bank 2017b) which, in turn, has caused Somalia to have the lowest tax to GDP ratio in the world (World Bank, 2019). This gives an indication of weak tax capacity as well as tax to GDP per capita. Studies such as those by Mohamud and Isak (2019), the United Nations (U.N.) Economic Commission for Africa (2019), and the World Bank (2015) provide evidence to support this. The following table shows Somalia's revenue by type as a proportion of GDP in recent years, showing how severely limited the state tax capacity is.

Table 1: Revenues (Only from Mogadishu's Tax Base) as a Proportion of Somalia's GDP

Description	2013	2014	2015	2016	2017	2018	2019
Domestic revenue/GDP	1.7	2.2	2.8	2.7	3.2	3.9	4.6
Tax/GDP	1.6	1.8	2	2.1	2.5	2.9	3.1
Non-tax revenue/GDP	0.1	0.4	0.8	0.6	0.7	0.9	1.5

Data sources: (International Monetary Fund [IMF], 2020; World Bank, 2017b).

Finally, there are, in general, few studies that investigate Somalia's tax system. Some works have examined taxation challenges and weaknesses (Isak, 2018; Raballand & Knebelmann, 2020), tax reforms (Mohamud & Isak, 2019), the state-building aspects of taxation (Abshir et al., 2020), and community-driven revenue generation (van den Boogaard and Santoro, 2021) in the country, but these do not address the challenges faced when trying to tax informal businesses. This paper aims to fill that gap in the literature by exploring the institutional experience of taxing informal businesses and the challenges associated with it in the context of the FGS. It focuses on taxation within the capital city, Mogadishu, as this is the FGS's only source of revenue. Other regions and cities in Somalia are taxed by their respective governments as fiscal harmonization policies have not yet been agreed. However, the sub-national governments can also benefit from this research, as informality is a nationwide economic challenge.

During the research, we used some tax data obtained from the revenue department. We also interviewed eight economists and tax officials, and three owners of small-scale businesses, in order to obtain their opinions about matters that the data and authors' observations do not address. A lack of statistical information about the sector prevented us from quantifying the number of SMEs and the extent of the informal economy in the city, and from measuring the revenue gap. However, the paper highlights the importance of conducting further quantitative studies.

We discuss informal taxation in the second section of the paper, and the establishment of the tax system in Mogadishu in the third. We examine experiences in taxing the informal sector in the fourth section, the challenges associated with this in the fifth section, and present our conclusion and recommendations in last section.

2. THE INFORMAL SECTOR AND ITS TAXATION

Once upon a time, economists paid no consideration to commercial and economic activities that were carried out outside of the formal framework of the economy. Sociologists and anthropologists were the only ones who appeared to study the importance of such business activities. However, in the 1950s and 1960s, the subject of the informal sector became increasingly important to economists (Gërxhani, 1999). The informal business sector was originally observed in developing countries and attracted increased attention in developed countries. The informal sector predominantly affects developing countries because of the huge amount of informal business that takes place in these territories.

Rao (2014) noted that:

> the informal sector consists of firms and individuals who are not fully registered and regulated, and therefore not in the standard tax net. Taxing the informal sector can be through registration and formalisation to push these firms and individuals into the tax net, or it can be through taxing them indirectly. In most countries there are several types of business registration and varying degrees of formalization (p. 19).

According to Auwal Ibrahim Musa (Rafsanjani), the executive director of Nigeria's Civil Society Legislative Advocacy Centre, meanwhile:

> The informal economy is described as the sum total of economic activity that happens outside state regulation, which is neither taxed nor represented in a country's GDP. Other descriptions depict it as economic activities lacking conventional accounting procedures, characterized by high incidences of non-reporting or under-reporting and is excluded from social measurement apparatus such as the Gross Domestic Product, GDP (Oduwole & Sanni, 2014, p. 3).

According to Medina and Schneider (2018), the existence of an informal economy is a larger problem for less developed countries. Countries with advanced economies have the lowest informal economy to GDP ratios, while emerging market, low-income countries and sub-Saharan African countries have the largest shadow economies (Medina & Schneider, 2018).

Mramba et al. (2017) state that "in Sub-Saharan Africa (SSA), the informal sector constituted from roughly 50% to 75% of non-agricultural employment, and 30% to 60% of gross national products (GNP) in 2000s" (p. 486). They note that the birth of the informal sector in sub-Saharan Africa is associated with economic adversity, a low standard of living, and a weak State. SMEs support and seek low-cost goods and services (Mramba et al., 2017). They add that "in many cases the informal sector is the only opportunity available for poor people to make them survive" (Mramba et al., 2017, p. 489).

