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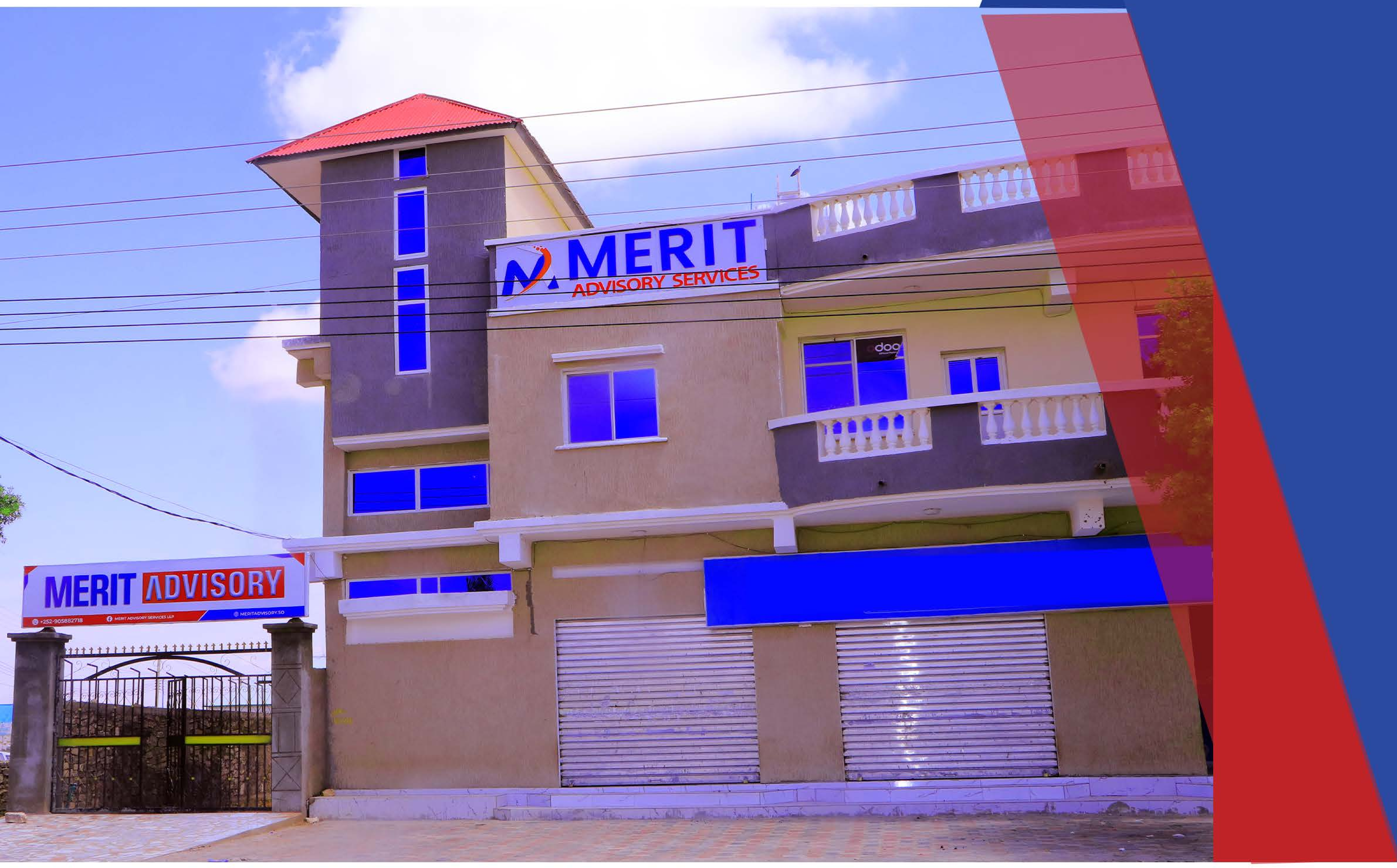
ADVISORY PAPER

UNLOCKING REVENUE POTENTIAL:

The Case for Implementing Value-Added Tax in Somalia



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ADVISORY AND RESEARCH UNIT

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1 Introduction

With unprecedented momentum, the Somali government will undoubtedly collect more indirect tax revenue after introducing a sales tax to the wider business sector. Indirect taxes, particularly value-added tax, drastically increase government revenue in the long run, as suggested by Keen and Lockwood [1] in their empirical macro study.

