INSTITUTE FOR STRATEGIC INSIGHTS AND RESEARCH

CAN SALES TAX BE EFFECTIVE IN SOMALILAND'S INFORMAL ECONOMY? CHALLENGES, IMPACTS, AND POLICY SOLUTIONS

Abdiwahab Sancawl | March 2025

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Introduction

The new president of Somaliland His Excellency Mr. Abdirahman Mohamed recently proposed the introduction of a sales tax, the first proposal of its kind in the country. The proposal includes taxation on sales conducted through merchant accounts linked to mobile money platforms such as Zaad, E-Dahab, MyCash, and Sahal, as well as transactions made via bank e-wallet systems. Additionally, the policy extends to taxing telephone calls, SMS, and internet data usage (Presidential Office).. This ambitious initiative is intended to expand the country's tax base, enabling the government to generate the revenue necessary to finance essential public services and development projects.

Sales tax is a consumption-based tax levied on goods and services at the point of sale. It is typically paid by the customer and collected by businesses, which are responsible for remitting the tax to the government. Shoup et al., (1984). Sales taxes play a crucial role in generating government revenue, funding public services, and contributing to economic stability. There are several types of sales tax, each with distinct structures and applications. A standard sales tax applies a flat rate to all goods and services, making it straightforward but potentially regressive. Value Added Tax (VAT) is a multi-stage tax imposed at each stage of production and distribution, ensuring that taxation is based on the value added at every step. Another widely used system is the Goods and Services Tax (GST), which functions similarly to VAT but often applies a single uniform rate across all goods and services. Sales tax rates vary globally, depending on the country's tax structure and economic policies. In the case of Somaliland, the newly introduced sales tax is set at 5%, positioning it within the average global range. Nonetheless, taxation is a fundamental and legitimate function of any government, serving as a crucial mechanism for generating revenue to fund public services and infrastructure. It is not merely a fiscal policy but a necessity for the very existence and sustainability of the state, enabling it to fulfil its obligations to its citizens, maintain stability, and drive economic development. A well-structured tax system enables governments to generate revenue effectively and allocate public resources efficiently, ultimately improving the welfare of citizens. (Al Quraan 2020). However, the success of any taxation policy hinges on several key factors, including the overall economic landscape, the strength of enforcement mechanisms, and the level of public compliance. Without a robust tax administration framework, transparent financial reporting, and efficient collection systems, even the most well-intended tax policies may face significant challenges in achieving their intended objectives.

Given Somaliland's predominantly informal economy, where a vast majority of businesses and individuals

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operate outside the formal banking system, the feasibility and effectiveness of the newly introduced sales tax policy remain uncertain. The absence of a structured financial reporting system, limited tax enforcement mechanisms, and weak integration between mobile money payment platforms and formal banking institutions pose significant challenges to the implementation and compliance of the new sales tax.

This article examines the viability of the proposed taxation framework, assessing its potential economic impact, key challenges, and broader implications for businesses and consumers. Furthermore, it identifies fundamental reforms necessary to establish a more efficient and transparent tax administration system.

The Economic Impact of the Proposed Sales tax Policy

In general, the introduction of new taxation into an economy carries significant economic implications, affecting various sectors in different ways. On one hand, the additional revenue provides the government with greater financial capacity to fund essential public services, infrastructure projects, and development initiatives. On the other hand, it places an added burden on taxpayers. For businesses, increased taxation raises operational costs, which are often passed on to consumers in the form of higher prices for goods and services. This, in turn, weakens consumers' purchasing power, reducing their disposable income and potentially leading to lower overall consumption. Similarly, when taxes are levied directly on individuals, household budgets are constrained, limiting spending in other areas of the economy.

The impact of taxation on individuals, households, businesses and the country, are anchored on how the revenue is utilised. If invested in infrastructure, job creation, and essential services, the long-term benefits could outweigh the short-term financial strain, driving economic growth and resilience by stimulating employment and economic activity

The newly proposed sales tax by the Somaliland government is expected to have varying implications across different sectors. If implemented effectively and supported by complementary policies, it could provide the government with much-needed revenue to fund development projects, fulfil campaign promises, and sustain essential public services. The tax however poses a significant burden on a population that already struggles with low incomes. Businesses, in response to the tax, are likely to pass the additional costs onto consumers, many of whom are already living below the poverty line. This, in turn, could trigger inflationary pressures, further eroding purchasing power. Particularly concerning is the taxation of essential utilities such as water, electricity, telephone charges, internet data usage, and education-related expenses,

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which constitute a significant portion of household budgets alongside rent and food. In the short term, these added costs could make it even harder for families to afford essential services, disproportionately affecting lower-income groups.