There is an extensive informal sector in Somalia, even though there is no country statistical data in respect of this issue. The informal sectors in neighboring and other regional countries are also large. According to Schneider (2005), the size of the shadow economies of Ethiopia. Kenya, and Uganda as percentages of official GDP were 42.1%, 36.0% and 45.4% respectively. Comparison with the sub-Saharan average, which includes Somalia, implies that, for Somalia, this number is above 36%. This means that Somalia's case could be worsening due to its severe fragility (Kalyundu & Norregaard, 2020).

According to Kimani (2018):

> Somalia's economy is largely dominated by the informal sector and the majority of the population lives at subsistence level and is involved in micro and small-scale businesses. Despite being ranked last of 190 countries on the World Bank's Doing Business Index in 2016 and 2017, Somalia's private sector has demonstrated impressive resilience in areas such as telecommunications, financial services, construction, livestock, and fisheries. It has been estimated that Somali women make up over 60% of business owners, consisting of microenterprises as well as medium to large enterprises and businesses connected to the diaspora (p. 4).

According to Cantens and Raballand (2021), "taxing the informal sector…is usually an explicit objective for policymakers and tax authorities when the taxation of other areas, such as real estate, is poorly developed or enforced" (p. 14). They argue that the informal sectors in fragile countries, especially sub-Saharan Africa (including Somalia), should be taxed because "they represent numerous people with low bargaining power" (Cantens & Raballand, 2021, p. 14), They go on to state that:

> Taxation of this sector could bring more revenue than focusing on wealthy taxpayers, who have more bargaining power. It may however lead to limited increased revenue at the end of the process, especially when tax administrators face widespread corruption, and the informal sector is tolerated with limited taxation (Cantens & Raballand, 2021, p. 14).

The informal business sector is not completely without taxation. In many jurisdictions businesses in the informal sector pay VAT on purchases of inputs, presumptive taxes, and various local license fees (Action Aid, 2018). Taxes from informal businesses remain low in Somalia even though they have been rapidly increasing from a low base since 2012 when the FGS re-established the taxation system in Mogadishu. Raballand and Knebelmann (2020) carried out an experiment in rural villages in South Somalia and their results revealed that "the bulk of taxation is informal (for instance, clan or clergy contributions" (p. 19). They also note that informal taxpayers may be liable for both national and sub-national taxes, and that:

> multiple taxation at the sub-national level (that is, at the FMS, district and/or community levels) is often a major constraint for micro and small enterprises. It is these enterprises that provide income generation and growth. Multiple taxes, fees, charges, licenses, and so on make it difficult to establish new businesses and enter new markets (Raballand & Knebelmann, 2020, p. 19).

Raballand and Knebelmann (2020) state that taxpayers in Somalia "may also contribute to local governments, communities and even militias" (p. 19), something which is also noted by van den Boogaard and Santoro (2021).

Abshir et al. (2020) state that the challenges faced when taxing the informal sector are not unique to Somalia. Other countries have faced the same difficulties and have applied measures to ensure that their informal sectors are taxed appropriately. As noted by Phiri and Nakamba-Kabaso (2012), for example, in 2004, Zambia introduced "the Presumptive Tax on taxis and minibuses and the Turnover Tax on small-scale enterprises" (p. 6). They add that, following this, "a Base Tax on marketeers (2005) and an Advance Income Tax (AIT) (2007) for cross-border traders were introduced" (Phiri & Nakamba-Kabaso, 2012, p. 6). In addition, the United Nations (2019) indicates that "presumptive tax regimes have become an increasingly common method of taxing the informal economy in developing countries" (p. 9). Kenya is a good example, since it implemented a three percent business turnover tax (TOT) in 2008 on SMEs with turnovers under five million Kenyan shillings, whereas businesses with turnovers between 500,000 and five million Kenyan shillings must pay income tax and VAT (Ndaka, 2017).