Sales tax is different from VAT in many aspects, and it has a different impact on businesses. The purpose of the paper is to highlight the benefits of VAT over sales tax and make recommendations on ways of replacing existing sales tax with more efficient value-added tax.

Sales tax and Value-Added Tax (VAT) are both consumption-based taxes, but they differ significantly in how they are administered and collected along the supply chain. Sales tax is only levied at the final point of sale to the end customer. In this arrangement, only the ultimate customer pays taxes, whereas intermediary transactions between manufacturers, wholesalers, and retailers are often tax-free. This results in a simpler tax structure, but it is more susceptible to tax fraud since it depends on precise reporting at the time of sale and less transparent throughout the supply chain.

VAT, on the other hand, is a multi-stage tax system that applies at every stage of the manufacturing and distribution process. Each firm in the supply chain is taxed based on the value they bring to the product. Businesses can claim credit on their input taxes in the VAT system, thereby remitting the difference between input and output taxes to the tax administrators. This encourages businesses to self-comply with VAT directives and reduce enforcement costs. A well-designed value-added tax could contribute millions to the government's revenue pipeline while maintaining production efficiency and avoiding cascading effect sales tax.

[1] Keen, M., & Lockwood, B. (2010). The value added tax: Its causes and consequences. Journal of Development Economics, 92,

2 The Current Status of Taxes in Somalia

2.1. Comparison with regional states

Emerging economies have a great potential to increase the tax-to-GDP ratio by 8% to 9% points[2] . Around two-thirds of low-income countries have a tax-to-GDP ratio of lower than 15%, a tipping point over which growth accelerates. This shows that low-income countries have room to increase revenue, which amounts on average to 7%.

Somalia has an untapped tax potential of up to a 9 percent point increase to reach a 12% tax-to-GDP ratio. This can be achieved through the right policies and much-needed institutional reforms.

Somalia's domestic revenue pales in comparison to that of other countries in the region. This is primarily due to the political situation in the country, limited administrative capacity, and security challenges in major parts of the country. Though domestic revenue has increased dramatically in recent years, the generation of revenue is hampered by the informal economy, weak tax collection systems, and heavy reliance on foreign aid. It is important to note that while external support accounts for over 65% of the budget, domestic revenue only makes up 35% of the approved budget in 2024.

In 2023, Somalia's tax-to-GDP ratio was just 2.9%, which is very low compared to the region. For example, Kenya and Uganda have tax-to-GDP ratios of 15.8% and 13.5%, respectively. In absolute terms, Kenya generated $17 billion of domestic revenue, whereas Uganda made $5.9 billion of domestic revenue. On the other hand, Somalia's domestic revenue was $329 million.