If the government channels these funds into productive, socially beneficial investments, such as infrastructure projects that create jobs and generate additional economic activity, the initial financial strain on consumers could be offset by long-term economic growth and increased employment opportunities. On the other hand, if the tax revenue is primarily used for recurrent expenditures such as salaries, fuel, and office supplies, as has been common practice, the policy may weaken household budgets without providing meaningful economic benefits, potentially leading to prolonged inflationary effects and reduced consumer spending.

Somaliland's Economic Landscape and Challenges

The Somaliland economy is predominantly composed of informal businesses, ranging from small-scale enterprises to larger commercial entities. These businesses are typically characterized by a lack of standardized financial reporting system, a critical tool for effective tax administration. Without structured financial reporting, tax authorities face significant challenges in verifying business transactions and enforcing tax compliance, as the government must rely on businesses to self-report their sales figures. This reliance carries the potential for inaccuracies and underreporting, undermining the accuracy of the tax base. Notably, most sales transactions in Somaliland are conducted digitally through mobile money platforms like Zaad and E-Dahab. However, these transactions are often not linked to any formal bank accounts, meaning that they are not captured within the traditional banking system. The lack of integration between mobile money platforms and formal financial institutions makes it difficult for tax authorities to trace transactions, leading to significant gaps in the tracking of actual sales volumes. As a result, applying appropriate taxation becomes a complex task.

Moreover, the absence of designated business bank accounts and government-approved point-of-sale systems exacerbates these challenges. Without a formal accounting framework or a reliable oversight mechanism, businesses can under-report their sales or evade taxes altogether, further eroding the country's tax revenue. The government's existing tax collection infrastructure is underdeveloped, and the lack of digital integration between mobile payment systems and the banking sector only compounds the difficulty in ensuring effective tax administration. These systemic weaknesses collectively contribute to a fragile enforcement mechanism, which severely limits the government's ability to implement a transparent and efficient tax policy.

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The effectiveness of a sales tax policy depends on a fully functioning tax ecosystem, where tax administration infrastructure, a standardised accounting system, and a well-integrated banking network all work in harmony. In Somaliland, while the country enjoys a seamless mobile money payment system, the challenge of implementing such an ambitious policy is substantial. To ensure that the sales tax is effectively enforced and that the country can capture a broader tax base, several key reforms must be undertaken prior to its implementation. These reforms are essential to build the necessary foundations for the policy to succeed. Only once these foundational reforms are in place will Somaliland be able to implement the sales tax policy effectively, ensuring that the system is transparent, efficient, and able to support the government's fiscal needs.

Policy Reforms

Given the current economic landscape, where Somaliland's economy is largely informal and tax collection infrastructure remains underdeveloped, the proposed sales tax policy is likely to face significant challenges in implementation. If introduced within the existing framework, it could incentivise tax evasion rather than generate the intended revenue. For instance, mobile money merchants may resort to underreporting sales or shifting transactions to personal Zaad accounts instead of using registered merchant accounts to avoid taxation.

This article proposes a set of recommendations designed to enhance the effectiveness of the policy. These recommendations consist of multi-stage measures, encompassing both short-term actions that can be implemented within the current system to enhance compliance and enforcement, and long-term structural reforms designed to create a more transparent, efficient, and sustainable tax administration system. While short-term reforms focus on immediate adjustments to improve tax collection, long-term measures aim to modernise financial reporting, enhance digital integration, and strengthen enforcement mechanisms. These efforts are essential to ensuring that the sales tax policy contributes to economic stability rather than imposing an excessive burden on businesses and consumers.

The short-term recommendations serve as foundational measures that complement the existing tax administration infrastructure, ensuring effective tax collection and compliance. While key components such as the Taxpayer Identification Number (TIN), digital tax platforms, and an integrated tax information system are already in place (Ministry of finance); the following additional steps are necessary to enhance efficiency and address existing gaps:

A. Establish a Technical Expert Committee: Form a specialised committee of experts to assess the current tax landscape, identify implementation challenges, and develop a

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strategic road-map for rolling out the policy effectively.

B. Begin with large, registered companies: Initially apply the sales tax to large, registered businesses that already maintain bank accounts, as they have the capacity to comply with formal tax reporting requirements.

C. Formalise businesses of all sizes: Establish a business registration scheme and mandate the opening of a business bank account. Businesses without a valid business bank account should have their licences revoked, and/or their licences should not be eligible for renewal upon expiry.