According to Fjeldstad and Heggstad (2011), Tanzania has developed turnover and presumptive taxes that are more progressive and have lower thresholds than those applied in Zambia. Tanzania collects presumptive tax through a Block Management System, in which units of tax collectors move from building to building in the regions to identify SMEs, and informal enterprises pay presumptive taxes based their sales magnitude and accessible records. In Ghana, small businesses pay a flat rate turnover tax of 3% rather than ordinary VAT, while microbusinesses are subject to a stamp tax regime, under which a set tax is paid on a quarterly basis (Ehun, 2016; Prichard, 2009). In Ethiopia, small businesses with turnovers under the VAT threshold are required to pay a presumptive turnover tax (Bongwa, 2009).

Although Somalia has experienced decades of civil war and political unrest, its economy survived, largely in the form of an informal business sector, which predominantly consisted of small businesses in sectors including livestock and agriculture. In 2012, the FGS focused its attention on domestic revenue collection. It established a tax framework and began to collect presumptive tax from accessible businesses, road tax, and property tax (the municipality currently collects this) (World Bank, 2017b). According to Webersik (2006):

> The informalisation of the economy started in the late 1970s with urbanisation and the growth of demand for wage labour. The development of a formal private sector was impossible during the socialist regime, but even after the change of political orientation in the late 1970s most companies remained state-owned. This forced many small traders and business people into the informal sector (p. 1468).

Webersik (2006) also noted that the informal sector grew dramatically after the end of military rule in 1991.

Both the national government and subnational authorities are facing their own challenges in raising revenue from businesses that are not in the fiscal net. Mirito (2017), for example, discussed the challenges faced by the government when attempting to raise revenue in Somaliland. Van den Boogaard and Santoro (2021) found that informal revenue generation is prevalent in the Gedo region. According to their results, 71 percent of households “paid at least one informal tax or fee in the previous year” (van den Boogaard & Santoro, 2021, p. 26). They note that communities “are heavily reliant on voluntary contributions to maintain public goods” (van den Boogaard & Santoro, 2021, p. 6). They also show that informal revenue generation is regressive. They add that informal revenue generation can benefit local state institutions and cause more challenges for informal business sectors and governments (van den Boogaard & Santoro, 2021).

Haas (2017) notes that in Hargeisa, Somaliland, “property related taxes already make up the highest proportion of local taxes collected” (p. 3). However, she adds, “total overall local revenue collection remains low”. As a result:

> the Hargeisa city government is now exploring further ways to enhance its own-source revenues by reforming the municipal finance system and registering the informal sector to formalize and tax them more generally and potentially, more specifically, its property taxes… (Haas, 2017, p. 3).

Mackie et al. (2017) quoted an unnamed senior government official from Somaliland, who stated that “‘the government is not helping but it’s not hindering. It gives the informal sector space to develop and grow’” (p. 376). The official added that this meant “minimum government taxes” were applied (Mackie et al., 2017, p. 376). Therefore:

> the civil war and peace negotiations created a political and economic context in which informal economy workers could survive, but it remains unclear whether

> political pluralism and a more supportive policy context will continue, enabling an increase in both productivity and tax revenue from informal economy operations. Thus, workers themselves remain in an uncertain and in-between state of benign tolerance (Mackie et al., 2017, p. 376).

As revealed by Jordan (2016), and Boogaard and Santoro (2021), the Jubaland Revenue Authority manages informal sector revenue collection within Kismayo, and utilizes indirect taxes, such as turnover tax with segmentation and customs duties. However, other cities in Jubaland, like Gedo, use community-based taxation or informal payments to non-state actors, such as clan elders, religious leaders, civil society organizations, and private service companies.

Generally, most of the FMS in Somalia apply indirect taxes, such as turnover taxes with segmentation, to the informal sector. Public Resource Management in Somalia (PREMIS) "supports the establishment of core Public Financial Management laws, processes, systems and institutions, so that Federal Member States can assure transparency and accountability in public expenditure" (Adam Smith Institute, 2021). This involves registering and taxing informal businesses. According to the Adam Smith Institute (2021), PREMIS has "helped increase revenue across the four states".

The taxation of the informal economy can be an important revenue source for a government, as informal sectors can be large, as in Somalia. However, informal businesses are often taxed. This is done through numerous types of indirect taxation such as fees, local taxation, market taxes, charges, and licensing costs, which may be levied locally, nationally, or both. Many informal businesses in Mogadishu are not registered and do not have licenses. More medium-sized and large businesses, however, do have business licenses as they can afford to be registered (Abshir et al, 2020).

According to the International Labour Organization (ILO):

> The root causes of informality include elements related to the economic context, the legal, regulatory and policy frameworks and to some micro level determinants such as low level of education, discrimination, poverty, and…lack of access to economic resources, to property, to financial and other business services and to markets (ILO, 2016-2021).