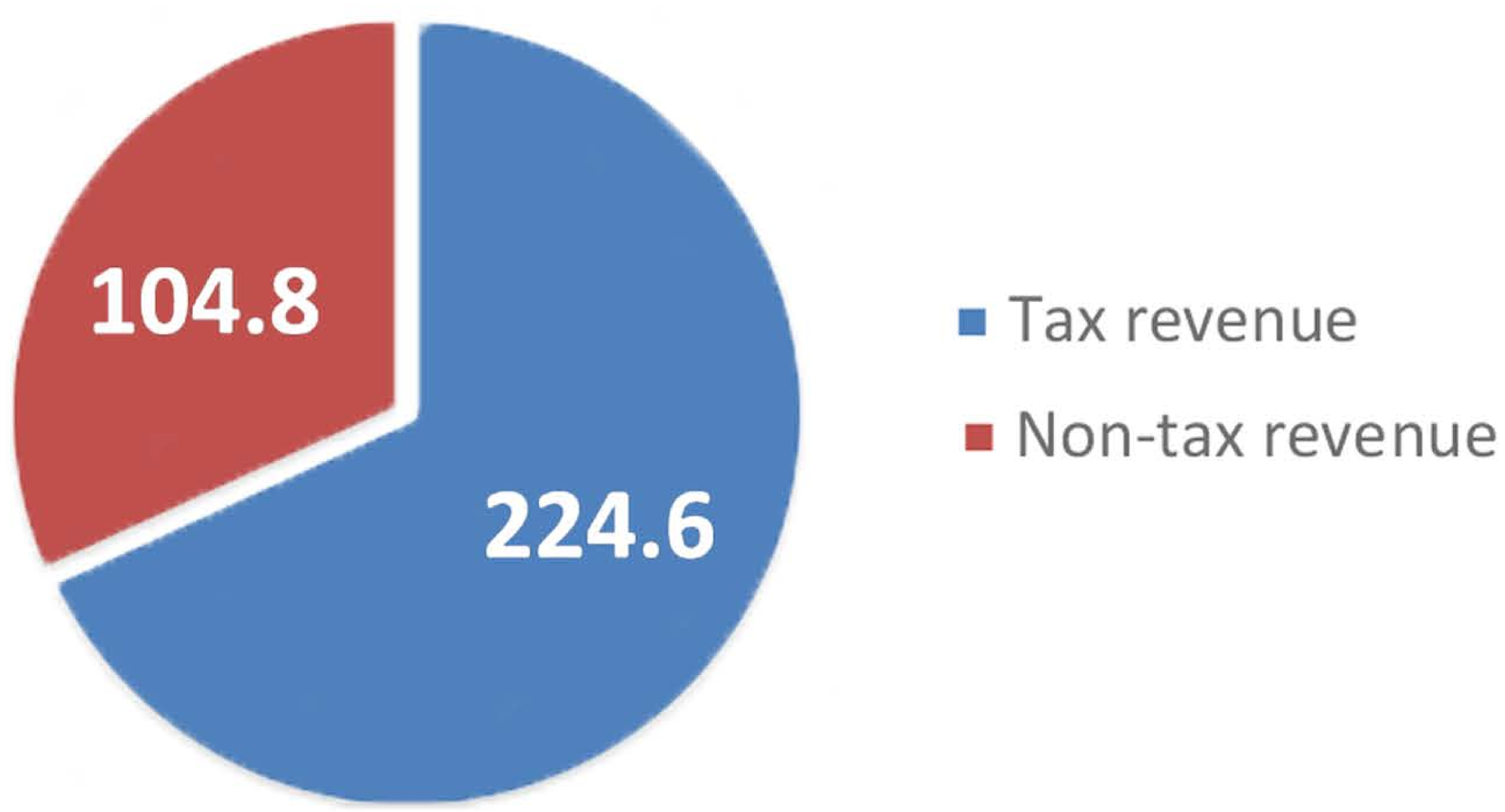
[2] Countries Can Tap Tax Potential to Finance Development Goals, IMF blog

COUNTRY	SOMALIA		KENYA		UGANDA	
Income Sources	in $Millions	%GDP	in $Millions	%GDP	in $Millions	%GDP
Tax Revenue	**225**	**2.0%**	**13,695**	**12.7%**	**5,480**	**12.6%**
Income tax	24	0.2%	6,783	6.3%	2,023	4.6%
Import duty	137	1.2%	915	0.8%	418	1.0%
Excise duty	29	0.3%	1,950	1.8%	1,810	3.2%
Value-added tax/Sales tax	35	0.3%	4,047	3.8%	1,650	3.8%
Non-Tax Revenue	**105**	**0.9%**	**3,324**	**3%**	**376**	**0.9%**
Total	**329**	**2.9%**	**17,019**	**15.8%**	**5,856**	**13.5%**
Sources: IMF country reports 2023						