D. Automate tax collection with telecom operators: Telecom companies should automatically deduct and remit taxes to the government through a real-time digital tax collection system installed and managed by the government. This system should be directly linked to telecom operators' servers, ensuring seamless, accurate, and efficient tax collection while enhancing compliance and transparency.

E. Develop a comprehensive sales tax management platform that simplifies tax calculation, collection, reporting, and compliance for businesses of all sizes. The platform should offer automated tax rate determination, real-time transaction tracking, and seamless integration with e-commerce and accounting systems. It must ensure full compliance with national tax regulations, including VAT, GST, and sales tax. The system should also feature automated filing and remittance, audit-ready reporting, and compliance monitoring tools to minimise errors and prevent tax evasion.

F. Introduce a simplified tax system for small businesses: Design a straightforward tax structure that minimises compliance costs for small enterprises, reducing the risk of evasion and encouraging voluntary participation.

G. Strengthen tax collection and enforcement mechanisms: Provide training for tax officials to enhance their understanding of the digital economy, mobile money transactions, and modern enforcement techniques. This will improve the government's ability to track and monitor taxable transactions effectively.

H. Offer tax incentives for businesses transitioning to the formal economy: Introduce temporary tax breaks or reductions for businesses that voluntarily register and formalise their operations, encouraging broader tax compliance. The government should provide additional non-financial incentives, such as awarding contracts for the procurement of goods and services.

J. Launch public awareness campaigns: Educate businesses and consumers about the new tax system, including how to register, report sales, and benefit from a simplified tax structure. Providing incentives for compliance will encourage participation.

K. Demonstrate the benefits of taxation: Develop transparency

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initiatives that show taxpayers how their contributions are being utilised for public services and infrastructure projects. Creating trust in the system will improve compliance and reduce resistance to taxation.

Strengthening Tax Collection Through Long-Term Reforms

The most challenging aspect of tax reform is the implementation of long-term structural changes that require both time and resources. These reforms are essential to achieving the full formalisation of businesses, enabling tax authorities to collect revenue efficiently and overcoming weak tax enforcement. Effective tax administration depends on a fully functioning banking system, where settlement and payment infrastructure operate seamlessly. In such a system, commercial banks would net out their balances at the end of each day through the central bank. This mechanism benefits both businesses and tax authorities by ensuring connectivity between mobile money merchant accounts, such as Zaad and Edahab, and bank accounts. Alternatively, banks could provide businesses with merchant bank accounts that are formally approved and directly linked to the tax authority. Without merchant bank accounts, tax collection becomes ineffective, as authorities struggle to trace business transactions accurately. The current mobile money merchant accounts pose challenges in correctly tracking sales. Additionally, the absence of a standardised financial reporting system prepared by certified accountants or bookkeepers makes it difficult for tax authorities to verify self-reported sales.

To transition into a fully formalised economy, three fundamental reforms must take place: banking reform, the establishment of an accounting standards board, and the introduction of a dedicated tax authority.

A. Banking Reform

- **Strengthening the central bank's role**: The central bank must establish a payment and settlement mechanism that allows commercial banks to net out their balances effectively.
- **Integrating mobile money with banking services**: All mobile money merchant account holders should be required to maintain a linked bank account. The Ministry of Commerce should mandate that businesses operate through bank accounts.
- **Enhancing Merchant Banking Solutions:** Banks should offer businesses Point-of-Sale (POS) merchant terminals or secure bank-linked digital wallets, both of which must be registered with the tax authority. This integration will enable real-time transaction tracking, improve tax compliance, and enhance financial transparency.

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B. Establishing Standardised Accounting Practices

- **Creating an Accounting Standards Board:** A governing body should be established to regulate financial reporting and ensure businesses maintain accurate records, allowing the tax authority to seamlessly assess taxable revenue.

- **Establishing an Accounting Certification Institute:** A professional certification body should be introduced to train accountants and bookkeepers who can work in collaboration with the tax authority to ensure compliance.

C. Introducing a Dedicated Tax Authority

A dedicated tax authority should be created to oversee tax collection, enforce regulations, and enhance compliance through modernised systems.

The successful implementation of both short- and long-term reforms will expedite the formalisation of businesses, strengthen tax enforcement, and establish a transparent financial ecosystem. A well-integrated framework connecting banking, accounting, and taxation will not only enhance revenue collection but also improve financial oversight, minimise tax evasion, and foster economic stability. By modernising financial infrastructure and regulatory frameworks, the government can create a more business-friendly environment and build a strong foundation for sustainable and inclusive economic growth.

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Somaliland Ministry of Finance and Development https://slmof.org/

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