Ali (2018a), investigating factors affecting tax evasion in respect of automobile tax in Banadir, found that there was a negative significant relationship between the tax system and tax evasion. However, there were positive significant relationships between the following factors and tax evasion: tax rate, corruption, income level, and education level. He states that "essential measures ought to be taken by the tax authorities to enhance income collection and decrease tax evasion. In addition, he recommends that a crusade against corruption, public enlightenment on tax issues and correction of tax procedures should be embraced" (Ali, 2018, p. 1). As indicated by Samantar and Abdulhai (2020), in "the past few years, the country's fiscal performance improved due to increased mobilization of domestic revenue and reforms in tax administration" (p. 7). However, they conclude that "Somalia's fiscal space is still extremely limited, and the COVID-19 pandemic has put extraordinary pressure on the FGS and FMS budget" (Samantar & Abdulhai, 2020, p. 23).

The informal sector in Somalia has faced many challenges, particularly in 2020, when it was affected by COVID-19. As noted by Abdullahi and Sharif (2020), many of the country's "businesses have closed while others, mainly in the informal economy, have been hugely impacted by the restrictions and efforts to fight COVID-19" (p. 1). This has resulted in less revenue being received by the government from a sector that already pays less tax than others. The FGS's Ministry of Finance implemented a short-term fiscal response to mitigate the impact of COVID-19, introducing 100% import tax relief on rice and dates[5], and reducing import tax on wheat flour and cooking oil by 50% (Barrow, 2020). By doing this, the government aimed to prevent a price hike for necessary commodities, as other relevant costs, such as shipping costs, had increased at that time.

In conclusion, the literature includes a number of recommendations for taxing the informal sector. First, the government should ensure that booming businesses in the informal sector are registered and taxed by increasing the incentives available for firms to become formalized and imposing penalties on those who fail to do so. Second, the simplest way to tax the informal sector is indirectly, by taxing the goods and services that it buys and sells, most obviously through broad-based consumption tax, and import and export duties. Finally, most of the literature notes that presumptive and turnover taxes are the most successful fiscal instruments and are targeted at the informal sector. Somalia plans to introduce turnover tax in 2022 and fiscal economists should keep an eye on this to see whether it succeeds or fails. The FGS has succeeded in taxing the informal sector indirectly, has previously tested presumptive taxes, and is planning to impose turnover taxes in 2022. However, current practices do not indicate that formalization of businesses will be incentivized or strongly enforced in the short to medium term, despite the daily taxes levied by local government on certain informal businesses. There is still a great need to improve the infrastructure and operating space for the informal economy.

3. RE-ESTABLISHING BUSINESS TAXATION IN MOGADISHU

Somalia's tax system became operational again in 2012, following the establishment of a new government on the basis of the Provisional Constitution which was adopted in the same year. Tax payment culture and other fiscal framework practices have been absent in the country since 1991. The absence of an active government during the period of conflict caused most business and economic transactions to take place informally. However, after the 2012 government was established, the Ministry of Finance began to build a fiscal framework, which included the collection of revenues from business communities and the general public. Taxes managed by the federal government include income tax—both corporate and individual—sales tax, stamp duty, registration, and road tax, while import and export duties are collected at the customs points, including airports and seaports. Regional jurisdiction taxes, which are administered by the Mogadishu Municipality, include property taxes, local market levies, and other charges, as it receives a certain amount from customs revenue (Isak & Ali, 2019). These are transfers from the federal government to help the capital city administration to deliver public goods to the locations of the taxpayers who contribute to the respective tax base. While the government has continued to implement reform measures, the lack of a properly managed tax system proves that the current framework has gaps relating to legal, policy, organizational, and personnel capacity matters. These gaps have limited the newly established government's ability to mobilize enough domestic resources to fund the delivery of public services.

[5] The full relief on import duty for dates reflects their massive consumption during Ramadan, when communities around the globe fast.