2.2.Somalia's heavy reliance on import taxes

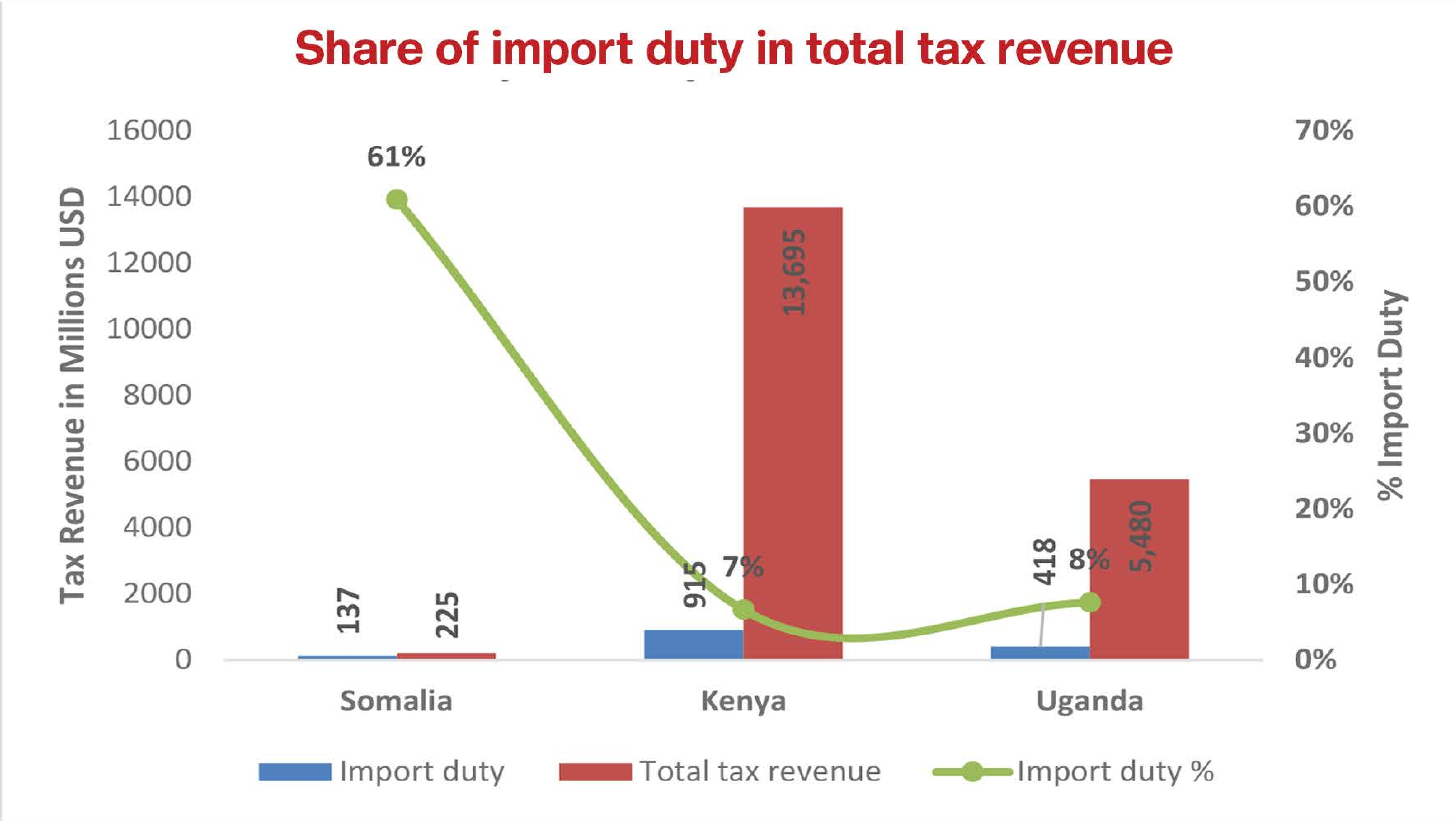
The domestic revenue of the Government of Somalia comes from tax and non-tax sources. In 2023, Somalia generated $224.6 million of tax revenue[3] and 104.8 million of non-tax revenue . This represents 2.9% of GDP, reflecting a meager domestic revenue collection. In comparison with Sub-Saharan Countries, the tax-to-GDP ratio was 15% on average[4].

Somalia Income Sources
(in millions US dollars)

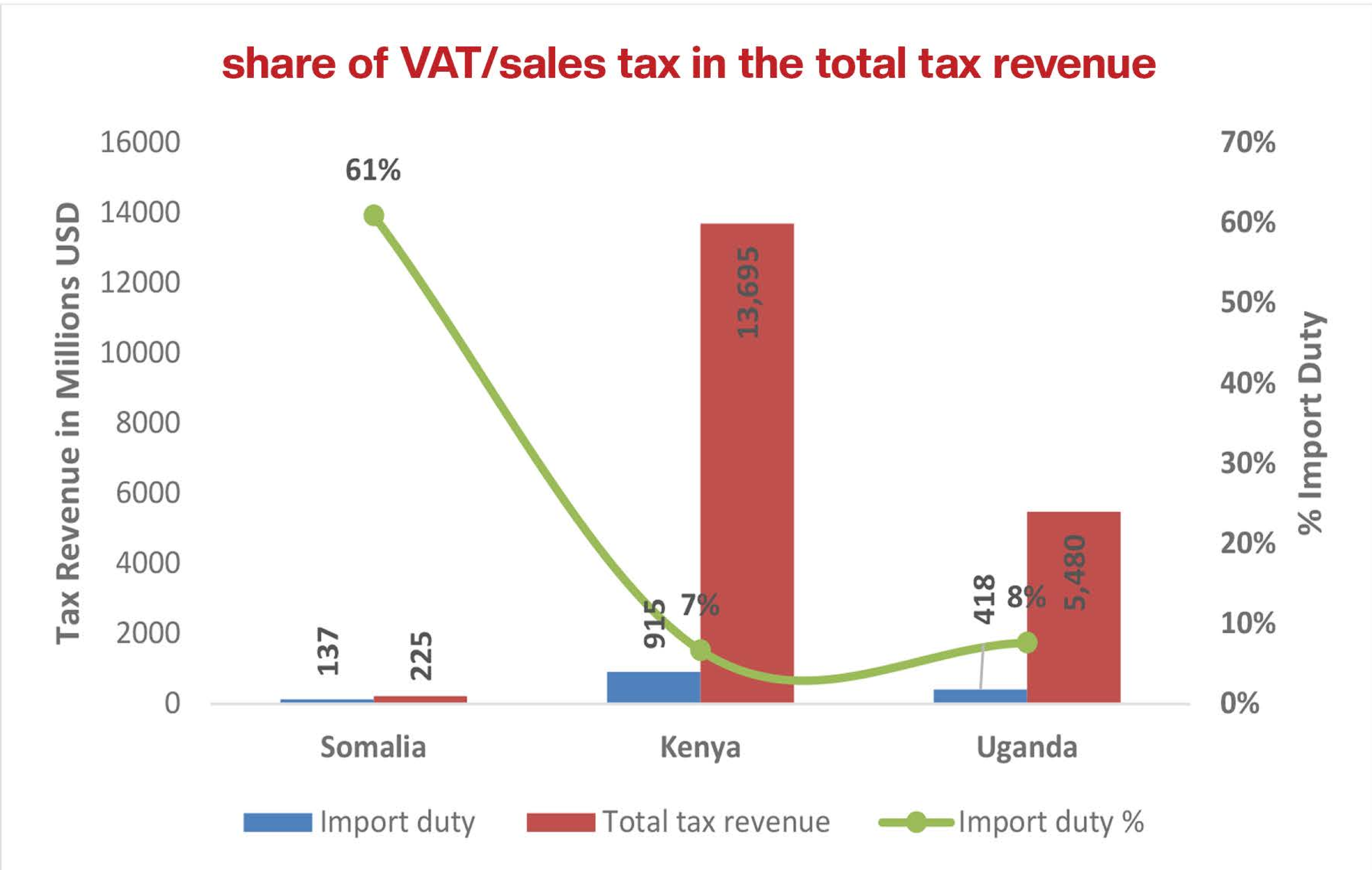


Somalia's domestic revenue is heavily reliant on customs taxes. In 2023, the revenue department of the Ministry of Finance collected $137 million in taxes from import duties, which represents over 60% of tax revenue and 1.2% of the tax-to-GDP ratio. Compared in the region, in 2021/2022, Kenya's import duty represented around 7% of tax revenue and 0.8% of tax-to-GDP , whereas Uganda's import duty was 8% of tax revenue and 1% of tax-to-GDP.

[3]Audited financial statement of the FGS, 2023
[4]Revenue generation in Sub-Sahara Africa during the pandemic, IMF report 2022



Somalia's sales tax collection is the lowest in sub-Saharan Africa. The sales tax, which accounted for only $35 million, was 15.5% of tax revenue and 0.3% of the tax-to-GDP ratio. In comparison to the region, Kenya collected over $4 billion in value-added tax (VAT) in 2021/2022, which accounted for 29.5% of tax revenue and 3.8% of tax-to-GDP[5]. Uganda collected $1.6 billion in VAT, which accounted for 30% of tax revenue collected and 3.8% of tax to GDP[6].