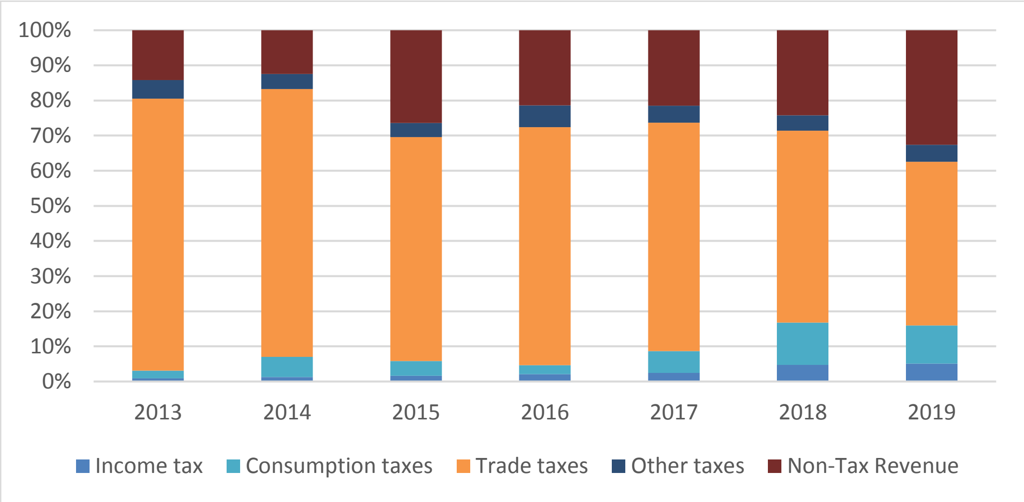
In order to establish a business taxation framework, the Ministry of Finance gradually implemented its short to medium-term tax strategy, as follows. First, the government started ad hoc tax collections, showing its disorganization, and coercive tax collection was safeguarded by its fiscal police unit. Building a rapid fiscal muscle was necessary in order to execute a newly enacted mini-budget for the last four months of 2012. Income tax collection from public servants started with deductions at source. Very little revenue was generated via sales tax and income tax collected from businesses by force. Collections were characterized by improper assessments, a dependence on cashiers, a large number of loopholes, a large amount of collusion between officers and taxpayers, and a coercive style of enforcement due to the use of the fiscal police (Isak, 2018). Despite the above conditions, the government grasped revenue from businesses, with the largest portion coming from customs, where import duty is collected from all incoming business commodities. Property taxes and some other regional charges were given to the municipality administration by regional administration law (Isak & Ali, 2019), adding surcharges to khat imports. Core revenue functions were not established and taxpayers' complaints went unheard. Work on key responsibilities, including taxpayer registration, segmentation, tax education, verification, and arrears management, has been almost non-existent. In addition, the administration of the informal sector and SMEs was part of the Ministry of Finance's short to medium-term revenue strategy, but it can be counted as one of Somalia's federal tax administration's failures.

Subsequently, the tax administration began to fix payments or negotiate them with businesses. In 2014, the tax administration began to tax formal and informal businesses by fixing the amount of tax due from each business based on the amount of capital it had. Kiosks paid small amounts of tax and corporations large amounts, and so on. These fixed amounts are paid as lump sums and are not calculated as measurements of the tax base (consumption, income, or wealth). This amount is presumed to include all types of tax for which the taxpayer is liable, regardless of the statutory amounts and rates (Mohamud & Isak, 2019). Lump-sum taxes, like poll tax or sin tax, have frequently been shown to have regressive effects, but could have a progressive impact if applied to luxury goods and services. The government accepted lump sum amounts from businesses—for example, $20 per month from small businesses and a higher amount from medium and large businesses. Furthermore, the FGS reintroduced road tax on vehicles and trucks using public roads, stamp tax on documents, invoices, and contracts, and property transfer tax on the transfer of property ownership from one individual or entity to another. The FGS collected these taxes in order to generate more revenue and provide social services to the Somali population, as the Ministry of Finance was still struggling to fulfill its obligations as the sole funding source for such a needy society due to the fact that it had limited funds. An immediate response to the resistance coming from business communities, and to the state's limited administrative capacity to manage taxation and access business's financial information, was to collect negotiated payments (Raballand & Knebelmann, 2020; World Bank, 2017b). One person interviewed for this paper stressed that "due to the fiscal pressure and growing public responsibilities, associated with weak administrative capacity, there was no way but to accept".

In 2017, the Ministry of Finance finally set a schedule for the application of the existing tax laws as there had been few improvements in tax administration, and developed several very basic tax reform measures which covered both tax administration and policy (World Bank, 2017b). The Inland Revenue Department started to enforce the existing tax laws by ending discussions with businesses about paying negotiated amounts although some, including Raballand and Knebelmann (2020) and Abshir et al. (2020), believe these negotiations still take place. These tax reforms had political support from the country's top policy officials.