[5] IMF Country Report, Kenya
[6] IMF Country Report, Uganda

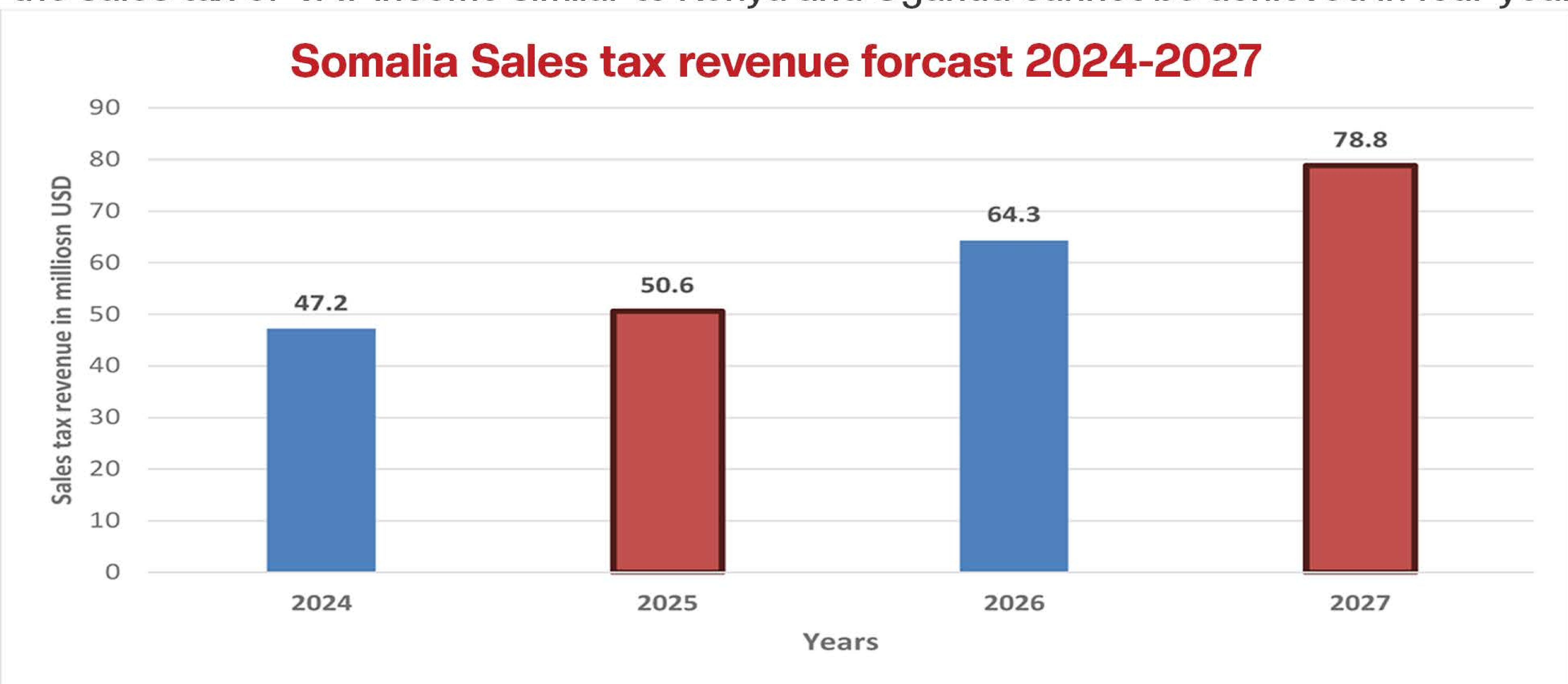
2.3. Potential for sales tax expansion

Somalia initiated the expansion of sales tax to significant enterprises and the general market to increase domestic revenue. This is a positive development that raises the government's domestic revenue. Nevertheless, with a VAT system in line with International best practices, Somalia could achieve a value-added tax to GDP ratio comparable to Kenya and Uganda, both of which generate 3.8% of VAT to GDP. In contrast, the current sales tax model only yields 0.3% of GDP which is far below the levels that would be generated by the above neighboring countries.

Somalia, Kenya & Uganda VAT		
	Revenue in $million	**%Tax/GDP**
Somalia	35	0.3
Kenya	4,047	3.8
Uganda	1,650	3.8

Somalia, Kenya, & Uganda using 5% VAT if Somalia implement reforms		
	Revenue in $million	**%Tax/GDP**
Somalia	135	1.2
Kenya	1,265	1.2
Uganda	454	1.1

Somalia has the potential to generated over 135 million VAT if it implements VAT practices similar to Kenya and Uganda. However, given existing practices, the sales tax collection prediction is much lower than the ideal collection levels. According to Somalia's medium-term revenue road map, the government expects sales tax revenues of $47.2 million, $50.6 million, $64.3 million, and $78.8 million from 2024 to 2027. This indicates that the sales tax or VAT income similar to Kenya and Uganda cannot be achieved in four years.



3 Value-added tax (VAT) adoption in Somalia

3.1. Juxtaposing sales tax with VAT

Sales tax is a consumption tax imposed by the government on the sale of goods and services. It is a type of tax that includes all general taxes charged at one stage of the supply chain, such as production, manufacturing, retail, or wholesale[7] .

In sales tax, both businesses and consumers are charged a certain percentage. The sales tax levies a tax on final transactions to customers, including homes and unregistered enterprises. An exemption certificate system or a "ring" system can be used to partially reduce taxes on investment items and other input purchases[8] .

Value Added Tax, or simply VAT, is a consumption tax on goods and services levied at each stage of the supply chain where value is added. It is collected in stages by businesses but ultimately charged in full to final purchasers.

In VAT, businesses calculate input and output tax. Input tax is the amount of tax paid by the business when purchasing its supplies, whereas output tax is the amount of tax charged by the business on goods and services. VAT is referred to as a deductible tax because producers are not usually required to pay the government the full amount of the tax they invoice to their customers. Instead, they are allowed to deduct the amount of tax they have been invoiced on their own purchases of goods or services intended for intermediate consumption or fixed capital formation. VAT may also be payable on imports of goods or services in addition to any import duties or other taxes on the imports.

[7] What Is Sales Tax? Definition, Examples, and How It's Calculated,
[8] Tax Policy Assessment Framework 2023

3.2. Use of the VAT globally

Value-added tax (VAT) is a widely used tax in the world. In 2016, during the compilation of OECD VAT guidelines, over 165 countries adopted this system compared to just around 80 countries in 1991 [9]. Today, VAT is a vital source of income for these countries as it generates billions in tax revenue[10] .