Businesses started to pay core taxes, such as sales taxes, as well as personal and corporate income taxes, and did not have the opportunity to engage in non-compliance at customs. Correspondingly, the cabinet of ministers issued ministerial instructions and regulations to cover some of the legal gaps relating to tax collection, as the tax laws were not up to date. Regulations were issued with the purpose of legalizing some taxable areas and amending a few of the tax rates being applied to particular goods and services. Somalia still needs complete and up-to-date tax laws which address current and potential tax issues. However, the principles of taxation, including equity, fairness and justice, were completely absent from the existing legislation. SMEs were outside of the framework as they were neither licensed nor asked to pay taxes. The pressing challenges were weak administrative capacity, instability, insecurity, and noncompliance from formal and informal businesses. These produced the following tax structure, which shows a high reliance on trade taxes rather than the establishment of sustainable income and consumption taxes.

Figure 1: Composition of FGS Revenue (Only from Mogadishu)



Data sources: IMF, 2020; World Bank, 2017b

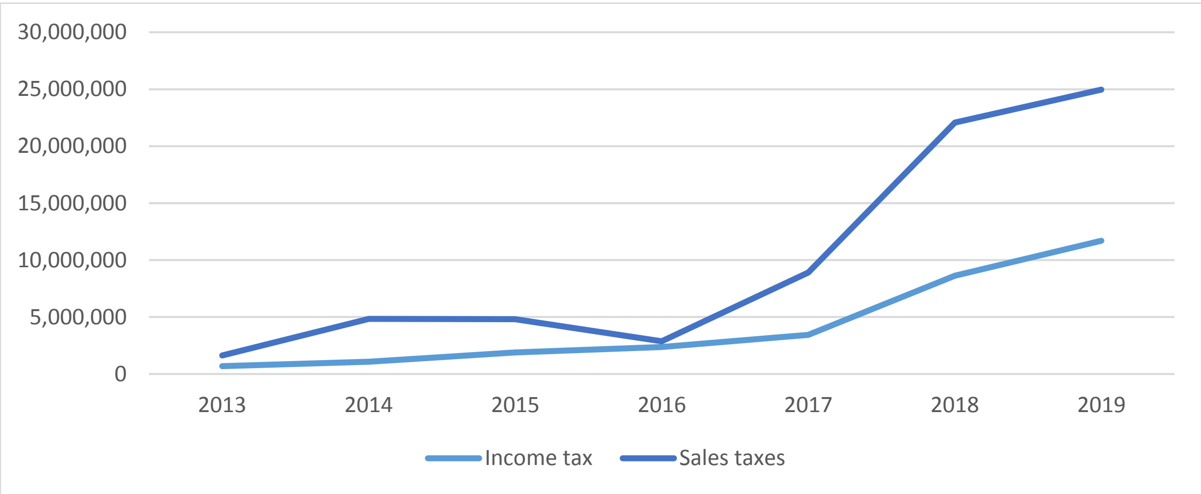
This graph shows the percentage composition of different types of government revenue in Somalia. The main revenue sources are customs taxes and non-tax revenue, while consumption and income taxes, although growing incrementally, still lag behind.

4. TAXING THE INFORMAL SECTOR IN MOGADISHU AND ASSOCIATED CHALLENGES

The first steps taken to formalize informal businesses were to register taxpayers, issue tax identification numbers, and issue compliance certificates. This was part of the implementation of important economic and tax reforms in mid-2018. Furthermore, the segmentation of the businesses by scale and the establishment of Large and Medium Taxpayer Office (LMTO) in order to formalize the largest taxpayers have positively impacted the government's efforts to enhance the tax system after the civil war. The LMTO succeeded in registering Mogadishu's largest contributing entities in the hotel, telecommunications, financial, transportation, and light industry sectors. In addition to this, non-profit organizations have been registered so that income tax can be collected from their employees. The issuance of a tax identification number and tax compliance certificate together contributed to the improvement of the compliance level of informal businesses and brought them into the tax net, as it could be made compulsory for them to have both certificates in order to renew their commercial license and to bid for tenders put out by the government, the United Nations, and non-for-profit organizations in Mogadishu. At this point, taxpayer registration had a positive impact through the formalization of more SMEs and informal operators, and even several large companies (Mohamud & Isak, 2019).

Having extended the tax base and developed a policy of taxing the informal sector indirectly, the next step for the Ministry of Finance was to reintroduce sales tax and income tax. Tax administration officials began to collect sales tax at the Port of Mogadishu (Isak, 2018). Businesses protested, citing that sales tax, by statute, has to be paid by the end consumer, while the Ministry of Finance was insisting on collecting it at customs. The Ministry of Finance did this, in part, to reduce administrative costs and to increase enforceability, bearing in mind the security challenges that the country faced (Mohamud & Isak, 2019). It was also the simplest and best way by which to tax the informal sector indirectly, since they only trade with these commodities coming through the customs (Mohamud & Isak, 2019). The personal income tax base was broadened to include both the private sector (personal and corporate) and non-profit organizations. This is a good example of broadening the tax base throughout a country. In addition, the Inland Revenue Department implemented policies that improved the application of existing tax laws, reduced informality by requiring businesses to register with the tax departments, and rebuilt the district tax office in order to capture informal businesses in each of Mogadishu's districts. At this point, business communities appear to have complied with the government's reform packages, so the government experienced a continued upward trend of domestic revenues, as shown in the following graph.

Figure 2: FGS Income and Sales Taxes



Data sources: IMF, 2020; World Bank, 2017b

The graph shows the incremental changes in income and sales tax income after formalization measures began to be taken in Mogadishu. However, due to poor administrative capacity, the revenues from these two tax sources remain very low.

The FGS has also taken measures to simplify and modernize tax collection. In this way, the Inland Revenue Department began to use technology-driven tax systems, accept mobile money—i.e., money other than cash—and make preliminary improvements to taxpayer services programs (Mohamud & Isak, 2019). These short to medium-term revenue strategy elements helped to engage the business communities and convince them to cooperate with the tax administration. In addition, a World Bank project has provided Somalia with the opportunity to implement a technological strategy which aims to achieve widespread use of automation—an Integrated Tax Administration System (KPMG Advisory Services Limited and KasmoDev Consulting, 2021). These measures, taken in addition to some transparency measures, are believed to be capable of forming the basis of a solid tax administration system which can develop a modernized registration system and taxpayer service, and simplify the tax system for potential taxpayers, including those in the informal sector.

The government is also tentatively planning to collect turnover tax in Mogadishu, with the aim of bringing informal operators, including small-scale businesses, into the taxation framework. In recent years, the federal government has struggled to bring a number of activities into the tax net, including those of hospitality, telecommunications, and airline companies as consumption tax on imported goods is paid in advance by the traders (IMF, 2018; 2019). Furthermore, the tax regime is expected to accommodate new business entities and help the government to formalize activities that are happening in the shadow economy. The introduction of turnover taxes has had a positive impact in several developing countries, including Tanzania (Fjeldstad & Heggstad, 2011). The aim of this is also to generate more tax revenue for the government. However, there is a lot to do, as noted by ActionAid (2018) while discussing how this tax policy instrument could, if well-managed, bring more business entities into the government's fiscal net.

First, the current nature of the country's economy indicates the existence of a huge informal sector, as informality exists throughout the region. Although there is no country-level statistical data on the shadow economy, neighboring countries have large informal economies as, on average, a sub-Saharan country's shadow economy is more than one-third of its GDP. Given Somalia's fragile situation, the situation there is likely to be worse than in other countries in the region.

Second, the activities of most dominant (specialized) sectors of the economy are informal and are legal tax havens. Tax laws fully exempt the application of taxes on transactions arising from the agriculture, livestock, and fishery sectors. This has led the tax authorities to ignore the informalization of operators in these markets, as other related administrative fees are managed by the relevant ministries. Most tax laws were enacted during the evolution of the agriculture industry in Somalia, as this sector was also dominated by state companies. The bias in favor of state-owned enterprises (SOEs) has persisted in the long-term tax policies.

Third, the weakness of the government's administrative and enforcement capacities allowed for the existence of an extensive informal sector. Although the government formalized several activities in sectors in Mogadishu, most retail business activities are neither formalized nor taxed. The informal sector is not well managed due to the fact that the tax system is still fragile. The government's tax administration capacity is very limited. Weaknesses include a lack of sufficient equipment and limited use of information technology. Although company law has been passed, commercial licensing capacity is still limited. Other studies, including Isak (2018), have also noted this. According to Raballand and Knebelmann (2020), "these administrative weaknesses result in a situation in which some essential functions of an effective tax administration are simply not undertaken" (p. 22).