As Somalia thrives to mobilize domestic revenue, a key source of generating millions of tax revenue is a well-designed **value-added tax**. This necessitates the use of international best practices when developing tax policies. Though VAT imposition mechanisms could generate revenue, they also require enforcement mechanisms to ensure every citizen pays a fair share of tax.

3.3. Why should Somalia introduce VAT and abolish the current sales tax model?

Sales tax is administratively inferior to the value-added tax, or VAT, as it has a significant disadvantage over VAT. The following are three key shortcomings of the sales tax.

1. Lack of cross reporting:

Unlike VAT, sales tax lacks a cross reporting requirement as retailers don't have the option to report their input taxes to offset output taxes. This gives an incentive for both businesses and buyers to avoid buying sales taxes. On the other hand, VAT has an intrinsic audit trial. The buyer is encouraged to disclose a transaction to the government in order to claim a credit, which drives sellers to do the same because they know the government is aware of the transaction. This could be exacerbated by the implementation of a withholding VAT [11].

2. Cascading (imposing tax on taxes) effect

The term "cascading" refers to a scenario in which tax is applied to previously taxed products or services [12]. Cascading happens on sales taxes because sales tax doesn't differentiate between business and consumer purchases, resulting in a tax accumulation over the course of production, which in turn causes price distortions. This results in the taxation of products on multiple levels, including wholesale, retail, and ultimate consumption. Conversely, VAT guarantees that only ultimate consumption is subject to taxation, while input purchases are eligible for refunds.

3. Increased tax evasion

In the sales tax, there is an increased risk of tax evasion because the government doesn't have a record of all transactions that happened in the market and this is known to the marketeers. This provides an incentive for both the consumer and the vendor to conceal the number of sales made in order to avoid paying taxes. VAT, on the other hand, encourages voluntary tax compliance because it provides a natural self-enforcement mechanism in the form of a purchase receipt, which every buyer needs to claim tax credit.

[9] OECD (2017), International VAT/GST Guidelines, OECD Publishing, Paris.
[10] What Is Sales Tax? Definition, Examples, and How It's Calculated,
[11] No taxation without information: deterrence and self-enforcement in the VAT.
[12] Tax Policy Assessment Framework (TPAF).

4 Recommendations on Implementing VAT

1. Value-added taxes, known as VAT, should be implemented as a replacement for the existing sales tax system. This will remove the cascading effect of the sales tax and ensure increased revenue for the government.

2. Establish a minimum registration threshold within which businesses that fall below such thresholds are exempt from the obligation to submit their VAT returns.

3. The government should give businesses an option to appoint an accountant (agent) to submit VAT returns on behalf of the business. Businesses shall make VAT returns every month or at least quarterly.

4. Get started on the process of establishing a VAT register for the purpose of claiming input taxes for purchases made by the firm. The best approach is to use the invoice-credit method, which is applied globally. The government may choose to use an electronic VAT registration in order to speed up the process.

5. Introduce the VAT zero-rating, which means that the sale of goods and services is subject to 0% VAT. It is aimed at stimulating company growth by lowering the tax burden on qualified transactions, therefore enhancing the competitiveness of local enterprises, particularly exporters.

6. Impress destination or origin-based VAT, a process of imposing tax on domestic consumption while exports are exempted from VAT.

5 Summary

It is apparent that Somalia's tax collection is below the optimum level, and it has to catch up with regional countries like Kenya and Uganda. As of December 2023, Somalia's tax-to-GDP was just 2.9%, which is extremely low in practical terms.

The Somali government can potentially generate revenue through indirect taxes, but the question is to which tax policy instrument is more efficient and how to implement it. As we previously discussed, the current sales tax is inefficient as it distorts prices and imposes additional taxes.

The advisory note argues that a well-structured VAT system in line with international best practices could yield more revenue than the current sales tax system. The best implementation mechanism, taking into account a specific, successful case similar to Somalia, is a topic for further research.

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