Fourth, most SMEs in the city of Mogadishu stay in the informal sector because the costs involved in accessing the regulations and staying formalized are too high. Studies by Loayza

(1997) and de Soto (1988) also discuss this phenomenon. If incentives are not provided, SMEs that are mostly informal can't be brought into the formal economy. Somalia is one of the worst countries in which to run a business, as the environment does not help SMEs to grow quickly. In fact, in 2020, the World Bank ranked Somalia last of 190 economies for ease of doing business (World Bank, 2020).

Finally, the tax administration has engaged very little with the business community historically. Interviews conducted with long-serving and retired tax officials for this research revealed that there has always been a lack of engagement with the public in general and with business communities in particular. In the pre-independence period, the ruling colonial administration did not engage with taxpayers and took a coercive approach, enforcing their fiscal demands. Post-independence governments have not paid the necessary attention to the private sector. Furthermore, the case became extreme in 1969, when the socialist military regime came in and established SOEs to supply almost all goods and services, while nationalizing most existing private companies. In 1991, the outbreak of civil war marked the beginning of a period of anarchy during which non-state actors demanded numerous payments from the public and, in particular, from the business community. In addition, the current government should provide multiple taxpayer services, including tax education, transparency services, solutions for the multiple payments currently required, and the responsive implementation of the fiscal side of the social-state contract. Fjeldstad et al. (2018) address the importance of improving taxpayer-tax administration relations.

5. CONCLUSION AND RECOMMENDATIONS

The tax system has been recovering rapidly in Mogadishu and, to a lesser extent, in other sub-national Somalian states. The existence of large numbers of informal businesses had placed a heavy burden on the nation's tax collection system. The informal sector, which comprises a wide range of small-scale and agricultural businesses, was not properly taxed in Somalia and, in particular, in Mogadishu. This paper has examined how the informal sector is treated by the fiscal offices in Somalia, utilizing a set of business data from the Ministry of Finance. It investigated data on the informal sectors and business taxation in other fragile and neighboring countries, as well as interviews with economists, tax officials, and SME owners in Mogadishu about their experiences. Observed challenges included the country's economic structure, the presence of specialized tax-relieved agriculture sectors (agriculture, livestock, and fishery), the government's limited administrative and enforcement capacity, the high costs involved in formalizing businesses, and the tax administration's historical failure to engage with the business community. The authors' recommendations for revenue authorities at both national and regional levels (including municipality level) follow:

1. Joint tax policies should be developed in order to improve administration and enforcement strategies, so that the number of informal activities happening outside of tax net can be reduced. This is also suggested by Kalyundu and Norregaard (2020).

2. Reforms should set out, prioritized, and sequenced. Recent tax reforms have only been at a basic level, so the tax administration needs to be integrated if it is to sequence tougher reforms effectively. The IMF (2017) also highlighted the importance of this.

3. The tax system should be simple and cost-effective. Stakeholders should be able to understand it and it should not damage businesses. Simplifying tax procedures for the public would also eliminate the need to carry out unnecessary practices in respect of tax return

completion and submission, and the payment of tax (Bird, 2015). When discussing how Norway can support taxation in fragile states, Fjeldstad et al. (2018) state that the "first-priority ambition must be 'do no harm'" (2018, p. 34) while Bird's recommendation for an effective tax system is to "keep it simple" (2015, p. 31). The use of these strategies together could enable governments in fragile countries to build proper tax administrations.

4. The provision of better taxpayer services could improve the necessary engagement with the business community, as it could reduce the gap that has existed, long term, between the authorities and the taxpayers. The establishment of a taxpayer education scheme and continued business registration are highly recommended.

5. The government should incentivize SME owners in Mogadishu to formalize their businesses. They should simplify the process by lowering the burden of payments and the complex procedures that result in high costs for small-scale entities and, hence, discourage them from shifting to the legal framework. This process requires participation from an array of public institutions, including revenue offices, the municipality, and the Ministry of Commerce and Industries.

6. Booming informal businesses, including large and medium-sized enterprises, which are making good incomes should be captured and taxed. This could be achieved by increasing formalization incentives and imposing penalties on businesses that fail to become formalized.

7. Finally, the newly established statistical bureau should collect data about the informal sector and quantify its magnitude in order to make it simpler to calculate the informal economy as a percentage of the GDP. As a result of this, it would be possible to conduct further quantitative research.

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